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**NATIONAL ASSOCIATION OF  
REAL ESTATE INVESTMENT TRUSTS®**

April 14, 2009

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

Re: Discussion Paper; Preliminary Views on Financial Statement Presentation

Dear Sir/Madam:

We are pleased to submit this comment letter on the Financial Accounting Standards Board's (FASB) and International Accounting Standards Board's (IASB) joint *Discussion Paper; Preliminary Views on Financial Statement Presentation*. We are submitting these comments on behalf of the members of the Real Estate Equity Securitization Alliance (REESA). These members include the following real estate organizations:

- Asian Public Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts (NAREIT)® (U.S.)
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

The purpose and activities of REESA are discussed in Appendix I.

Members of the organizations identified above would be pleased to meet with the Boards or staff to discuss any questions regarding our comments.

We thank the FASB and IASB for the opportunity to comment on the Boards' preliminary views with respect to this very important project. Please contact George Yungmann, NAREIT's Sr. VP, Financial Standards at [gyungmann@nareit.com](mailto:gyungmann@nareit.com) or 1-202-739-9432 if you would like to discuss our comments.

Respectfully submitted,



**Comment Letter Submitted by the  
National Association of Real Estate Investment Trusts®**

**On behalf of the following members of the  
Real Estate Equity Securitization Alliance:**

**Asian Public Real Estate Association (APREA)  
British Property Federation (BPF)  
European Public Real Estate Association (EPRA)  
National Association of Real Estate Investment Trusts (NAREIT)® (U.S.)  
Property Council of Australia (PCA)  
Real Property Association of Canada (REALpac)**

**In response to the**

**Discussion Paper**

***Preliminary Views on Financial Statement Presentation***

**Issued by the Financial Accounting Standards Board and  
International Accounting Standards Board**

**October 2008**

Cc: Technical Director  
Financial Accounting Standards Board  
File Reference No. 1630-100



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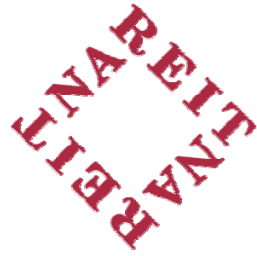
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## NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

April 14, 2009

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

Re: Discussion Paper; Preliminary Views on Financial Statement Presentation

Dear Sir/Madam:

### Background

REESA has been fully engaged in considering the Boards' discussions with respect to the Financial Statement Presentation project. As more fully explained below, companies that own and operate portfolios of investment property have been challenged in attempts to faithfully report the economics of their business under certain official financial accounting standards regimes. More specifically, under U.S. generally accepted accounting principles (GAAP) and certain other accounting regimes, the depreciated cost model results in earnings measurements and balance sheets that report neither the operating profitability nor the economic financial position of such companies. Additionally, under the fair value model available under International Financial Reporting Standards (IFRS), while balance sheets more faithfully present the economic financial position of property investment companies, achieving a presentation of earnings that reflects the operating profitability of investment property portfolios has been problematic. As a result, most REESA organizations have developed supplemental earnings metrics that more faithfully report the operating profitability of owning and operating investment property. In addition, companies in some of the regimes following the depreciated cost model supplementally report the fair value of investment properties. This supplemental information is not governed by formal accounting standards and is unaudited.

Investment property is an unusual asset class in that it is simultaneously an investment asset and an operating asset. Financial statement preparers, investors and financial analysts have recognized the unique business and economic characteristics of owning and operating investment property and have developed supplemental metrics to measure operating results and financial position that more faithfully reflect these characteristics. Appendix II and the research paper attached as Exhibit II-A discuss the business and economic characteristics of this industry. The supplemental metrics currently used by industry participants include Funds From Operation (FFO), EPRA Earnings, Net Asset Value (NAV) and others.



Appendix III provides additional information on the development and use of these supplemental metrics and Exhibits III-A through III-D attached are examples of industry analyst reports that illustrate users' reliance on these metrics. Accounting standard setters have also recognized these unique business and economic characteristics; the IASB in International Accounting Standard No. 40 *Investment Property* and the FASB in its Statement of Financial Accounting Standards No. 41 *Financial Reporting and Changing Prices: Specialized Assets – Income Producing Real Estate* (now superseded).

REESA members attended the first meeting of the Joint International Group focused on the Financial Statement Presentation project. Because of virtually unanimous support of the Group's members, as well as members of the Boards and regulators, expressed at this meeting for the management approach to creating new financial statement formats, REESA members saw this project as an opportunity to develop financial statements that would faithfully report the economics of owning and operating investment property from the perspective of these companies' management without the need to separately report unaudited supplemental measures.

The business and economic characteristics of investment property and the metrics used to analyze the operating results and financial position related to these assets provide a unique opportunity to link significant elements included in the statement of comprehensive income with significant elements reported in the statement of financial position. As further discussed in this comment letter and illustrated in the attached reports prepared by industry analysts, there is a fundamental and important link between rental revenue and "net property income" (NPI) reported in the industry's model statement of comprehensive income and the fair value of investment property reported in the model's statement of financial position. The industry's model is discussed below. Rental revenue less direct operating expenses yields NPI. The fair value of investment property is measured by either capitalizing a given year's NPI or discounting projected NPI at current investor yield requirements. The fair value of investment property is a significant factor in measuring the "net asset value" (NAV) of companies that own and operate portfolios of investment property. In turn, NAV is a significant factor used to price securities of these companies.

In addition, "income from operations" (IFO), included in the industry's financial statement model, is used by industry analysts as a basis for valuing equity securities of these companies. Analysts apply multiples to IFO per share to develop an indication of the price of equity shares.

### **REESA's Global Real Estate Industry Financial Statement Model (Model)**

The first step in REESA's process was to develop a globally accepted real estate industry financial reporting model. In September 2007 REESA executives approved such a model and, in October 2007, the model was discussed with the project staff of both the FASB and IASB. This REESA model is attached as Appendix IV. The model accommodates the choice of reporting investment property at depreciated cost or fair value and includes subtotals in the statement of comprehensive income that have long been important to the industry's financial statement users. As indicated above, these metrics included "net property income" (NPI) and "income from operations" (IFO).



IFO mirrors supplemental performance measures developed and recommended by EPRA, BPF, REALpac and NAREIT. The majority of companies that are members of these organizations report these supplemental metrics. These metrics include direct revenues and expenses of operating investment property, entity expenses (G&A), all interest expense, and taxes attributable to these revenue and expense items. These metrics are viewed by users of the financial statements as being reflective of the operating results of a real estate entity, outside of unrealized valuation changes and depreciation. Exhibits III-A through III-D provide examples of analyst reports that utilize these metrics as a basis for valuing the common shares of companies that own and operate investment property.

Further, the model links the statement of comprehensive income to the statement of cash flows by requiring the cash equivalent of *net property income* and *income from operations* to be presented on the statement of cash flows.

As the model was being finalized and vetted within each REESA organization, the Boards developed the cohesiveness principle and defined the categories in which assets, liabilities and, therefore, revenues, expenses and cash flows would be reported. As further discussed below, while REESA supports the cohesiveness principle, *the definitions of categories compromise the fundamental premise of formatting financial statements based on a management approach and frustrate the industry's goal to report metrics that are widely used by our industry's investors and financial analysts in audited financial statements.*

### **Comments on Discussion Paper**

The remainder of this comment letter provides the views of REESA on the Discussion Paper in the context of established financial reporting needs of financial statement preparers and users discussed above. Question numbers are as indicated in the Discussion Paper.

#### *Question No. 1*

REESA generally agrees that financial statements, *along with disclosures*, should:

- present a cohesive financial picture of an entity's activities (that is, assets and liabilities should be linked to both the statement of comprehensive income and statement of cash flows)
- disaggregate information in a manner that makes it useful in assessing the amount, timing and uncertainties of future cash flows
- present information in a manner that helps users to assess the entity's ability to meet its financial commitments as they come due and to invest in business opportunities

At the same time and as further discussed below, REESA disagrees with certain of the Boards' views regarding the specifics of achieving these objectives. Most importantly, we disagree:

- that business activities should be separated from financing activities for all entities/businesses



- with the definition of certain sections and categories defined in the Discussion Paper
- that income statement elements should be disaggregated by segment, function *and* nature on the face of the statement
- that the reconciliation schedule is necessary

In addition, REESA believes that reporting an investor's share of operating results of significant joint ventures or other unconsolidated affiliates as a single line in the statement of comprehensive income significantly diminishes the usefulness of this statement for entities that rely on joint venture arrangements. Many real estate companies around the world use joint arrangements to share funding requirements, spread risk, and for other reasons. The operations of the joint ventures, which could represent a substantial component of a real estate company's business activities, are viewed by management in the same manner as the operations of consolidated real estate operations. While the Discussion Paper does not identify this issue, it is very significant to the real estate industry reporting operating results based on a management approach.

We believe that the operating results of these types of ventures should be allocated to the significant categories of the statement of comprehensive income. The REESA model illustrates this allocation to *Net Property Income*, *Income From Operations*, and other sections of the statement. Without this allocation, significant consolidated metrics could not be reported in the financial statements.

#### *Questions Nos. 2, 9 and 10*

REESA does not believe that the separation of business and financing activities results in more decision-useful information for entities that own and operate investment property. As discussed in the background section of this letter, the operating metric that deducts operating costs, interest expense and applicable tax expense from rental revenues is widely used as a supplement to "net earnings" to value entities' equity securities by applying multiples to this metric. The REESA model provides this metric as a subtotal that is representative of those used in the global investment property industry. *REESA's goal is to have companies in the global industry uniformly report this metric in the audited financial statements rather than reporting variations of the metric as unaudited supplemental information.* Further, this goal addresses industry analysts' frustration with the inconsistency in presentation and their difficulty in tracing the adjustments made to calculate the operating metric reported to the audited financial statements. This is particularly true of adjustments contained within an entity's share of operating results of unconsolidated affiliates. This goal would not be achieved if business and financing activities, and related tax expense, were reported in separate sections of the statement of comprehensive income.

Further, the Business Investing sub-category will not likely provide additional value to users in understanding the business of a real estate entity. We believe that there will be few assets and liabilities, if any, that could meet the definition of Business-Investing as outlined in the Discussion Paper. However, currently real estate companies generally report all costs of development, acquisition and capital maintenance expenditures in the investing section of the



cash flow statement. Under the proposed definition of categories in the Discussion Paper, these significant expenditures would be reported in the Business- Operations section as these expenditures would be linked to the investment property assets, the core assets of the business. As noted earlier, investment property is simultaneously both an investment asset and an operating asset. It is critical to segregate cash flows arising from property operations from cash flows used for revenue growth, development and acquisition. This has been addressed in the REESA model by linking the statement of comprehensive income to the statement of cash flows by requiring the cash equivalent of *net property income* and *income from operations* to be presented on the statement of cash flows – information important to industry analysts.

*Question Nos. 3 and 4*

REESA agrees that both equity and discontinued operations should be reported in sections separate from the business, financing and tax sections of the financial statements. Further, we are not troubled that dividends would not be reported in an equity section of the income statement.

*Question No. 5*

REESA strongly agrees with the view that a management approach should be used to classify assets and liabilities within sections and categories of the balance sheet. We further agree that this approach would produce the most useful view of an entity to users and that this approach far outweighs the potential for reduced comparability of financial statements.

We believe that the most useful comparability would be achieved by uniform reporting in each industry. This uniformity would be achieved either through market forces brought to bear on companies by industry financial statement users or through industry efforts to agree on the format and content of financial statements for companies in a given industry. REESA has attempted to facilitate the process for the global real estate industry via the second alternative -- forming a global industry consensus based on input from financial statement preparers, users and auditors on the format of real estate industry financial statements.

However, REESA is concerned that a strictly defined separation of assets and liabilities (and thus elements of income and cash flow statements) would frustrate the management approach. As described above, the financial statement sections defined in the Discussion Paper (Business Operating, Business Investing, Financing, Taxes) would not allow the application of the management approach to the financial statements of companies that own and operate portfolios of investment properties.

*Question No. 7*

REESA agrees that assets and liabilities should be classified based on the way those items are used in each of a company's reportable segments instead of at the entity level.

*Question No. 11*

Consistent with a management approach, REESA agrees that a final standard should provide for management to choose the most meaningful classification of assets and liabilities in the



statement of financial position. Among the global real estate industry, companies in some countries report a traditional classified balance sheet while in other countries assets and liabilities are reported in order of reverse liquidity – the common presentation in North America.

*Question No. 13*

REESA agrees that assets and liabilities that are measured on different bases should be reported on separate lines in the statement of financial position. This is important in the real estate industry where certain real estate assets may not meet the definition of investment property in IAS 40. In these cases, investment property measured at fair value should be reported separately from real estate that is measured at depreciated historical cost.

*Question No. 14*

REESA has not developed a consensus as to whether an entity should report components of comprehensive income in a single statement of comprehensive income.

*Question No. 15*

REESA believes that indicating the category to which an item of other comprehensive income applies would enhance the decision usefulness of this information.

*Question No. 16*

REESA does not agree that financial statement elements should be disaggregated by *nature* on the face of the financial statements. We are very concerned that reporting income statement elements by function *and* nature, will add significant complexity to the face of the financial statements. We believe this increased detail will only distract the user from understanding the entity's underlying operating performance and overall profitability. We believe that any breakdown of income statement elements by nature should be reported in the note disclosures.

*Question No. 17*

As discussed in the Background section of this letter, in order to provide management's view of operating results in the real estate industry, taxes applicable to business activities should be reported in the business category. For example, capital gains taxes on sales of real estate should be reported in the section of the statement of comprehensive income that includes the gain. Further, ordinary income taxes resulting from "trading activities" (the acquisition or development of real estate for sale) should be reported along with the profits generated by this activity.

An acceptable but less favorable alternative would be to provide a breakdown of income tax expense in a separate income tax section. This breakdown would indicate the source of the profits or gains to which taxes relate.





*Question No. 19, 20 and 23*

REESA believes that the use of the direct method of presenting cash flows would enhance the usefulness of cash flow information. However, we believe that field tests should determine whether the cost of presenting cash flows using the direct method would exceed the benefits to financial statement users. While we believe that one-time costs would be relatively significant, we believe that the on-going costs would not exceed the benefits of enhancing the decision-usefulness of cash flow information.

At the same time, REESA strongly believes that reporting under the direct cash flow method and providing management's discussion and analysis of the changes in elements of cash flow over time eliminates the need for the reconciliation schedule proposed in paragraph 4.19 of the Discussion Paper. If the primary goal of financial reporting is to provide information to enable users to project the amount, timing and uncertainties of future cash flows, solid analysis of the elements of cash flow over time would provide the necessary information directly. REESA, therefore, believes there would be no need for understanding the items that reconcile elements of comprehensive income to cash flow.

REESA further believes that the reconciling items proposed by the reconciliation schedule provide little value to users. We believe that for most line items, it will prove to be a mathematical exercise where there will be one reconciling item representing the "accrual" difference between the statement of cash flows and the statement of comprehensive income. Users and analysts will continue to require further information to understand the accrual, defeating the intent of the schedule. To illustrate the point, consider the example where entities will need to reconcile cash receipts received from lease rentals to rental income reported on the statement of comprehensive income. One has to consider, i) changes in accounts receivable from lease rentals, ii) the impact of straight-lining of rent, iii) the amortization of lease incentives against rental income, and iv) the impact of amortization related to lease intangibles arising from a business combination. These four items would be represented by one reconciling item (the "accrual") on the reconciliation schedule. Users of the financial statements will seek information on these four items separately, outside of the reconciliation schedule.

Lastly, REESA believes that, if the financial statements truly reflect a management approach by reporting key industry metrics such as *Net Property Income* and *Income From Operations* on the face of the statement of comprehensive income, the users of financial statements would clearly be able to segregate underlying operating performance from valuation adjustments and remeasurements. Thus, there would be no need for a reconciliation schedule.

Cc: Technical Director  
Financial Accounting Standards Board  
File Reference No. 1630-100





Asian Public Real Estate Association  
Singapore



British Property Federation  
United Kingdom



European Public Real Estate Association  
Netherlands



National Association of  
Real Estate Investment Trusts  
United States



Property Council of Australia  
Australia



Real Property Association of Canada  
Canada



## REESA – The Real Estate Equity Securitization Alliance

REESA, the Real Estate Equity Securitization Alliance, is a global alliance created to further equity investment in real estate on a securitized basis. REESA focuses on cross-border investment, international taxation, financial reporting standards initiatives, educational outreach to investors and global research. The members of REESA are leading member-based trade associations with a significant interest in the world of securitized equity real estate investment:

- Asian Public Real Estate Association, APREA
- Association for Real Estate Securitization (ARES) (Japan)
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts, NAREIT® (U.S.)
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

The formation of REESA was, in part, a response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the securitized real estate industry, REESA's view is that the industry, as well as standard setters, will gain considerable benefits through the development and application of global accounting and financial reporting standards and the uniform application of the standards.

Since the formation of REESA, members have worked together on a number of tax and accounting related projects, among others, and have shared their consensus views with regulators and standards setters. These projects include:

- Financial Statement Presentation
- Reporting Discontinued Operations
- Real Estate Sales – IFRIC D21
- Capitalization of Borrowing Costs - IAS 23
- Accounting for Joint Arrangements – ED 9
- Consolidated Financial Statements – ED 10
- IASB 2007/2008 Annual Improvements to IFRS
- FASB/IASB Leasing project
- OECD developments on cross border real estate flows and international tax treaties

## Overview of the Commercial Real Estate Industry

Developments over recent years have confirmed real estate's emergence as a mainstream global asset class. Estimated real estate transactions worldwide were over \$523 billion in 2008 (\$1.2 trillion in 2007)<sup>1</sup>, with an estimated further \$66 billion of funds with real estate assets under management<sup>2</sup>. In 2008 real estate transactions in Europe were \$215 billion (2007: \$401 billion), In the Asia Pacific region \$151 billion (2007: \$270 billion) and in the Americas \$156 billion (2007: \$554 billion).

The United States has by far the largest real estate market, followed by Japan and the four major European economies. Almost 30 percent of the world's high quality commercial real estate is located in the United States. The Europe, Middle East and Africa (EMEA) region together represents more than 20%<sup>3</sup>.

In recent years, there has been an emergence of the growth and number of international global real estate funds totaling 303 in 2008 (2007: 281) according to the Macquarie Funds Database. This growth has been primarily due to the diverse opportunities in the private and public capital markets for domestic investors to participate in foreign real estate markets. Several factors underlie the increase in global real estate investment, including:

- The emergence of real estate as an asset class that is increasingly seen as an important solution to the ever growing retirement/savings needs of an aging global population.
- Real estate companies are themselves increasingly expanding globally.
- More of the major industrialized countries are launching Real Estate Investment Trust (REIT) or similar structures which are facilitating the transfer of ownership of real estate from the private to the public markets (China and India have recently announced the introduction of REITs in 2009). The top 10 real estate companies worldwide had a total market capitalisation of \$140 billion as of 13 April 2009, with 36% of the value being represented by REITs<sup>4</sup>.
- Investors in general are increasing their investment in global funds —attracted by what they perceive to be underdeveloped REIT markets overseas, with opportunities of achieving greater diversification and returns than that of domestic markets.

*Exhibit II-A* contains an overview of the US commercial real estate market and includes an analysis of real estate as an investment asset class. The paper, prepared by Penn State University for NAREIT, clearly concludes that real estate is an asset class with unique characteristics that differentiate it from other asset classes.

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<sup>1</sup> Real Capital Analytics [www.rcanalytics.com]. Based on independent reports of properties and portfolios \$10 million and greater.

<sup>2</sup> Macquarie Global Property Securities Analytics Funds database (previously the AME Capital Funds database).

<sup>3</sup> EPRA Monthly Statistical Bulletin March 2009

<sup>4</sup> Reuters Knowledge- Real Estate Industry Overview

However, one important consistency between real estate and other major asset classes is that, analysts use similar tools to estimate real estate values as with other assets. Specifically, values are based on forecasts of future cash flows discounted back to the present at a rate of return that reflects the underlying risk associated with those cash flows. The process is relied upon by lenders in loan underwriting, by investors in determining expected returns, and security analysts when calculating net asset values (NAVs) of REITs.

## **Exhibit II-A**

### **Industry Overview**



Brent W. Ambrose, Ph.D.  
Jeffery L. and Cindy M. King Faculty Fellow  
and Professor of Real Estate

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January 11, 2008

George L. Yungmann, CPA  
Sr. VP, Financial Standards  
National Association of Real Estate Investment Trusts  
1875 I Street, NW, Suite 600  
Washington, DC 20006-5413

Dear George;

It is with pleasure that Ken Lusht and I transmit the following white paper titled "Overview of the Commercial Real Estate Industry" that was commissioned by the National Association of Real Estate Investment Trusts (NAREIT®).

The perspective of the paper is that real estate is an asset class with unique characteristics that differentiate it from other asset classes and that distinguish the real estate industry from other economic activities such as manufacturing and the financial sector.

We hope you find this report useful. If you have any questions or comments, please do not hesitate to contact either Ken or myself.

Sincerely yours,

*Brent*

Brent W. Ambrose, Ph.D.  
Jeffery L. and Cindy M. King Faculty Fellow and  
Professor of Real Estate





# **Overview of the Commercial Real Estate Industry**

**Brent W. Ambrose, Ph.D.**  
**Jeffery L. and Cindy M. King Faculty Fellow and Professor**  
**The Pennsylvania State University**

**and**

**Kenneth Lusht, Ph.D.**  
**Professor and Associate Dean Emeritus**  
**The Pennsylvania State University**  
**and**  
**Distinguished Professor, Florida Gulf Coast University**

January 11, 2008

Submitted to the National Association of Real Estate Investment Trusts (NAREIT).®

## Table of Contents

Executive Summary .....	ii
1. Real Estate Economics: Some Fundamentals .....	1
1.1 U.S. Real Estate Markets: Capital Flows .....	1
1.2 Economic Characteristics of Real Estate .....	2
1.3 Estimating Real Estate Value.....	3
Capitalization Rates and Vales .....	4
“Leased Fee” Value .....	5
A Note on Land Values.....	5
Estimating the Value of Entities that Own Portfolios of Investment Property.....	6
2. The Real Estate Industry .....	7
2.1 The Space Market .....	7
2.2 The Asset Market.....	9
2.3 The Development Process.....	10
3. Macro Level Performance Issues.....	11
3.1 Real Estate’s Role in Portfolios .....	11
3.2 Are REITs Stocks or Real Estate? .....	14
3.3 The Performance of Commercial Real Estate.....	14
4. Leases and Lease Strategy .....	17
4.1 Overview of Leases.....	17
4.2 Real Estate Leases.....	18
4.3 Effective Rent .....	19
4.4 Leasing Strategies .....	19
4.5 Lease versus Own .....	20
5. Micro Level Analysis: Property Development .....	21
5.1 The Development Process.....	21
5.2 Risk, Return and Value .....	22
5.3 Development Feasibility and Decision Rules .....	25
5.4 Development Financing .....	26
6. Real Estate Investment Analysis: The Effect of Leverage .....	29
6.1 Overview of a Mortgage .....	29
Types of Mortgages .....	29
6.2 Financial Leverage.....	31
Financial Leverage and Value .....	32
Financial Leverage and Investment Performance.....	32
Financial Leverage and the Source of Equity Returns.....	34
7. Conclusion .....	36
References.....	38

## **Executive Summary**

Real estate contributes significantly to the wealth of the United States and is one of the four “core” investment asset classes, along with cash (T-bills), stocks, and bonds. The total market value of non-government owned real estate was approximately \$25 trillion in the mid 2000’s, exceeding the stock market valuation of about \$20 trillion. As a result of this size, the impact of the real estate industry on the overall economy is significant. Analysis of the component parts of the U.S. Gross Domestic Product (GDP) indicates that the real estate industry (residential and commercial real estate) accounts for almost 20 percent of the country’s economic output. Commercial real estate accounts for 6% of the GDP. Focusing on commercial real estate, total transaction volume in the U.S. was (about) \$300 billion in 2006, and should approach that number in 2007. For comparison, in 2001 the volume was \$65 billion, and in 2004 \$160 billion. This represents growth of almost 50% during the past three years and about 350% over the past six years. Local, private investors still account for the largest share of transaction volume, followed by private, national investors, REITs, foreign investors, and space users.

This paper provides an overview of the commercial real estate industry, including that sector of the industry that owns and operates portfolios of investment property. The paper also provides an analysis of real estate as an investment asset class. There are seven sections covering (1) real estate economics, (2) the interactions between the space and asset markets, and the linkage provided by new development, (3) the role of real estate investments within the broader portfolio context, (4) the concepts of real estate leases and how they differ from leases on equipment and other assets, (5) the property development process, (6) the role of debt in real estate investment, and (7) a brief summary and conclusion.

An overriding theme is that real estate is an asset class with unique characteristics that differentiate it from other asset classes and that distinguish the real estate industry from other economic activities such as manufacturing and the financial sector. These distinguishing characteristics are discussed in section 1. Primary among them are

immobility and heterogeneity. While these are physical characteristics, they impact the economics of the marketplace. For example, immobility and heterogeneity lead to product market segmentation resulting from differences based on investor demand and relatively high debt-equity ratios used to finance real estate investments. Unlike assets such as equipment, investment properties have the expectation of substantial residual property value apart from the value that can be associated with financial contracts in place, notably leases. In addition, real estate differs from other asset classes by having high transaction costs and other barriers to entry, long-lasting improvements, and a relatively slow reaction of supply to changes in demand. These characteristics have implications for the overall efficiency of the market.

Section 1 also includes a discussion of real estate value estimation. Because real estate competes in the broader capital markets, analysts use the same tools to estimate real estate values as other assets. Properties are treated as single economic units, with their values based on forecasts of future cash flows discounted back to the present at a rate of return that reflects the underlying risk associated with those cash flows. This process is standard regardless of whether the asset in question is real estate, a bond, or a piece of equipment. Furthermore, the process is relied upon by lenders in loan underwriting, by investors in determining expected returns, and security analysts when calculating net asset values (NAVs) of REITs and other owners of investment property. Two key conclusions from this part of the paper are that value is driven by the expected cash flows from an investment property, and that there is often not a direct link between the value of leases in place or the cost of building components and the fair value of the property.

Section 2 continues with a presentation of how the supply and demand for real estate as an investment and as a physical location interact with each other. As a unique industry, real estate comprises three interrelated components referred to as the space (or physical) market, the asset (or capital) market, and the development process. Since the characteristics of the space market are often tied to the ultimate use of the real estate within that market, the space market is often delineated by its functionality (e.g. residential, office, industrial, retail, hotel, and mixed-use.) Furthermore, the immobility

feature of real estate adds a location characteristic to the space market (e.g. central business district, suburban, etc.) Because of these interacting characteristics, the space market is highly segmented. This differentiates real estate from other assets, such as automobiles, aircraft, or equipment that are not tied to specific locations or use.<sup>1</sup> Within this space market, the interaction of supply and demand determines the “price” paid for the use of real estate, which is often in the form of a lease. In contrast, the asset market describes the investment activity for real estate and investors make buy/sell decisions based on the expected future cash flows derived from real estate existing in the space market. In the asset market, prices change due to forces from the space market, and in reaction to changes in the returns offered by other assets in the broader capital market. As a result, the real estate asset market is integrated into the broader capital market. Finally, the development process completes the real estate industry by creating new supply in the space market based on values observed in the asset market. One of the characteristics differentiating the real estate industry from other asset classes is that the supply response occurring in the space market adjusts slowly to shocks in the asset and space market. As a result, the real estate industry is exposed to cycles of over and under development.

Section 3 discusses measuring real estate performance and how real estate fits in mixed asset portfolios. Modern portfolio theory is based on the fundamental proposition that investors can generate an improved risk/return relationship by combining assets with return series that are not perfectly correlated. While differences exist among academics regarding how to properly measure real estate returns, the general consensus is that real estate returns are not highly correlated with other assets and, as a result, real estate assets provide a significant diversification opportunity to investors. Indices that track the performance of REITs and those that track the performance of direct real estate investment reveal that commercial real estate investments offer an attractive risk-return trade-off and that real estate has an important role in mixed asset portfolios.

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<sup>1</sup> For example, commercial jet aircraft can be quickly diverted from low demand routes to high demand routes or converted from passenger to cargo service.

Section 4 is devoted to real estate leases and leasing strategies. These are key considerations in the marketplace, as the long-life expected for most real estate easily allows for the economic separation of control from ownership through the use of lease contracts. In general, the unique characteristics of real estate ensure that even long-term real estate leases fail to meet the Financial Accounting Standards Board's requirements for being classified as capital leases. For a variety of reasons, most businesses find that leasing real estate is preferred to ownership. For example, leasing is often more cost effective when space requirements are less than quantity supplied in a typical building in the desired location. In this case, purchasing a property would place a firm in the "real estate business" by requiring that it assume the risks of ownership for leasing space that it does not occupy. Given the importance of leasing to the real estate industry, section 4 discusses the differences in real estate leases arising from property characteristics in the space market as well as various leasing strategies.

Recognizing that new property development is integral to linking the space and asset markets, section 5 provides greater detail on the project level risk and return characteristics associated with the various phases of the development process. Risks and expected returns to a developer can be substantial, and given the immobility and durability of improvements, development decisions in the private sector have long lasting impacts on the public in terms of urban form and the quality of life. This partly explains why development is a highly regulated activity.

The development process is surprisingly front-end loaded in terms of value creation. As regulation increases, the initial permitting and due diligence stage is where the risk level is highest and where ultimate value is largely determined. Developer control is also at its peak then, with control rapidly diminishing when construction begins and the process becomes effectively irreversible. We also note that at this point of diminishing control is when the dollar investment accelerates. Thus it is difficult to overstate the importance of decisions made prior to that point.

The risks and returns associated with development (and later investment) also provide insights into the relationship between cash flows and property value. An umbrella observation is that there is often not a direct link between the value of leases in place and the value of a property. In fact, as noted above, much of the ultimate value of a property is created at the initial permitting stage, typically prior to any lease contracts being in place. This same idea holds through the development and investment continuum. Below or above market rents may create a gap between property value and the value of current leases, and furthermore, real estate has substantial residual value after the expiration of existing leases in place. The latter is in contrast to many other leasing situations, such as for equipment, which unlike real estate tends to lose value over time.

The use of debt in the real estate industry differs significantly from its use in other industries. This is the topic of section 6. Due to the immobility and durability features of real estate, lenders are willing to use real estate as collateral for long-term debt contracts, creating mortgage contracts. This also matches well with the existence of long term lease contracts that provide more certainty about future cash flows. For these reasons we observe much higher debt to equity ratios in real estate markets than we do in other industries. While the prominence of debt in most properties' "capital structures" does not impact the market value of those properties, it does impact both the expected return to equity and the risks associated with achieving that return. The use of debt also shifts the source of return outward, with a higher percentage of total return coming from terminal value relative to operations. Because capital gains are typically taxed at a lower rate than regular income, pushing the source of returns toward capital gains, along with the deductibility of interest on mortgage debt, are tax related explanations for high debt to equity ratios.

## **1. Real Estate Economics: Some Fundamentals**

Real estate contributes significantly to the wealth of the United States, and is one of the “core” investment asset classes, along with cash (T-bills), stock, and bonds. This section presents data on the flow of funds in U.S. real estate markets, discusses the economic characteristics of real estate that differentiate it from other asset classes, and concludes with a description of the process of value estimation.

### **1.1 U.S. Real Estate Markets: Capital Flows**

The U.S. dominates commercial property markets, accounting for approximately one third of world value. For comparison, Europe as a whole contributes about the same percentage. The total value of non-government owned real estate was approximately \$25 trillion in the mid 2000’s, compared to an approximate stock market valuation of about \$20 trillion at that time.<sup>2</sup> About 55 percent of real estate value was in private equity, 19 percent in private debt, 16 percent in public debt and 10 percent in public equity.<sup>3</sup>

Though the value of real estate is concentrated in developed land, the latter is only about 6 percent of the total land area in the U.S. The largest shares of land use are water areas and federal land (about 23 percent), followed by forest land (21 percent) and then various agricultural uses. These numbers have changed only slightly over the past two decades. In terms of percentage change, however, developed land has increased by about one-third during that period.<sup>4</sup>

Real estate competes with other asset classes in the capital markets, and over the past several years there has been a sharp increase in transaction flows. Total commercial real estate volume in the U.S. was (about) \$300 billion in 2006, and should approach that number in 2007. For comparison, in 2001 the volume was \$65 billion, and in 2004 \$160 billion. This represents growth of almost 50% during the past three years and about

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<sup>2</sup> Source: Ling and Archer (2005) and updated by the authors.

<sup>3</sup> Source: Geltner et al (2007).

<sup>4</sup> Source: Ling and Archer (2005).



350% over the past six years. Local, private investors still account for the largest share of transaction volume, followed by private, national investors, REITs, foreign investors, and space users.

## **1.2 Economic Characteristics of Real Estate**

Real estate assets have unique characteristics that differentiate them from other asset classes, and distinguish the real estate industry from other economic activities such as manufacturing and the financial sector. Primary among these characteristics are immobility and heterogeneity. While these are physical characteristics, they impact the economics of the marketplace. Immobility is associated with localized and segmented markets, and in the public sector largely explains the regulation of land use. Property owners are hostage to their locations, and therefore society has determined those locations should be afforded varying degrees of protection from surrounding land use that may negatively impact quality of life and in turn property values. Zoning and environmental regulations are the most visible examples. Immobility also creates differences in accessibility across properties, a major factor in explaining land values and land use patterns.

Immobility and heterogeneity also help to explain the local/regional focus of most analyses. Competition is largely confined to a limited geographic area, with that area dependent on property type. The single family home market is the most narrowly defined, while larger commercial uses, for example retail centers, have a wider area of potential interest. Heterogeneous products also contribute to market segmentation. In commercial markets segmentation occurs on the basis of both price and quality, with higher end, more costly properties in larger Metropolitan Statistical Areas (MSAs) tending to be concentrated in institutional portfolios. As a result, a high percentage of properties in REIT portfolios are in the 30-35 largest MSAs. These are referred to as institutional or investment grade properties. Thus there is a segmentation of competition between institutional grade and “other” markets.

Immobility and long-lasting improvements help explain the relatively high debt-equity ratios used to finance property. Collateral that can not be moved and which promises to endure is attractive, as is the fact that over time, land value increases tend to offset any depreciation of the improvements. Put differently, unlike assets such as equipment, there is the expectation of substantial residual property value apart from the value that can be associated with financial contracts in place, notably leases.

Other characteristics that differentiate real estate from other asset classes include barriers to entry, notably high transaction costs and land use regulations, and a relatively slow reaction of supply to changes in demand. Barriers to entry are associated with a slow reaction of markets to new information. This inefficiency implies that more or better market knowledge and experience may have a payoff. One result is that a significant portion of both institutional and private real estate investors choose investment strategies focused either geographically or by property type.

A relatively slow reaction of supply to changes in demand (an inelastic supply curve, at least in the short to medium term) further differentiates real estate markets from the relatively efficient product and financial markets.

### **1.3 Estimating Real Estate Value**

Because real estate competes in the capital markets, analysts estimate the market value of property using the same tools as are applied in the valuation of other asset classes. That is, a forecast of future cash flows is developed, and then discounted to a present value at the required return. The required return reflected in the discount rate is the sum of the pure time value of money and a risk premium. This estimating approach is the industry standard; relied upon by lenders for determining collateral value when making loan decisions, by investors when estimating expected returns, and securities analysts when making estimates of value, for example the Net Asset Values (NAVs) of REITs and other companies that own and operate portfolios of investment property. Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. Fair value differs from

the historical cost that is reported on balance sheets based on current U.S. GAAP, and it is increasingly supported on the basis that periodic “marking to market” provides more transparency than historical based measures.

The value estimate is critical, as the price paid ultimately determines the rate of return to the investor, recognizing that the cash flows that are achieved are not affected by the price paid. The rate of return can be divided into the portion attributable to operating cash flows, and the portion attributable to changes in the value of the property. Value change is realized either at sale or when the property is refinanced. The contribution of value change to the total return is case specific, but under a set of reasonable assumptions about operating cash flows, value change, and holding period, a 25 percent to 40 percent contribution is not uncommon. Thus value creation and change is a critical factor in achieving target returns.

### **Capitalization Rates and Vales**

Industry observers and participants often refer to capitalization rates when discussing property values. The capitalization rate is calculated by dividing a single year of cash flow (typically the expected first year operating income) by the value estimated by discounting cash flows, or in the case of a transaction that has been completed, dividing the single year of cash flow by the actual transaction price. Taking the inverse of a cap rate produces a price-earnings multiplier that is completely analogous to the P-E ratios that often accompany securities analysis. And, the interpretation is the same. P-E ratios differ across companies and sectors for two fundamental reasons; differences in risk and differences in expected cash flow and value growth. Thus we observe higher multiples for growth stocks than for more stable stocks such as utilities. The same is true in real estate markets, where properties expected to experience relatively high growth in operating cash flows and value will sell at higher multiples (lower cap rates) and therefore higher prices than properties with more modest expectations. More precisely, a property that sells at a cap rate of, say, 8 percent, and experiences 3 percent annual growth in cash flow and value, will produce a total return of 11 percent.

Published surveys of appraisers and investors typically report on average capitalization rates by property type, often broken out by MSA or region.

### **“Leased Fee” Value**

The values estimated for properties are often “leased fee” values, reflecting any impact of rents that are not at market levels. Thus a property encumbered by a lease(s) at below market rent will have a leased fee value that is lower than its fee simple value. That value will reflect the below market rents, as well as the impact of the conversion to market rents when the current leases expire. The distinction between leased fee and fee simple values recognizes that the value of the real estate is often different than the value of the leases in place. References to leased fee and fee simple values are consistent with the accepted idea that property values are a function of the productivity reflected by the expected cash flows from investment property as a single entity. Also consistent with this idea is that the use of the “cost approach,” which estimates property value by adding the costs of the individual physical components of the buildings and land, has been largely abandoned for commercial properties. Cost estimates are now used mainly by developers to compare to the expected market value at completion, another application of the difference between component costs and market value. That is, while replacement costs estimates are regularly used in comparisons to fair value, they are not themselves a reliable basis of fair value estimates. Thus, neither the value of leases in place nor the summed values of the component parts of a property provide appropriate bases for estimating the fair value of investment property.

### **A Note on Land Values**

An appreciation for how land use and land values are determined provides additional insight. Land value, like the value of already developed properties, is a function of the expected cash flows and value changes associated with what economists and appraisers call the property’s highest and best use. Highest and best is the use that maximizes the land’s value, which is equivalent to maximizing the expected risk adjusted return. It follows that if land is developed into a use different than its highest and best use, the resulting return will not be sufficient to compensate for the associated risk. Thinking

about this with reference to value estimation, it is seen that a non-highest and best use development can incur costs equivalent to a development at the highest and best use, but have a different market value at completion. This reinforces the conclusion that the cost of building components is unlikely to equal the market value.

### **Estimating the Value of Entities that Own Portfolios of Investment Property**

Most investment analysts translate individual asset values into estimates of the value of companies that own portfolios of investment property. In addition to estimates of the fair value of real estate assets, most analysts estimate the value of other significant assets and the company's debt in order to estimate the NAV of the entity. The NAV is then used as a basis to value the company's shares. Share estimates are generally valued at premiums or discounts to NAV based on various factors unique to each company. These factors include the quality of management, the prospects of new development, the quality of properties in the portfolio, etc.

Entity values may also be estimated based on multiples of performance metrics, primarily Funds From Operations (FFO). FFO, as defined by NAREIT, has been used by most REITs as a supplemental performance measure and as a basis for estimating a REIT's share value.

## **2. The Real Estate Industry**

The real estate industry comprises three interrelated, yet distinct, components commonly referred to as the space market, the capital market, and the development process. In addition, by interacting with these components, forces from outside this system, such as changes in broader capital markets or local and national macro economic conditions, impact the real estate industry in a variety of ways. This section describes these components and their relation to one another.<sup>5</sup>

### **2.1 The Space Market**

The first component, the space market, describes the physical nature of real estate. The term “space” denotes the physicality of real estate in that it ultimately provides a physical location and/or shelter for the individual activities that take place within that space. Since the characteristics of the space market are often tied to the ultimate use of the real estate within that market, market participants normally delineate space markets by their functionality. Thus, we use the term “residential” space market when referring to the use of real estate in providing shelter from the natural elements for individuals or households. Similarly, we refer to the “office” space market when describing the use of real estate to provide shelter to firms so that their employees can conduct business. Thus, we define the space market according to its intended use, with the traditional (and most common) uses being residential, office, industrial, retail, hotel, and mixed-use.<sup>6</sup>

One of the key features distinguishing real estate from other assets is its specific locality. The fact that real estate is tied to a specific location makes each asset unique and thus market participants often add a location characteristic to the intended use when describing a specific space market. For example, one often classifies office markets as being “central business district (CBD)” or “suburban” and hotel properties as being “business-class” or “resort.”

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<sup>5</sup> See DiPasquale and Wheaton (1992) and Fisher (1992) for a more in-depth treatment of this topic.

<sup>6</sup> It is common to refer to non-residential real estate as “commercial.”

The interaction of real estate location with real estate use often results in a segmented real estate market. A market is classified as segmented when it can be broken into various “sub-markets”. As a result, the space market is segmented along location and use dimensions. Further reflecting the unique nature of real estate, the space market is also segmented by quality. Thus, the real estate space market is normally classified by type of use, location of the property, and quality of property being provided.

Regardless of how we characterize its physicality, the space market brings together the suppliers of existing real estate (building owners and landlords) and the ultimate end users who determine the demand for space. As with any market, the fundamental law of economics dictates that the interaction of supply and demand will determine the “price” of space. In the space market, the observable price comprises two components: rents and occupancy. Rent is normally the monetary amount paid by the user to the owner (and is usually quoted as an amount per unit of space). Quoted rents are often easily observed and reported. However, quoted rent normally does not fully reflect the actual “price” paid for the use of real estate. The actual economic rent is impacted by factors such as periods of “free rent” and allowances for building out the space to the demander’s specifications (called tenant improvements). These factors are often not disclosed – making the determination of economic rent difficult to most outside observers. An exception is that experienced valuation consultants use actual market data to determine economic rents.

Although economic rents are difficult to observe, one factor readily observable and directly linked to economic rent is occupancy level. Occupancy describes the actual amount of physical space utilized and its converse, vacancy, describes the amount of space currently available to meet end-user demand. In a well functioning space market, the amount of vacant space will reflect the overall demand for space. Normally, one would consider that a space market in equilibrium (i.e., supply equaling demand) would have zero vacant space. However, in real estate markets a positive amount of vacant space is optimal to facilitate end-user turnover. Furthermore, given the long-term nature of some real estate lease contracts, space providers may prefer to retain some vacant

space (in effect as inventory) in order to have the option to meet future demand that could result in higher economic rents.

The final identifying characteristic of the space market is the shape of the supply curve. Unlike the traditional upward sloping economic supply curve (higher prices leading to greater supply), the short-run real estate supply curve is inelastic reflecting the fixed-nature of the market. That is, due to construction lags, the supply of real estate can not expand (or contract) instantaneously to reflect changes in user demand. This leads to potential imbalances in supply and demand. As will be discussed below, the development process is responsible for adding new property to the space market and the economics for new development depend upon values determined in the capital market as well as external forces coming from the construction activity.

## **2.2 The Asset Market**

The real estate asset market describes the investment activity for real estate. As such, the asset market brings current owners wishing to sell real estate (supply) together with investors wishing to purchase real estate (demand). In this market, investors make buy/sell decisions based on the expected returns offered by real estate. As with any financial asset, the fundamental driver of expected returns is expected future cash flow. Thus, the asset market is linked to the space market through the cash flow provided by the real estate. Cash flow is a function of the economic rents obtained in the space market along with property expenses.

To external observers, the capitalization rate is the link between the supply and demand for investment real estate and the property cash flow. The capitalization rate is the property level net operating income (typically first year income) divided by the property sale price. In essence, the capitalization rate provides a mechanism for linking the current market value of a property to the property's discounted cash flow in perpetuity.

Market capitalization rates may change for a variety of reasons. For example, changes in the supply or demand of investors can alter capitalization rates. An increase in investor



demand for real estate will increase prices resulting in a decline in observable capitalization rates. Analogously, a decrease in investor demand for real estate would cause a decline in prices resulting in an increase in observable capitalization rates (all else being equal). Thus, changes in investor supply or demand will impact the value of real estate by changing the market capitalization rate, which, as discussed in section 1, translates a given dollar of cash flow into value.

Furthermore, because the capital markets are well integrated (i.e. capital flows freely to investments offering the most attractive combination of risk and expected return), changes in the supply and demand in other investment markets will impact the supply and demand for real estate investments. Thus, forces in the capital markets that increase (or decrease) investor required rates of return will increase (or decrease) the market capitalization rate resulting in a decrease (or increase) in the underlying real estate value. As a result, the real estate asset market is highly integrated and investors only differentiate across property uses or location as a means of denoting the specific assets being transacted.

### ***2.3 The Development Process***

The development industry closes the loop between the asset market (where value is determined) and the space market (where use is determined). Real estate development is a business activity that seeks to profitably provide new real estate to the space market. Profitability in this context depends upon being able to provide space that has a “value” greater than the costs of production. For real estate development, the cost of production reflects all land, material, labor, fees, and the cost of invested capital required to produce new space. Thus, the developer looks to the asset market to determine the potential value for new space and only provides that space when the expected value exceeds the cost of production. Put differently, the development industry provides a feedback mechanism that allows for the cash flows determined in the space market, which then impact property values, to determine the level of new real estate added to the space market.

### **3. Macro Level Performance Issues**

Real estate's emergence as a prominent asset class makes it necessary to not only be able to measure its investment performance, but also to use that performance as the basis for mixed asset portfolio allocation decisions.

These macro level topics are the subject of this section. Included are real estate's role in portfolios, measuring real estate investment performance, and interpreting and using performance indices.

#### **3.1 Real Estate's Role in Portfolios**

Modern portfolio theory began with Markowitz (1952), who combined the considerations of risk and return to provide the beginnings of a solution to the question of how best to allocate capital across various asset classes. From this beginning came not only portfolio theory, but later widely used capital asset value models, most famously the Capital Asset Pricing Model (CAPM).

Portfolio theory is based on the fundamental proposition that the investor can generate an improved risk/return relationship by combining assets with return series that are not perfectly correlated. At one extreme, consider two possible investments with returns that are perfectly correlated; that is, they move up and down exactly the same each period. Dividing capital between these two investments with their correlation of +1.0 would have no advantage over simply investing all of the capital in one or the other. The result in either case would be the same expected return and volatility. Now consider two investments with returns that are perfectly negatively correlated; that is, when the return on one changes, the return on the other changes in the opposite direction by an equal amount. This is a case of a -1.0 correlation, with the result that dividing capital equally between them would produce the same expected return, but with -0- portfolio volatility. Real world correlations between investments are never at the extremes, but there are

diversification benefits whenever correlation is less than 1.0, and the farther from 1.0 the greater the benefit.

Portfolio managers are typically less interested in measuring correlations between individual investments than they are in measuring correlations among asset classes. These measures are the basis for allocating capital, and thus the common reference to the percentages of capital invested in the various asset classes. It follows that investment performance is almost always reported with reference to, and comparisons among, the “core” asset classes of cash (T-bills), stocks, bonds, and real estate.

Since portfolio theory began to dominate institutional practice in the 1970s, a great deal of effort has gone to answer the question of what is real estate’s proper role. Early efforts were hampered by insufficient data and sometimes data of questionable reliability. This began changing with the increased transparency associated with the emergence of REITs and the globalization of property markets. Both NAREIT and the National Council of Real Estate Investment Fiduciaries (NCREIF) began accumulating real estate investment performance data in the 1970s. A consistent finding has been that real estate’s relatively low correlation with other asset classes makes it an attractive candidate for inclusion in mixed asset portfolios. While correlation estimates vary by sampling period and across property markets, a reasonable conclusion is that the correlation between the returns to stocks and the returns to REITs and non-REIT listed real estate companies has been between .30 and .40, suggesting substantial diversification benefits.

Given this evidence, the question becomes not whether real estate belongs in portfolios, but rather how much real estate is appropriate. This is not easy to answer, as there has been a persistent gap between the prescriptions that result from the application of portfolio theory, and what is observed in practice. While the percentage allocations suggested by theory and empirical evidence vary across sampling periods, the percentage for real estate has seldom been less than 15 percent, and some credible research suggests something closer to 30 percent. These suggestions are what might be expected based on real estate’s share of U.S. investment wealth, but they stand in contrast to actual practice,

which is that real estate is typically around 5 percent of institutional portfolios, with a non-trivial portion of portfolios containing no real estate.

Are portfolio managers unaware of what they are missing? Probably not, yet most continue to allocate smaller than prescribed percentages. There is no shortage of explanations for this puzzle, three of which in our view deserve the most consideration. First, there may be the suspicion that the risk measure (standard deviation) underlying portfolio theory is not as reliable with reference to real estate. Second, it is likely recognized that direct investment in segmented markets like real estate requires a focus and expertise within specific, often local markets. These skills are lacking by most portfolio managers. This also helps to explain the growth of REITs, which carry with them the required expertise. The third explanation for the theory/practice gap is a combination of inertia and the fear of a bad decision, particularly when that decision is contrary to accepted practice. The portfolio manager who was alone in allocating, say 20 percent to real estate, and in the short run it performs poorly, is potentially more visible (and possibly more accountable) than the manager, who, like many others, allocated 5 percent.

The discussion to this point has been with reference to capital allocation across asset classes. The other issue is the applicability of portfolio theory within an asset class. That is, can portfolio theory be used to do things like allocate the real estate portion of a mixed asset portfolio among different property types or geographic areas, or be used to make allocations within a stand alone real estate portfolio? Some argue that it can and should be used in this way, while others point out that the whole objective of portfolio allocations is to maximize the performance of the overall portfolio, and not the performance of individual components of the portfolio. Another constraint on using portfolio theory within the real estate asset class is that there is sometimes insufficient performance data available for individual properties and property types. This constraint mainly affects direct investment real estate, but is much less an issue with respect to REITs and non-REIT listed companies.

### **3.2 Are REITs Stocks or Real Estate?**

Since the late 1980s the percentage of property held by REITs and non-REIT listed companies has increased sharply, beginning in the U.S. and more recently globally. REITs offer liquidity not available with direct investment, and because they are securities, a greater level of transparency with respect to performance measures and management accountability. At the same time, because REIT shares are liquid and trade daily in public markets, the prices of those shares reflect changing investor expectations with respect to developments in the overall economy as well as in real estate and financial markets. As a result, the correlation of publicly traded REIT returns with those of other market-priced equities, while attractively low, tend to be higher than the correlations of direct real estate investment returns with those of the same market-priced equities.

### **3.3 The Performance of Commercial Real Estate**

Indices that track commercial real estate performance can be divided into two main categories: those that track the performance of REITs, and those that track the performance of direct investment real estate. Table 3.1 below shows return measures across the core asset classes for the period 1992 through the third quarter of 2007. This period covers the beginning of the “modern” era of REITs through the most recent data available. The FTSE/NAREIT Equity REIT index is calculated and published by FTSE Group in cooperation with NAREIT. The TBI index (Transaction Based Index) is developed by MIT and tracks returns from direct investment real estate.

**Table 3.1**  
**Quarterly Performance Measures, 1992 – 2007 (Q3)**  
**“The Modern REIT Era”**

	T-Bills	Bonds	S&P 500	TBI	NAREIT
Arithmetic mean	.92%	1.60%	2.94%	3.13%	3.49%
Standard deviation	.37%	1.99%	7.36%	3.55%	6.99%
Coefficient of variation	.40	1.24	2.50	1.13	2.00
Geometric mean	.92%	1.58%	2.68%	3.07%	3.26%

Source: NAREIT database, 2007.

An important similarity between the TBI and FTSE NAREIT indices is that both are transaction based, meaning they avoid some of the measurement difficulties associated with alternative indices that are appraisal based. There are also some differences between the TBI and FTSE NAREIT indices with respect to how their returns are calculated.

One of those differences is that the TBI returns are reported on an unlevered (property level) basis while the FTSE NAREIT returns are reported on a levered (equity level) basis. This helps explain both the higher returns and the higher volatility of the REIT index. Also contributing to the volatility difference is the point made earlier that REITs are traded as securities with prices that reflect factors that affect equity securities generally. A number of researchers have attempted to adjust the various performance indices for these kinds of differences.<sup>7</sup>

Table 3.1 shows returns calculated two ways: over a single period (arithmetic mean) and a holding period (geometric mean). Consider a \$1 investment which grows to \$1.20 the first year, then falls to \$1.08 the second and final year. The arithmetic mean return is  $(20 \text{ percent} - 10 \text{ percent}) / 2 = 5 \text{ percent}$ , while the holding period return (IRR) is 3.92 percent.

<sup>7</sup> An excellent example is in Geltner, D. et. al, *Commercial Real Estate Analysis and Investments*, 2<sup>nd</sup> ed., 2007, Thomson, ch. 25.

During relatively stable markets, the difference between arithmetic and geometric return measures tends to be relatively small. When markets are more volatile, the arithmetic mean tends to be higher than the geometric mean. Care should be taken when comparing indices, as some published data is unclear whether the returns reported are arithmetic or geometric.

Both the TBI and FTSE NAREIT returns are generated from the experience of investors whose portfolios tend to be concentrated in the largest 30 to 35 MSAs, and further concentrated within those markets in investment or institutional grade properties. Therefore, the indices may or may not represent the broader real estate market.

Finally, though relative asset class performance naturally varies across sampling periods, during the modern REIT era real estate equity shares have achieved returns more than 100 basis points greater than the performance of the broader equity indexes as measured by the Dow Jones Wilshire 5000 index. Based on these returns and the low correlations of returns between real estate and other asset classes, there is virtually unanimous agreement that real estate has an important role in mixed asset portfolios.

## **4. Leases and Lease Strategy**

### **4.1 Overview of Leases**

The concept of leasing assets recognizes the economic separation of control from ownership. Leasing allows the lessee (the tenant in real estate) to gain control over real estate for a predetermined period while the lessor (the landlord or property owner) retains full ownership rights. Given the long-life expected for most real estate, leasing effectively separates the shorter-term use of property from the longer-term ownership interests in the property.

The Financial Accounting Standards Board (FASB) makes the distinction between “operating” and “capital” leases depending upon whether the lease conveys economic “ownership” to the lessee. Under operating leases, the lessee receives only the right to use the property during the lease term. Since the lessee does not receive any ownership benefit, the full lease payment is recognized as an operating expense and the lease is not recorded on the firm’s balance sheet. In contrast, under a capital lease the lessee assumes some of the risks of ownership. As a result, the accounting treatment for capital leases requires that the lease be recognized as an asset on the balance sheet as well as a liability. Acknowledging that a strong incentive exists to record leases as operating leases, the FASB requires that a lease be treated as a capital lease if any of the following conditions exist:

- (1) the lease term is greater than 75 percent of the asset life;
- (2) ownership of the asset is transferred to the lessee at the end of the lease;
- (3) the lessee has the option to purchase the asset at the end of the lease for a “bargain price;”
- (4) the present value of the lease payments are greater than 90 percent of the current asset market value.

In general, most real estate leases are structured such that they do not meet these conditions and are thus classified as operating leases. For example, even relatively long-term leases (say, 30-years) with multiple renewal periods will be shorter than the



expected life of a well maintained building. Furthermore, the residual real estate remaining after the lease term often has significant value helping establish that the rental payments will not exceed 90 percent of the current asset value. By classifying real estate leases as operating leases, the lessor recognizes that the real estate investment is an asset that produces cash flows that are recorded as income. It is worth emphasizing that the fourth item in the FASB test of capital leases explicitly recognizes that real estate leases are “operating” leases since the residual value of real estate (i.e. the present value of all future cash flows accruing to real estate after the expiration of the lease) normally exceeds 10 percent of the present value of the leases in place. The longevity associated with physical buildings leads to the large residual values.

#### **4.2 Real Estate Leases**

Real estate leases come in three basic flavors: gross, net, and hybrid. The gross real estate lease implies that the property owner pays all operating expenses associated with the property. Thus, the gross lease fits most closely with the concept of an operating lease as defined by FASB since the owner remains responsible for all expenses associated with the property and the lessee has limited control over the property only during the lease term. In contrast, net leases provide that the tenant will pay most operating expenses. In fact, the triple net lease specifies that the tenant pays all operating expense, including property taxes, insurance and maintenance. As a result, triple net leases appear to convey “ownership” to the lessee. However, even under this type of lease the lessee does not retain the property’s residual value and thus still meets the FASB definition of an operating lease. Finally, the third lease type, the hybrid lease, combines characteristics of both net and gross leases.

Real estate leases often share similar characteristics depending upon the type of property being leased. For example, retail leases often provide for a base rent plus a percentage of gross sales, referred to as percentage rent. Percentage rent is designed to align the interests of the property owner with the retail business such that the property is maintained in order to make it as attractive as possible for potential customers. Gross

leases often contain expense stops or index clauses that limit the property owner's exposure to increases in expenses due to inflation.

Real estate leases often contain a variety of embedded options that cover future contingencies. For example, real estate leases often contain renewal options that allow the lessee and lessor to recontract for the use of the space at the prevailing market price. In effect, the renewal option provides the lessee with flexibility to meet future space needs and capitalize any investments and relationships created at that location. From the lessor's standpoint, the renewal option provides a mechanism that allows for periodic rent payment adjustments to better match market conditions.

### **4.3 Effective Rent**

Earlier a distinction was drawn between quoted and economic rent, the key point being that economic rent is a more complete measure that reflects the actual price being paid for the use of space, including such things as rent concessions and tenant improvements. A third way that rent is sometimes described is as "effective rent". It can be calculated based on either quoted or economic rent, and is the present value of the rent converted into the equivalent level annuity payment. Expressing lease contracts on an effective rent basis enables comparisons of contracts with differing terms.

### **4.4 Leasing Strategies**

One of the most important concepts in leasing real estate concerns the implications of the generally observed downward sloping term structure of rents. That is, longer-term leases generally command lower rents than shorter-term leases. This concept, similar to the concept of the term structure of interest rates, implies that rent levels observed in the space market are a function of lease length. One aspect not fully reflected in the effective rent calculations is the differences in risk across leases of various terms (longer term leases containing rent escalation clauses are often considered as being less risky since they reduce the uncertainty about future cash flows). In addition, shorter-term leases provide tenants with greater flexibility with respect to future space utilization and this option to either expand or contract space use in the future results in a premium placed on

short-term rent contracts. As a result, we often see a downward sloping lease term structure with longer-term leases having lower rents than shorter-term leases.

#### **4.5 Lease versus Own**

In general, the decision to lease or buy real estate ultimately hinges upon the cost/benefits associated with leasing versus owning. For a variety of reasons, many businesses find that leasing real estate is preferred to ownership. Leasing is often more cost effective when space requirements are less than the quantity supplied in a typical building in the desired location. In this case, purchasing a property would place a firm in the “real estate business” by requiring that it assume the risks of ownership for leasing space that it does not occupy. Furthermore, owning property often requires a large capital commitment to an asset that is not integral to the firm’s core business. Finally, many firms find that leasing offers additional flexibility to leave markets or consolidate to a different location more efficiently than if space were owned.

## **5. Micro Level Analysis: Property Development**

Real estate development is an economic activity that significantly impacts both the private and public sectors. This section extends the discussion of the space and asset markets from section 2, by providing more detail on the project level risk and return characteristics associated with the various phases of the development process.

### ***5.1 The Development Process***

As discussed in section 2, development links the space and asset markets. Risks and potential returns to developers can be substantial, and given the immobility and durability of improvements, development decisions in the private sector have long lasting impacts on the public in terms of urban form, quality of life, and property values. This largely explains why the development process is a highly regulated activity, and becoming increasingly so.

Development is often thought of as a linear process that begins with an idea and ends with stabilized occupancy and perhaps a sale to an investor. In fact, while references to the various stages of development makes the discussion more manageable, in practice the process tends to be non-linear. It is the rare project that proceeds smoothly from idea to occupancy, on time and with no changes or surprises. There may be political and regulatory issues, delays or denials in the permitting process, construction problems and cost overruns, a market that softens, a design that needs change, and a marketing plan that disappoints. From idea through occupancy may take several years, and it is not possible to foresee all sources and magnitudes of risk and return. It follows that developers require substantially higher returns than do investors in completed and occupied projects.

Except for very small projects, the complexity of the process requires a development team with a variety of skills. The team will typically include those involved in planning, design, permitting, due diligence, engineering, construction, marketing, leasing (or

selling), and property management. It is unusual for all of these functions to be completed in house. More common is to outsource some or all of them.<sup>8</sup>

## **5.2 Risk, Return and Value**

Figure 5.1 below summarizes the development process, including comparisons of risk, expected return, and value added at the various stages.

Perhaps the most important lesson from Figure 5.1 is that while we may associate development with a building coming out of the ground, or with a completed project occupied by tenants, the value-adding process is in fact much more front-end loaded. The ratio of value to investment is highest in the initial stages, as decisions with respect to site selection, the price to pay for the land (or the opportunity cost if the site is already owned), design, permitting and due diligence are where ultimate value is largely determined. Permitting is of particular importance as differences in permitted uses can have a significant impact on value. It is interesting that this value is created at a point that is typically prior to any leases in place.

As the importance of permitting has increased, it has become less common for developers to purchase already permitted land. The value added prior to that point would require a purchase price that would consume a significant portion of development profits. As a result, it is more common now than in the past for developers to absorb the risks associated with taking the site through the permitting and due diligence process.

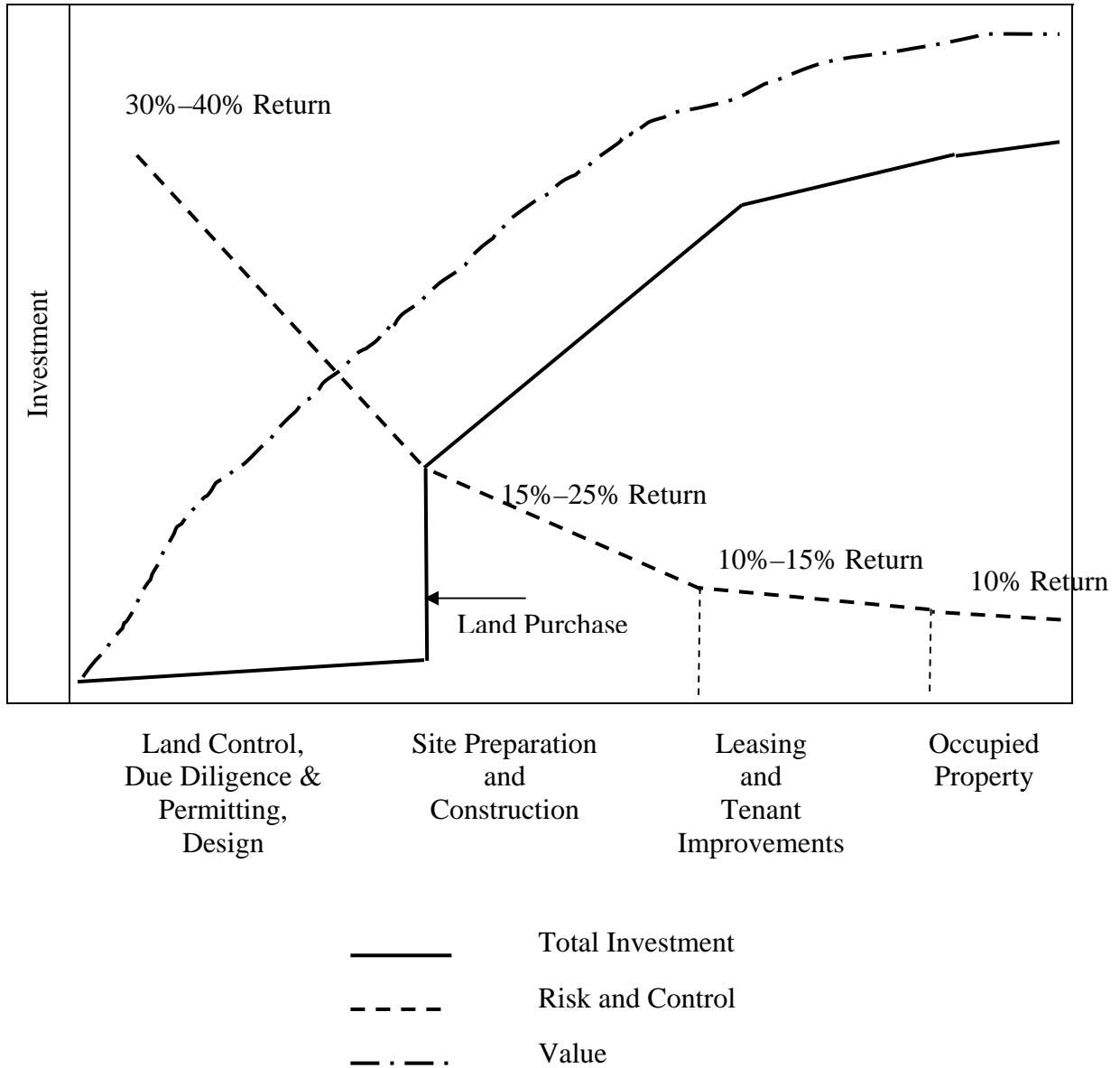
Consistent with the idea that substantial value is created early in the development process, the risk level is highest at that point. Though there is a relatively low dollar investment in the early stages, it is at high risk. Things like market changes, legal and regulatory issues, soil problems, and so on can and often lead to a project being abandoned, delayed or substantially changed prior to the onset of construction.

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<sup>8</sup> The development team is discussed in detail in Peiser, R., and A. Frej. *Professional Real Estate Development*, 2<sup>nd</sup> ed., 2003, Urban Land Institute, ch. 1-2.

Figure 5.1

Development Stages



Source: Geltner, D. et. al, op. cit., p. 759. Modified by the authors.

Figure 5.1 illustrates another important characteristic of development, which is that as the process moves forward, the developer's control declines. This is seen by considering a building under construction. At that point, there is little that can be done to substantially change course without enormous cost, and therefore the development decision and attendant costs are effectively irreversible. Notice too, that this loss of control is occurring at a time when the dollar investment is rapidly increasing. For these reasons it is difficult to overstate the importance of decisions made prior to the onset of construction.

Because the risk level declines as development proceeds, there is an associated decline in expected returns. At the extremes, the expected return to an institutional investor that purchases the property after it is fully leased will be substantially less than the expected return to the developer. The absolute returns shown on Figure 5.1 are not meant to be precise, as they will differ across projects. However, they are consistent with the results of limited empirical work (McGrath, 2005), and the relative returns do reflect typical risk-return relationships along the development continuum.

A final insight from Figure 5.1 relates back to the observation that a substantial portion of value is created early in the development process. It was noted that this value exists despite the fact there may as yet be no tenants committed. The expectation is that those tenants will appear, but at that point there is by definition no relationship between the value of leases in place and the value of the property. The same idea holds throughout the development and investment continuum. Because the economic life of a property typically exceeds by a large margin the remaining terms on existing leases, the property will have a substantial residual value at the expiration of those leases. This is particularly so because unlike assets such as equipment, real estate tends to increase in value over time. Also, when rents under current leases are either above or below market, a property's value will be different than the sum of the value of those leases.

As discussed in section 1, when a property is encumbered by a long term lease(s) at below market rents, the property as if vacant is likely to have a higher value than it does as occupied. This contractual inertia is one explanation for what is sometimes referred to as the “gray collar” around many central business districts. These are areas with older, industrial type buildings, housing tenants that signed long term leases at now favorable terms, and who are unwilling to move. The fair value of the underlying real estate in such cases greatly exceeds the value of the leases in place, due to the residual value that will be captured when the leases expire and the site is free to be put to its current highest and best use. Thus for a variety of reasons, a property’s value is seldom as low as the collective value of leases in place. This is recognized in capital markets, in appraisal practice, and as noted earlier in FASB distinctions between operating and capital leases.

### ***5.3 Development Feasibility and Decision Rules***

Development decision rules are conceptually similar to other investment decisions. Developers are expected to accept projects that maximize land value, which is equivalent to selecting projects with expected NPVs of -0- or higher, or alternatively, that are expected to produce IRRs that meet the minimum hurdle rate. Said another way, the present value of future cash inflows must equal the present value of cash outflows applying appropriate discount rates.

For many kinds of investments, including investments in occupied properties, it is common practice to use a single discount rate to estimate NPV, or to have in mind a minimum acceptable IRR. Single discount rates are used despite the fact that it is recognized that risk changes over time, and that a conceptually superior approach would be to discount each periodic cash flow at the appropriate risk rate for that period. However, it is also recognized that estimating future and frequent changes in risk (and therefore periodic discount rates) is a difficult task, and that occupied properties are likely to be relatively more homogeneous than new developments with respect to risk levels over typical holding periods. Thus the use of a single “blended” rate is considered acceptable.



The situation is different for development projects, which have risks that vary substantially from idea through occupation. The single biggest overall change in risk takes place when the negative cash flows associated with development convert to the positive cash flows expected when occupied. The negative cash outflows are much more certain to be incurred than are the cash inflows. Thus it makes sense to separate the NPV calculation into at least two parts. The cash outflows should be discounted at something around the risk free rate, while the expected inflows that will begin sometime in the future should be discounted at a much higher rate. Estimating the latter is difficult, but in practice a reasonable estimate can be made by starting with the current market capitalization rate and adding the expected rate of future income and value growth. Good discussions of rate determination and estimation can be found in most real estate investment texts.<sup>9</sup>

In practice, rules of thumb are often used in place of a discounted cash flow analysis. One common approach is to accept projects with some minimum level of expected gross profit. For example, a development with total costs of \$20,000,000 might be acceptable if the expected selling price upon completion was \$24,000,000. Required margins vary across developments, but a range of 15 percent to 25 percent is frequently observed. The investment/value relationship shown at occupancy in Figure 5.1 is consistent with that range.

#### **5.4 Development Financing**

Section 6 will discuss differences across mortgage loan instruments with respect to repayment agreements. Here the focus is on the sources and uses of debt and equity funds at the various stages in the development process. Development debt financing (referred to as construction or interim financing) differs from the financing of already occupied properties (called permanent financing) in several ways. First, while some institutions make both construction and permanent loans, it is more common to specialize in one category or the other. Primary sources of construction loans are commercial

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<sup>9</sup> For example Brueggeman W. and J. Fisher, *Real Estate Finance and Investments*, 12<sup>th</sup> ed., ch. 10, 2005, McGraw Hill.

banks and mortgage banking companies. Mortgage backed securities emerged in the 1980s to provide increased liquidity and to provide the real estate industry with more diverse, efficient and consistent sources of capital. Two important sources of permanent financing are insurance companies and pension funds. Permanent loans are used to pay off (or “take out”) construction loans. The suppliers of construction and permanent loans tend to be different in an attempt to match their assets and liabilities. Banks, for example, have shorter term assets (deposits) which they match with shorter term interim loans, while insurance companies and pension funds are fiduciaries holding long term savings that they match with longer term loans.

A second difference between construction and permanent loans is that the sources of the former tend to be local or regional, while the latter are often national or international. Local market knowledge and the ability to observe construction progress are of primary importance to a construction lender, but are less important to a permanent lender.

A third difference between interim and permanent loans is in the timing of the loan disbursements and repayments. Construction loans are divided into “draws” that are each a portion of the total loan commitment. The dollar amounts of the draws are designed to correlate with construction progress and hopefully value in place at the time. Interest accrues based on the total drawn, but there are no periodic repayments to the lender. Rather, as noted above, the loan amount plus the accrued interest is repaid in a lump sum using the proceeds of the permanent loan.

Though the construction loan funds are obtained before the permanent loan funds, it is common practice to obtain the commitment for a permanent loan prior to the commitment for the construction loan. This is driven by construction lenders who do not want to be in the permanent loan business, and therefore want assurance that their loan will be repaid at the end of construction. At the same time, the permanent lender’s concern is that at the end of the construction period the project will not be producing the expected cash flow. This would have obvious implications for the collateral’s value, and for the property owner’s ability to service the debt. Therefore, permanent loans almost

always contain contingency clauses relating to such things as minimum occupancy levels before the permanent loan will be fully disbursed. This situation explains the existence of what are referred to as mini-perm or bridge loans that are used to bridge the potential financing gap between the completion of construction and the achieving of the minimum requirements for the full disbursement of the permanent loan. There are various sources of mini-perms, including some construction lenders.

Construction loans tend to be relatively homogeneous with respect to their structures, but that is not the case for permanent loans. There are a myriad of contractual possibilities that affect the cost of the debt and the cash flows to the developer and lender. One example is a “participating loan,” which in addition to the interest rate, assigns to the lender a portion of the benefits that would otherwise flow to the equity position. This could be a percentage of cash flows, a percentage of cash flows above a threshold amount, and/or a percentage of the proceeds of sale. Specific agreements are limited only by the creativity of the lender and borrower. Not surprisingly, the compensation expected by lenders, just as equity investors, is consistent with the risk profile of the development process. Construction loans command higher returns than permanent loans, and mini-perms commonly require a premium over construction loans.

The complexity of debt markets is such that developers, particularly those relatively new to the business or to a specific market, often use the services of a mortgage broker to identify and make contacts with prospective lenders. Brokerage fees vary by the size of the loan, with a range of 1 percent to 2 percent not uncommon.

Equity for development projects may come from a variety of sources. The original seed money is typically supplied by the developer. Outside equity may come from private equity firms, opportunity funds, and sometimes insurance companies and pension funds.

## **6. Real Estate Investment Analysis: The Effect of Leverage**

Leverage is the use of debt capital to finance investment. Debt represents a senior claim to the cash flow produced by an investment while equity, in contrast, is the residual claimant. In this section, we describe the fundamentals of using debt to fund real estate investment and describe how the use of leverage affects real estate values and investment performance.

### **6.1 Overview of a Mortgage**

A mortgage is simply a debt contract that is secured by a claim on real estate. The debt contract is created by a “promissory note” that specifies the interest rate and maturity date. A mortgage is then created by pledging real estate as collateral in case the borrower fails to repay the promissory note. The minimum requirements for a valid mortgage are that the contract identify the borrower and the lender, clearly state the terms of the loan (the interest rate charged, the maturity date of the loan, and the required payments), the amount being borrowed, fully describe the property securing the loan (usually through a valid survey description), and that the borrower and lender sign the document.

### **Types of Mortgages**

While mortgages generally fall into two categories, fixed-rate or variable-rate, commercial real estate often sees additional financing contracts containing hybrid interest rate features as well as equity participation provisions. As the name implies, the contract interest rate on a fixed-rate mortgage (FRM) is constant for the life of the mortgage. From the borrowers’ perspective, the benefit from this arrangement is that the periodic (usually monthly) mortgage payments are constant. Given the constant payment, the traditional fixed-rate mortgage provides for full amortization such that the principal is completely repaid by the loan maturity date. Since market interest rates do not remain constant over time, the fixed-rate mortgage exposes the lender to significant interest rate risk. If interest rates rise unexpectedly after loan origination (perhaps due to an increase in inflation), the borrower will continue to make payments based on the contract interest

rate. However, if market interest rates fall after origination, then the borrower may repay the loan early (prepay) by refinancing the loan at the lower, market interest rate.

Lenders, recognizing the problems associated with committing to long-term, fixed-rate debt contracts, created variable-rate (also called adjustable-rate) mortgages in an effort to shift interest rate risk to the borrower. Under a variable rate contract, the mortgage contract rate is adjusted periodically (usually annually) to reflect changes in the market interest rate, and thus, the required mortgage payment changes to reflect the new economic environment. During periods of rising interest rates, the mortgage contract rate is adjusted upward and the lender is protected from unexpected shocks. Furthermore, during periods of declining interest rates, the mortgage contract rate is adjusted downward thereby reducing the borrower's incentive to prepay the loan. Thus, variable rate mortgages offer lenders some protection from unexpected prepayments. The protection is not complete, however, as these types of instruments typically include caps on the frequency and magnitude of interest rate changes.

In addition to fixed-rate and variable-rate mortgages, the commercial real estate market often utilizes hybrid mortgages having features such as interest-only provisions or partial amortization. As the name implies, an interest-only mortgage is a debt contract which does not require any principal repayment – the borrower is only required to pay the interest costs associated with the debt. At the debt maturity, the borrower is then required to pay back the full principal amount often by refinancing into a new mortgage. Given the greater default risk exposure associated with interest-only mortgages, these loans often have shorter maturities than fully amortizing mortgages. In fact, lenders will often set the loan maturity such that the loan's maturity date is earlier than the underlying lease maturity dates in order to ensure that sufficient cash flow will exist to successfully underwrite the new mortgage.<sup>10</sup> However, interest-only mortgages do provide borrowers with lower periodic debt service payments since no principal payments are required.

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<sup>10</sup> If the loan maturity date corresponds with the underlying lease expiration, then the lender faces the risk that market leasing conditions would result in insufficient cash flow (with a corresponding reduction in property value) to underwrite a new mortgage that would cover the principal payment on the existing mortgage.

Recognizing that some borrowers prefer the lower payments associated with interest-only mortgages while lenders would prefer the risk-reduction associated with amortization of principal, lenders developed the partial amortization mortgage. The partial amortization mortgage combines the features of borrower preferences for low periodic payments with lender preferences for risk reducing shorter maturities. The partial amortizing mortgage sets the periodic amortizing debt payment based on a long amortization date (usually 30 to 40 years) while also setting a loan maturity date significantly earlier (usually 5 to 10 years). Because the loan has not fully amortized at the maturity date, the borrower is expected to refinance the loan.

Finally, for commercial real estate investments, many investors utilize hybrid mortgages containing an equity participation feature. As the name implies, the “participation mortgage” provides the lender with the opportunity to participate in the equity cash flows (both operating income and capital appreciation) generated by the property. To compensate the investor for giving up part of the property operating and residual cash flows, the lender may extend a higher loan-to-value ratio and/or a lower interest rate than would otherwise occur. Specific agreements about the participation format are limited only by the creativity of lender and borrower. However, in a participation type mortgage, the lender looks to the expected return from the property income and appreciation as well as the interest income from the mortgage debt to provide sufficient total return to justify the debt.

## **6.2 Financial Leverage**

Above we considered the various types of real estate debt available to investors and discussed the complexity of certain types of these instruments. In this subsection, we examine the role of debt and the effect that its use has on value and investor risk and expected return.

## **Financial Leverage and Value**

The financial economics literature concerning the impact of firm financing decisions on the value of the firm is voluminous. In their seminal analysis, Miller and Modigliani (1961) show that, under the assumption of a perfect capital market, the choice of capital (debt or equity) used to finance a firm (or real estate project) has no impact on the value of the firm (or real estate project). To see this, consider two identical real estate properties. Property U is financed with all equity (i.e. unlevered) and Property L is financed with 90 percent debt and 10 percent equity (i.e. levered). The “law of one price” mandates that the underlying values of U and L must be equal since both properties are identical (and produce the same cash flows). This is made clear by realizing that an investor in the unlevered property can reproduce the same expected return as an investor in the levered property by simply borrowing 90 percent of his investment funds on his personal account to purchase the unlevered property – in effect, recreating the levered position. This being the case, there is no value added by debt in place. A different way of arriving at the same result is to recognize that the underlying risk of the investment is not changed by the source of the investment funds. Thus capitalization and discount rates are not affected by the mix of debt and equity. This proposition has been codified in finance as the “separation principle” – that a firm’s market value is independent of the management’s financing decision.

## **Financial Leverage and Investment Performance**

Though a property’s market value is unaffected by the financing decision, that decision does affect investment performance to the individual investor. As with any investment, an investor’s expected return on a real estate investment is the expected future cash flow divided by the capital used to acquire the property. For example, assume a property can be purchased for \$1 million and it is expected to produce \$100,000 in rental cash flow next year and then be sold for \$1 million. Assuming the investor’s equity investment is \$1 million, the simple one-year holding period return for this investment is 10 percent. Now, assume that the investor can borrow 50 percent of the purchase price using a simple one-year interest-only mortgage with an interest rate of 8 percent. Under this mortgage, the borrower receives \$500,000 in debt capital and commits to an interest payment at the

end of the year of \$40,000 plus the return of the principal amount. At the end of the year, the investor receives a net rental cash flow of \$60,000 (\$100,000 less the interest payment of \$40,000) plus expected sales proceeds less the mortgage principal payment (\$1 million less \$500,000). Thus, the investor's equity return is now 12 percent (\$560,000 divided into \$500,000). If our investor were able to borrow 90 percent of the purchase price (under the same terms as before), then the equity return would increase to 28 percent.

Since we discussed in the previous section that the Miller and Modigliani (1961) separation principle holds that the firm's capital structure has no impact on the fundamental value of the firm, the second M&M principle is that the expected return on equity is a function of the firm's debt/equity ratio and the spread between the cost of debt and the fundamental asset return. Relating this concept to value, as the proportion of debt increases the expected return to equity also increases. This results in a capitalization rate (the weighted average cost of capital) that remains unchanged. As a result, value remains unchanged, which is consistent with our earlier discussion.

Furthermore, the previous example illustrates a number of basic principles of financial leverage. First, the example was constructed such that the use of debt generated positive leverage. That is, as the amount of debt increased, the expected return for the equity investor increased. Positive leverage occurs when the property level expected return is greater than the cost of debt. In the previous example, the property had an expected return of 10 percent while debt cost 8 percent – generating positive leverage. As long as positive leverage exists, greater use of debt will increase the expected return on equity. In contrast, negative leverage occurs when the cost of debt is greater than the property return and any use of debt will reduce the equity investor's expected return.

Since there is no free lunch, the second principal associated with leverage is that greater leverage increases the risk to the investor by increasing the volatility of expected returns. To see this, note from the previous example that the debt payment has a senior claim on the property cash flow (both operating as well as capital return). Now assume that the



property rental cash flow falls to \$50,000 due to an unexpected tenant vacancy (or expense). The investor is still required to make the interest payment of \$40,000, leaving only \$10,000. As a result, the equity investor's expected return falls to 2 percent. In contrast, the overall property return is 5 percent. However, in all likelihood, the property's expected sale price will also decline with the fall in rental cash flow. Thus, if we assume that the expected sales price declines to \$800,000, then the investor's expected return drops to -38 percent since he is required to pay back the \$500,000 mortgage principal first, leaving only \$300,000 for the equity investor.

The purpose of this example is to show that leverage has positive as well as negative implications for investors. Using leverage can greatly increase the expected equity returns. However, this increase in expected returns comes at the cost of increasing the volatility associated with those returns, and at the extreme the costs of financial distress.

### **Financial Leverage and the Source of Equity Returns**

As discussed above, the use of debt will alter the equity investor's expected returns and risk. The expected return on equity is a function of the underlying property return, the leverage ratio, and the spread between the cost of debt and the property return. However, leverage also alters the source of the equity investor's return. In other words, leverage changes the percentages of the equity return that come from operations and capital gain.

To demonstrate this effect, assume that an investment costs \$1,000 and will produce net operating income of \$50 at the end of the year. We expect the property to be sold for \$1,100 at the end of the year. Thus, our hypothetical investment has a total expected return of 15 percent (5 percent operating return plus 10 percent capital appreciation). Now introduce a 50 percent debt-asset ratio with the cost of debt at 8 percent. The expected return to the equity investor increases to 22 percent (\$10 in cash flow plus \$100 in capital appreciation divided by the \$500 capital investment). However, the expected operating return has declined to 2 percent while the expected capital gain has increased to 20 percent. Thus, the use of leverage has reduced the equity investor's operating return and increased his expected return from the capital appreciation. To the extent that our tax

code favors income from capital gains (the capital gains tax rate is lower than the ordinary income tax rate), the tax code provides an additional incentive for the equity investor to use leverage to shift the source of his return from operating income to capital appreciation. Again, this shift (and the attendant increase in expected return) is not accomplished without increasing the financial risk associated with the use of debt.

## **7. Conclusion**

Real estate is a significant component of the wealth and economy of the United States, accounting for approximately 20% of the U.S. Gross Domestic Product. The commercial real estate sector alone accounts for about 6% of U.S. economic activity. Given the size and importance of real estate investment, the National Association of Real Estate Investment Trusts (NAREIT) commissioned this paper to provide an overview of the commercial real estate industry, including that sector of the industry that owns and operates portfolios of investment property.

An overriding theme is that real estate is an asset class with unique characteristics that differentiate it from other asset classes and that distinguish the real estate industry from other economic activities such as manufacturing and the financial sector. These differences emerged in the sections discussing real estate economics, the interactions between the space and asset markets, the role of real estate investments within the broader portfolio context, the concepts of real estate leases, the property development process, and the role of debt in real estate investment.

In addition to the differences between real estate and the other asset classes, one important consistency is that, because real estate competes in the broader capital markets, analysts use the same tools to estimate real estate values as with other assets. In particular, values are based on forecasts of future cash flows discounted back to the present at a rate of return that reflects the underlying risk associated with those cash flows. This process is standard regardless of whether the asset in question is real estate, a bond, or a piece of equipment. Furthermore, the process is relied upon by lenders in loan underwriting, by investors in determining expected returns, and security analysts when calculating net asset values (NAVs) of REITs. Among the key conclusions of the paper are that value is driven by the expected cash flows from the property, that value can not be reliably estimated based on either leases in place or the cost of building components, and that the market value estimating techniques used in real estate are consistent with the GAAP 'fair value' definition.



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## **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

## REAL ESTATE

### REITs

## SECTOR VIEW

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We, Ross L. Smotrich and Jeffrey S. Langbaum, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

## 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 rolled 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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Investors should consider this report as only a single factor in making their investment decision.

April 01, 2009

**PLEASE SEE IMPORTANT DISCLOSURES BEGINNING ON PAGE 89**

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**Table of Contents**

---

Executive Summary.....	5
What Is the Focus of this Primer? .....	6
A REIT Defined.....	8
Real Estate Investment Trusts.....	8
<u>Part One: A REIT Defined</u> .....	14
Internal versus External Management .....	15
UPREITs and DownREITs.....	16
<i>REIT Advantages</i> .....	17
<i>Total Return Vehicle</i> .....	17
<i>Funding Growth</i> .....	18
Dividends/Current Income .....	22
Commercial Real Estate Performance.....	23
Low Correlation with Other Indices .....	23
Long-Term Performance .....	23
<u>Part Two: History</u> .....	28
<u>Part Three: Fundamental Overview</u> .....	36
<u>Part Four: Stock Analysis and Valuation</u> .....	62
<u>Part Five: Indices and Exchange-Traded Funds</u> .....	74
<u>Part Six: Current and Future Trends</u> .....	80
<u>Part Seven: Glossary of REIT Terms</u> .....	86

## Table of Figures

Figure 1: UPREIT Structure .....	16
Figure 2: Types of U.S. Listed REITs by Equity Market Capitalization, as of 12/31/08 .....	19
Figure 3: Listed U.S. REITs by Property Type (based on equity market capitalization), 12/31/08 .....	19
Figure 4: Largest Companies by Sector, as of December 31, 2008 .....	19
Figure 5: Number of Companies in FTSE NAREIT Composite Index, 1971–2008 .....	20
Figure 6: Growth of Market Cap for FTSE NAREIT Composite Index, 1971–2008 (\$ in billions) .....	21
Figure 7: REITs in the S&P Indices .....	22
Figure 8: REIT Dividends versus S&P 500 Dividends, December 1995–February 2009 .....	22
Figure 9: REIT Correlation with Other indices .....	23
Figure 10: Five-Year REIT Performance versus Major Indices, February 2004–February 2009 .....	24
Figure 11: 15-Year REIT Performance versus Major Indices, October 1992–February 2009 .....	24
Figure 12: Fund Flows, January 1998–February 2009 (\$ in billions) .....	25
Figure 13: Timeline of REIT History versus Sector Stock Performance, January 1972–February 2009 .....	28
Figure 14: REIT IPO Boom of 1993–96 .....	31
Figure 15: Employment Growth and Household Formation, 1976–2008 .....	38
Figure 16: U.S. Job Growth, 2000–10E (in 000s) .....	38
Figure 17: Annual Job Growth (000s) versus Apartment Revenue/NOI Growth .....	39
Figure 18: Rent versus Buy Spread, 1995–2008 .....	40
Figure 19: Rental Growth (through 2014E) .....	42
Figure 20: Completions and Absorptions (through 2014E) .....	42
Figure 21: Sales of New and Existing Single-family Homes — 1968–2008 (annual rate, in 000s) .....	43
Figure 22: Average Rate for Single-Family Mortgage Loans — Monthly Basis, 1989–2009 .....	43
Figure 23: Industrial Market Completions, 1980–2014E .....	44
Figure 24: U.S. Industrial Market Completions versus Inventory, 1980–2014E .....	45
Figure 25: World GDP, U.S. GDP, Global Trade Growth, 2001–2010E .....	45
Figure 26: ISM Manufacturing and Non-Manufacturing Indices, July 1997–February 2009 .....	46
Figure 27: U.S. Industrial Absorption — Forward Projections, 1991–2014E .....	46
Figure 28: U.S. Industrial Occupancy, 1990–2014E .....	47
Figure 29: U.S. Industrial Rent Change, 1990–2014E .....	47
Figure 30: U.S. White Collar Job Growth, 1991–2014E .....	49
Figure 31: U.S. Office Absorption, 1991–2014E .....	49

Figure 32: U.S. Office Completions, 1980–2014E .....	50
Figure 33: U.S. Office Occupancy, 1989–2014E .....	51
Figure 34: U.S. Effective Rent Change, 1989–2014E .....	51
Figure 35: Shopping Centers – Shopping Center Formats .....	52
Figure 36: New Construction — Less than 800,000 sq. ft. (in millions of sq. ft.) .....	53
Figure 37: Regional Mall Deliveries (in thousands of sq. ft.) .....	54
Figure 38: Consumer Confidence, 1995–2009 .....	56
Figure 39: Real Personal Consumption Expenditures, 1995–2009 .....	56
Figure 40: U.S. Retail Sales Losing Share in Real Personal Consumption Expenditures .....	57
Figure 41: Effective Rent of Shopping Centers, 1990–2012E .....	58
Figure 42: REIT Historical Forward Multiples — Overall Average, 1996–2009 Year-to-Date .....	63
Figure 43: REIT Historical Sector P/FFO Forward Multiples, 1998–2009 .....	64
Figure 44: Example of a REIT NAV Calculation (Mack-Cali Realty) .....	66
Figure 45: REIT Dividends versus S&P Dividends versus 10-Year Treasury Yield .....	67
Figure 46: Simon Property Group — Capital Structure, as of 12/31/2008 (\$ in millions) .....	71
Figure 47: REIT Indices Comparison .....	76
Figure 48: Real Estate ETFs .....	76
Figure 49: Unprecedented U.S. REIT Volatility – 13 Years of Daily RMZ Returns .....	77
Figure 50: Global Proliferation of REIT and REIT-Like Structures .....	83
Figure 51: REIT Stocks Under Coverage .....	84

## **Executive Summary**

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## Executive Summary

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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 passthrough 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 passthrough 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 macro-economic 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

relatively stable due to closely correlated supply and demand, largely attributed to the short development cycle.

- **Retail (Regional Malls and Shopping Centers).** Near term, the retail sector is driven less by the consumer and more by retailer exposure. Longer-term fluctuations in consumer spending, consumer confidence, and, in turn, retail sales affect that balance.

### *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 take into account 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.

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*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.

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**Part One: A REIT Defined**

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## Part One: A REIT Defined

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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 larger-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.

### *REIT Structure*

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.

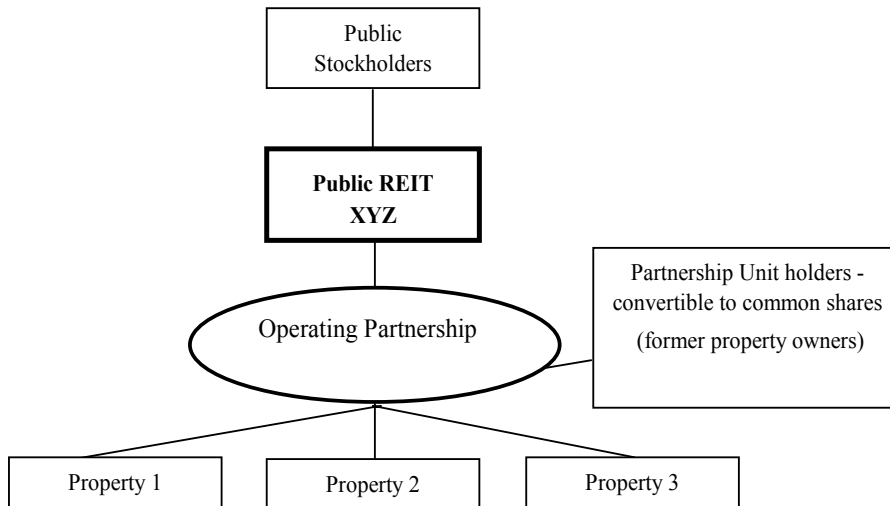
Compensation of the external manager, on the other hand, is an issue that is commonly debated. The compensation structure of an external management agreement resembles that of what is typically seen in the private equity or hedge fund world. The main components consist of a base fee (normally approximately 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



Source: Barclays Capital

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.

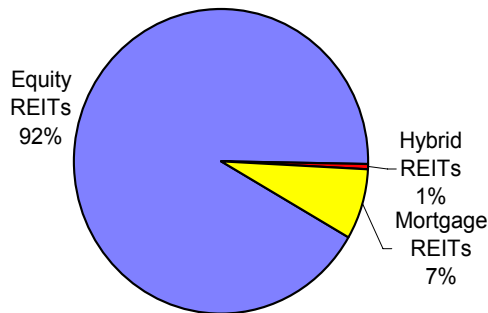
Alternatively, a REIT can expand its earnings platform by forming joint ventures (JVs) with other investors, acquiring private equity capital. In a typical joint venture, an outside source provides a portion of the capital to fund a specific project, and the REIT uses its management and other resources 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.

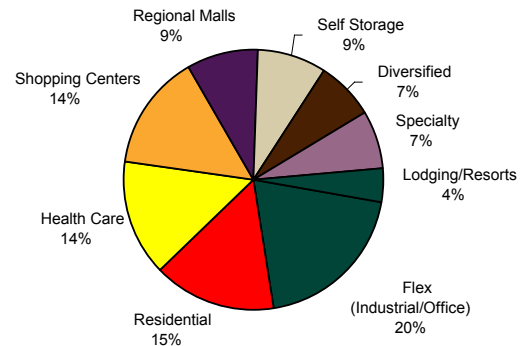
Equity REITs are typically classified by the types of properties owned. The NAREIT Index is segmented by property types, including office, residential (apartments), shopping centers, and regional malls. In Figure 2, we list the property types by market capitalization and type, and in Figure 4, we list the largest companies by sector.

Figure 2: Types of U.S. Listed REITs by Equity Market Capitalization, as of 12/31/08



Source: NAREIT

Figure 3: Listed U.S. REITs by Property Type (based on equity market capitalization), 12/31/08



Source: NAREIT

Figure 4: Largest Companies by Sector, as of December 31, 2008

<b>RESIDENTIAL SECTOR</b>			<b>DIVERSIFIED</b>		
	<b>Ticker</b>	<b>Total Equity Market Cap (millions)</b>		<b>Ticker</b>	<b>Total Equity Market Cap (millions)</b>
<b>APARTMENTS</b>					
Equity Residential	EQR	\$ 8,037.82	Vornado Realty Trust	VNO	\$ 9,269.56
AvalonBay Communities Inc.	AVB	\$ 4,662.96	Washington Real Estate Investment Trust	WRE	\$ 1,482.61
Essex Property Trust Inc.	ESS	\$ 2,056.52			
UDR Inc.	UDR	\$ 1,877.93	<b>HEALTHCARE</b>		
Camden Property Trust	CPT	\$ 1,665.74	HCP Inc.	HCP	\$ 7,016.16
BRE Properties Inc.	BRE	\$ 1,426.46	Ventas Inc.	VTR	\$ 4,796.40
Home Properties Inc.	HME	\$ 1,310.66	Health Care REIT Inc.	HCN	\$ 4,365.75
Apartment Investment & Management	AIV	\$ 1,169.45	Nationwide Health Properties Inc.	NHP	\$ 2,853.31
Mid-America Apartment Communities	MAA	\$ 1,047.59	Senior Housing Properties Trust	SNH	\$ 2,051.64
<b>COMMERCIAL SECTOR</b>			<b>RETAIL SECTOR</b>		
<b>OFFICE</b>			<b>SHOPPING CENTERS</b>		
Boston Properties Inc.	BXP	\$ 6,644.27	Kimco Realty Corp.	KIM	\$ 4,867.68
Alexandria Real Estate Equities Inc.	ARE	\$ 1,944.65	Federal Realty Investment Trust	FRT	\$ 3,649.59
Highwoods Properties Inc.	HIW	\$ 1,737.96	Regency Centers Corp.	REG	\$ 3,251.00
Mack-Cali Realty Corp.	CLI	\$ 1,608.79	Realty Income Corp.	O	\$ 2,413.81
Corporate Office Properties Trust	OFC	\$ 1,583.95	Weingarten Realty Investors	WRI	\$ 1,801.34
Douglas Emmett Inc.	DEI	\$ 1,583.94	Equity One Inc.	EQY	\$ 1,357.08
SL Green Realty Corp.	SLG	\$ 1,477.42	National Retail Properties Inc.	NNN	\$ 1,347.21
Kilroy Realty Corp.	KRC	\$ 1,107.09	Alexander's Inc.	ALX	\$ 1,295.04
Franklin Street Properties Corp.	FSP	\$ 1,043.80	Tanger Factory Outlet Centers Inc.	SKT	\$ 1,189.60
<b>INDUSTRIAL</b>			<b>REGIONAL MALLS</b>		
ProLogis	PLD	\$ 3,689.99	Simon Property Group Inc.	SPG	\$ 11,996.86
AMB Property Corp.	AMB	\$ 2,292.76	Macerich Co.	MAC	\$ 1,382.20
<b>FLEX - OFFICE/INDUSTRIAL</b>			<b>Taubman Centers Inc.</b>		
Liberty Property Trust	LRY	\$ 2,240.94	TCO	\$ 1,347.02	
Duke Realty Corp.	DRE	\$ 1,615.12	<b>STORAGE</b>		
			Public Storage	PSA	\$ 13,528.86

Source: SNL, Barclays Capital

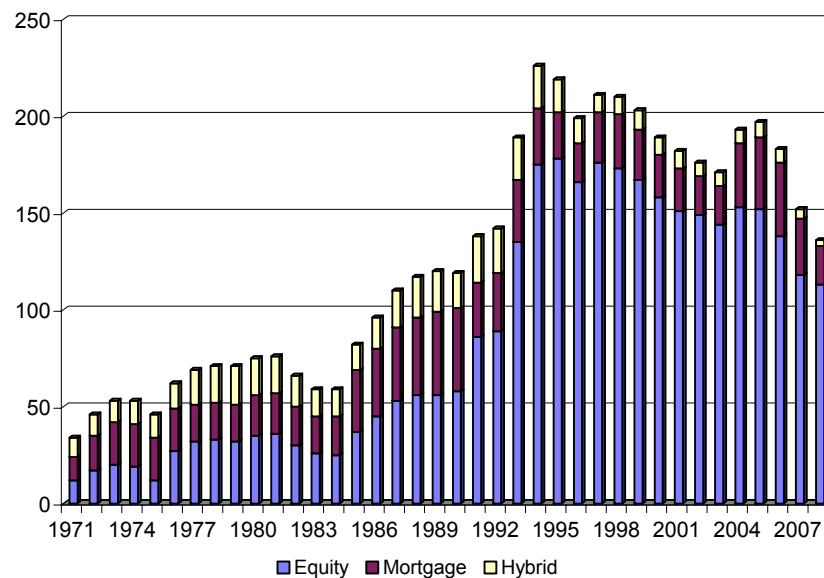
There are two types of mortgage REITs, commercial and residential. Commercial mortgage REITs invest primarily in loans and securities backed by commercial properties. The companies typically run a matched book of assets and liabilities, with the focus on credit risk management, as opposed to interest 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.

### *Rapid Growth*

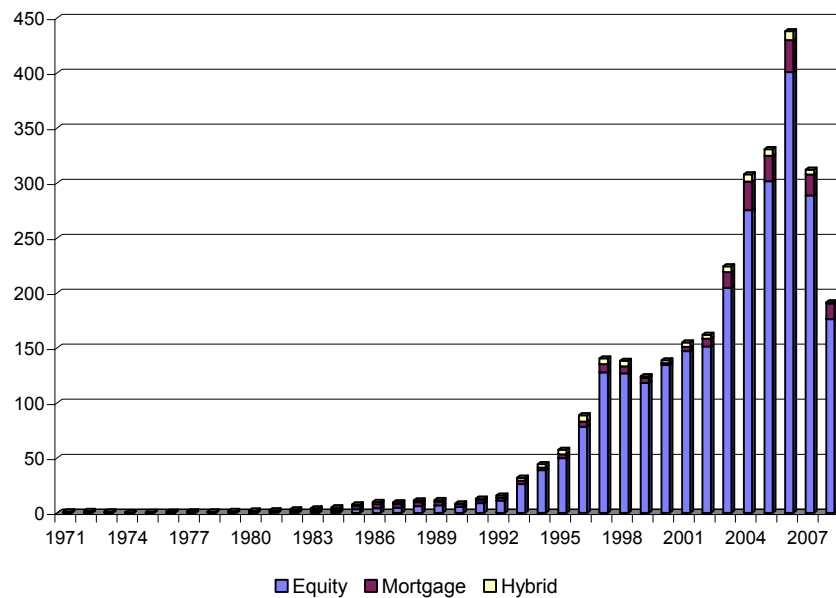
As of December, 2008, 136 public REITs with an aggregate equity market capitalization of \$191 billion (down 56% from \$438 billion at the end of 2006) were tracked by the FTSE NAREIT Composite Index. In contrast, the aggregate market capitalization was only about \$13 billion in 1991. Meanwhile, the 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

Figure 6: Growth of Market Cap for FTSE NAREIT Composite Index, 1971–2008 (\$ in billions)



Source: NAREIT

Notwithstanding rapid growth over the last 16 years, industry experts estimate that REITs have captured only \$700 billion–\$800 billion (1.5%–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.

Figure 7: REITs in the S&amp;P Indices

S&P 500 Index			S&P 400 Mid Cap Index			S&P 600 Small Cap Index		
	% Weight in the Index		% Weight in the Index		% Weight in the Index		% Weight in the Index	
AIMCO	AIV	0.01%	Alexandria Real Estate Equity	ARE	0.32%	Acadia Realty Trust	AKR	0.13%
AvalonBay Communities	AVB	0.06%	AMB Property Corporation	AMB	0.26%	BioMed Realty Trust	BMR	0.32%
Boston Properties	BXP	0.07%	BRE Properties, Inc.	BRE	0.22%	Colonial Properties Trust	CLP	0.13%
Equity Residential	EOR	0.08%	Camden Property Trust	CPT	0.23%	Cedar Shopping Centers	CDR	0.09%
HCP, Inc.	HCP	0.07%	Cousins Properties Incorporated	CUZ	0.07%	Diamondrock Hospitality	DRH	0.13%
Health Care REIT, Inc.	HCN	0.05%	Duke Realty Corporation	DRE	0.23%	EastGroup Properties, Inc.	EGP	0.27%
Host Hotels & Resorts	HST	0.04%	Equity One, Inc.	EQY	0.08%	Entertainment Properties Trust	EPR	0.26%
Kimco Realty Corporation	KIM	0.03%	Essex Property Trust	ESS	0.29%	Extra Space Storage	EXR	0.25%
Plum Creek Timber, Inc.	PCL	0.07%	Federal Realty Investment Trust	FRT	0.49%	Franklin Street Properties Corp.	FSP	0.25%
ProLogis	PLD	0.03%	Highwoods Properties, Inc.	HIW	0.24%	Home Properties	HME	0.41%
Public Storage, Inc.	PSA	0.10%	Hospitality Properties Trust	HPT	0.21%	Inland Real Estate Corporation	IRC	0.20%
Simon Property Group	SPG	0.13%	Liberty Property Trust	LRY	0.32%	Kilroy Realty Corporation	KRC	0.26%
Vornado Realty Trust	VNO	0.07%	Macerich	MAC	0.18%	Kite Realty Group Trust	KRG	0.06%
Total		0.81%	Mack-Cali Realty Corporation	CLI	0.22%	LaSalle Hotel Properties	LHO	0.13%
			Nationwide Health Properties	NHP	0.41%	Lexington Realty Trust	LXP	0.12%
			Potlatch Corporation	PCH	0.16%	LTC Properties, Inc.	LTC	0.17%
			Rayonier	RYN	0.38%	Medical Properties Trust	MPW	0.12%
			Realty Income Corporation	O	0.33%	Mid-America Apartment Communities, Inc.	MAA	0.30%
			Regency Centers	REG	0.41%	National Retail Properties, Inc.	NNN	0.41%
			SL Green	SLG	0.15%	Parkway Properties	PKY	0.08%
			UDR	UDR	0.29%	Pennsylvania Real Estate Investment Trust	PEI	0.06%
			Weingarten Realty Investors	WRI	0.21%	Post Properties	PPS	0.21%
			Total		5.71%	PS Business Parks, Inc.	PSB	0.23%
						Senior Housing Properties Trust	SNH	0.66%
						Sovran Self Storage	SSS	0.20%
						Tanger Factory Outlet Centers, Inc.	SKT	0.34%
						Total		5.80%

Source: NAREIT

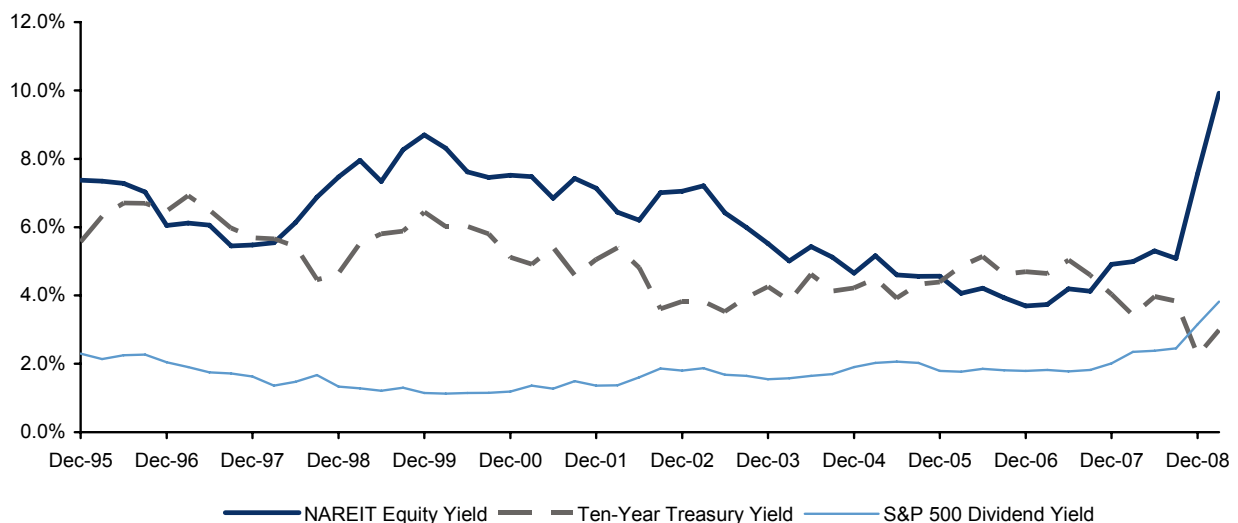
**Why REITs?**

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&amp;P 500 Dividends, December 1995–February 2009



Source: Bloomberg, NAREIT

## 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

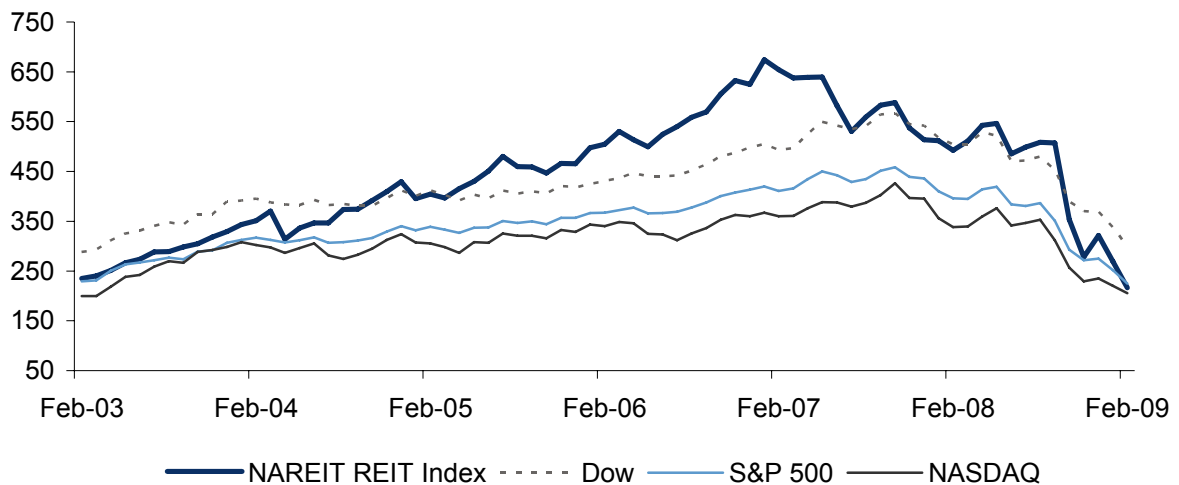
	<b>5-year</b>	<b>10-year</b>	<b>15-year</b>
S&P 500	0.84	0.57	0.43
Dow	0.78	0.52	0.48
NASDAQ	0.74	0.17	0.13

Source: Bloomberg, NAREIT, FactSet

## Long-Term Performance

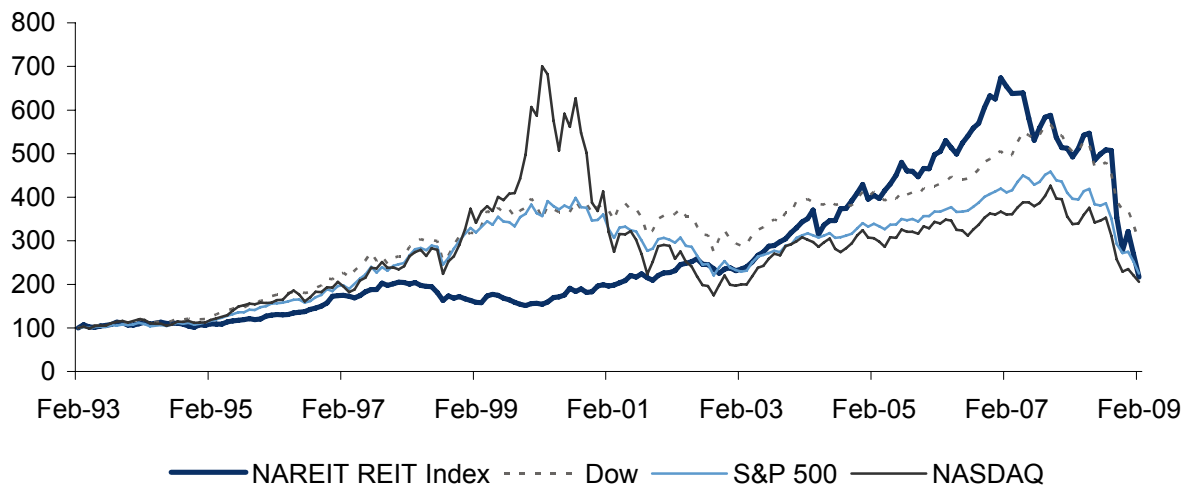
Over the three-year period ending February 28, 2009, the compound average annual total return of the FTSE NAREIT U.S. Composite REIT Index (down 33.6%) has underperformed the S&P 500 (down 16.2%, Nasdaq (down 11.8%), and the Dow Jones Industrials (17.7%). However, this underperformance appears to be 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%).

Figure 10: Five-Year REIT Performance versus Major Indices, February 2004–February 2009



Source: Bloomberg, NAREIT

Figure 11: 15-Year REIT Performance versus Major Indices, October 1992–February 2009



Source: Bloomberg, NAREIT

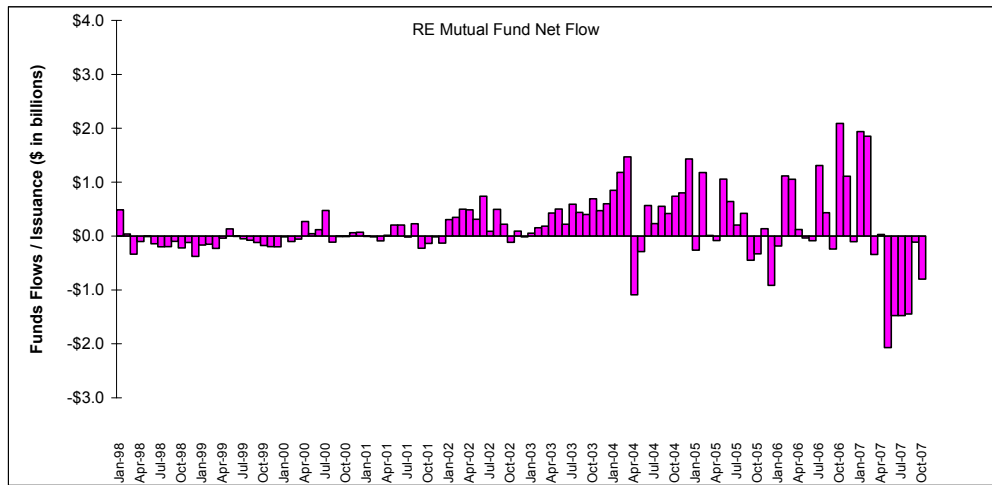
### Strong Returns Attracted Fund Flows

Notably, REITs were one of few investment alternatives where an investor could get steady double-digit returns for the 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)



Source: AMG

**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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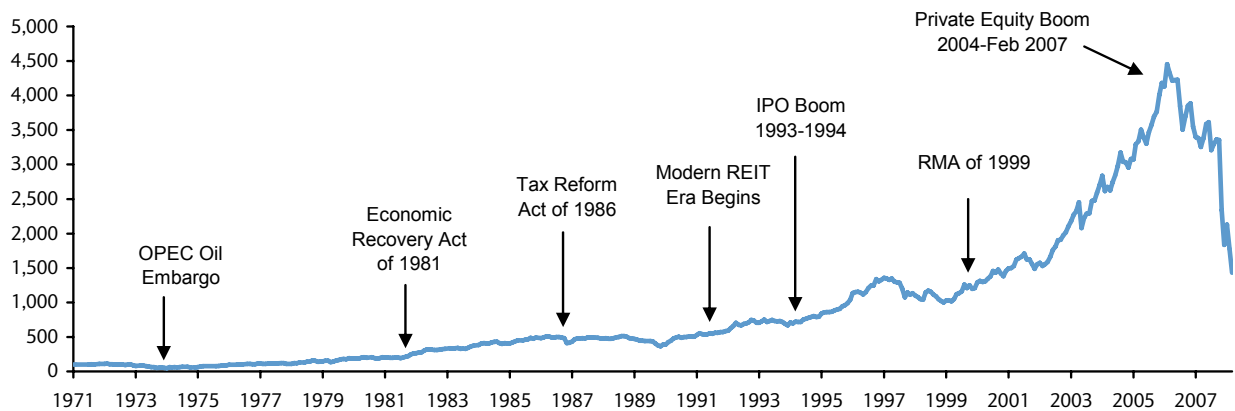
**Part Two: History**

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## 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



Source: NAREIT, Barclays Capital

### *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 to builders and investors, 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.

### *Seeds of a Downturn*

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.

### *Health Care REITs Boom*

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.

### *Recovery and Expansion*

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 average 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.

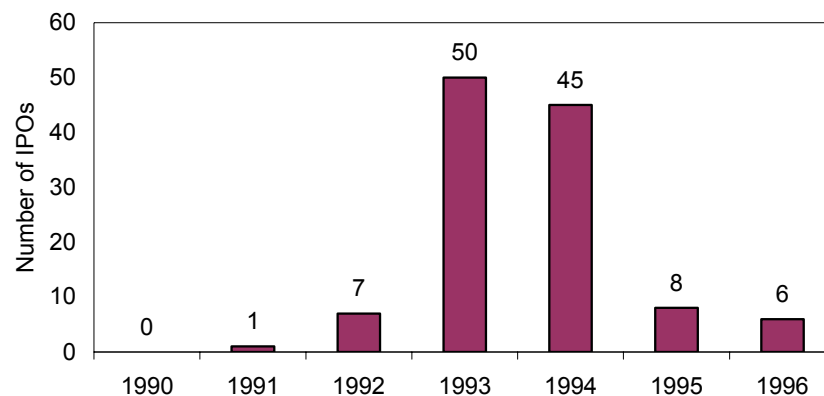
More broadly, many real estate companies were facing insolvency in the early 1990s because of a lack of capital to fund new investments. Banks had tightened their lending standards after experiencing an influx of foreclosed properties during the real estate downturn. Therefore, real estate developers 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



Source: NAREIT, Barclays Capital

### *Omnibus Budget Reconciliation Act of 1993*

Increased investor interest in REITs can further be attributed to the Omnibus Budget Reconciliation Act of 1993.<sup>1</sup> 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.

### *Modernization Act of 1999*

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<sup>2</sup> (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.

### *Jobs and Growth Tax Relief Reconciliation Act of 2003*

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

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<sup>1</sup> 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.

<sup>2</sup> 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.



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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 EOP 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 became 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**

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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 multi-family 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,

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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 multi-family 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 in-line 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.

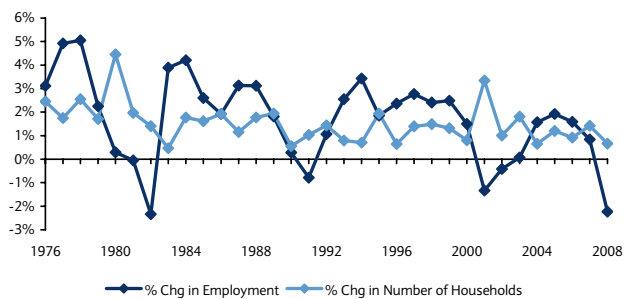
### *Multi-family REITs*

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**

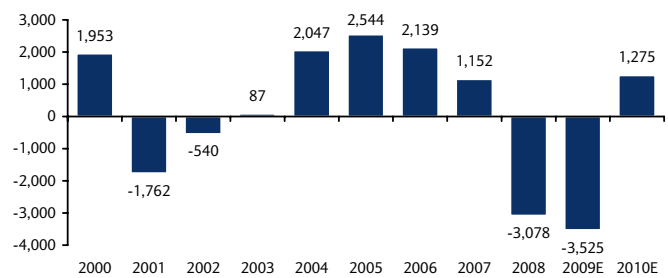
The sector's most notable driver of demand is job growth. As the economy expands, jobs are created, driving demand for housing. To illustrate, the multi-family industry decline of 2001–03 can be largely attributed to a considerable loss of jobs over that period. In contrast, one of the contributors to 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.

Figure 15: Employment Growth and Household Formation, 1976–2008



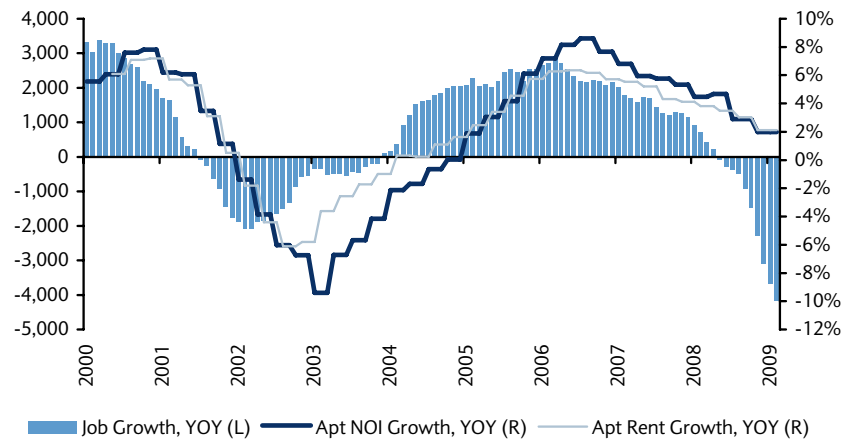
Source: BLS, U.S. Census Bureau

Figure 16: U.S. Job Growth, 2000–10E (in 000s)



Source: BLS, company documents, Barclays Capital

Figure 17: Annual Job Growth (000s) versus Apartment Revenue/NOI Growth



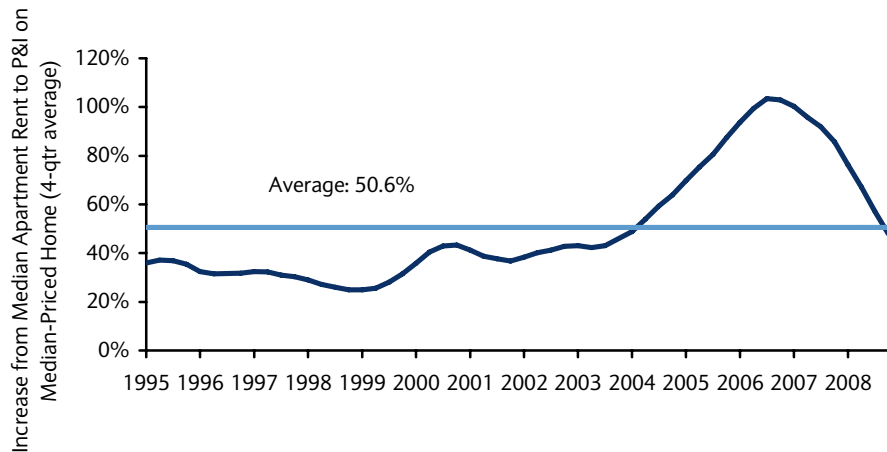
Source: Barclays Capital, BLS, company documents

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 year-end 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



Source: Witten Advisors

### 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.

Multi-family 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



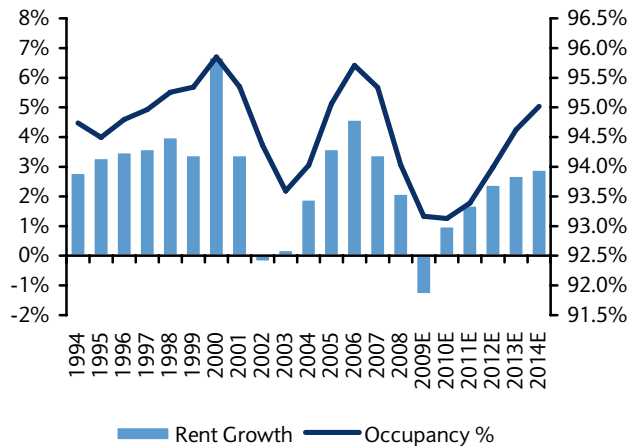
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2003 and 2006. However, many of those units are now re-entering the rental market and developments originally scheduled to be condos are being finished as rentals.

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.

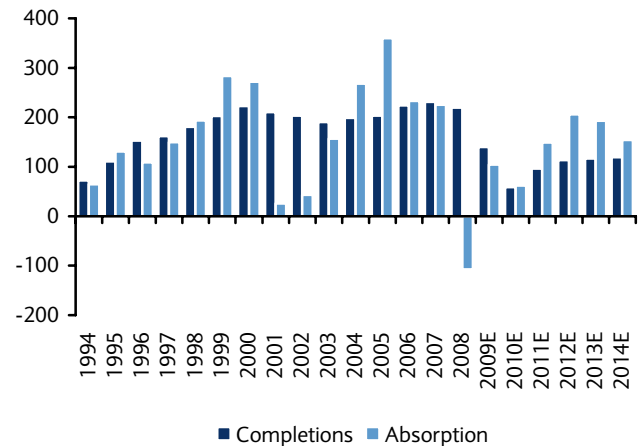
Despite favorable demographic conditions, the rapid increase in unemployment in most markets, which drove negative net absorption in 2008, is expected to be a drag on demand during 2009 and into 2010. Development pipelines and starts across the industry are shrinking, but single-family housing supply 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.

Figure 19: Rental Growth (through 2014E)



Source: CBRE Econometric Advisors, Barclays Capital

Figure 20: Completions and Absorptions (through 2014E)



Source: CBRE Econometric Advisors, Barclays Capital

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.

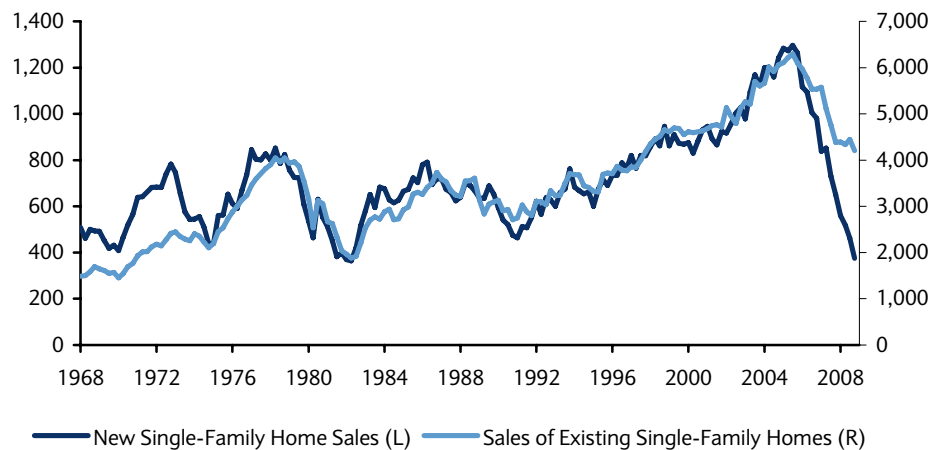
### Correlation to the Housing Market?

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.

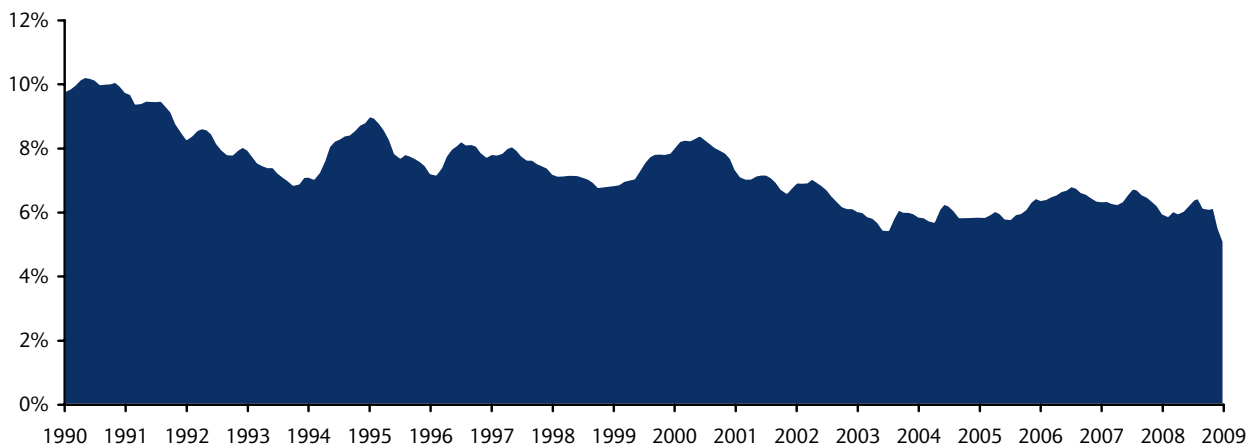
For the past year, however, the severe downturn in the for-sale housing market has coincided with deterioration in the multi-family rental market. The for-sale housing sector led the economy into recession, and supply overhang from that market has exacerbated the impact of increasing unemployment on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

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



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

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



Source: Federal Reserve Bank

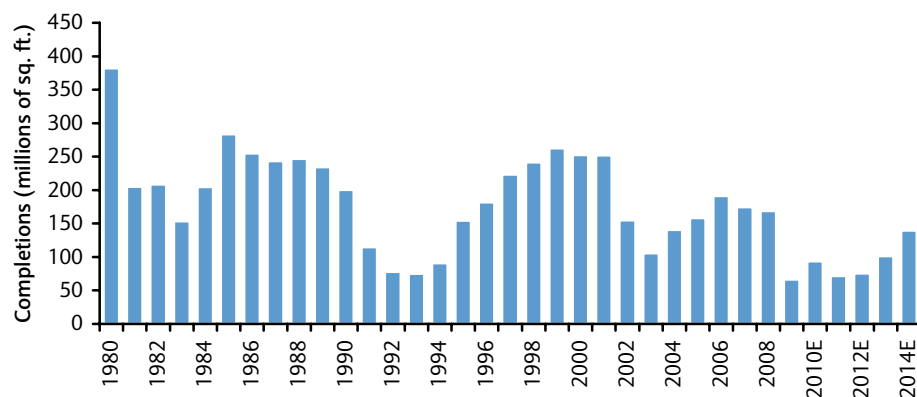
**Industrial REITs** We have historically considered the industrial sector to be relatively stable and defensive, by virtue of its traditional lease structure, short development cycle, correlation of demand with broader economic direction, and relative ease of financing. It includes distribution centers, 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

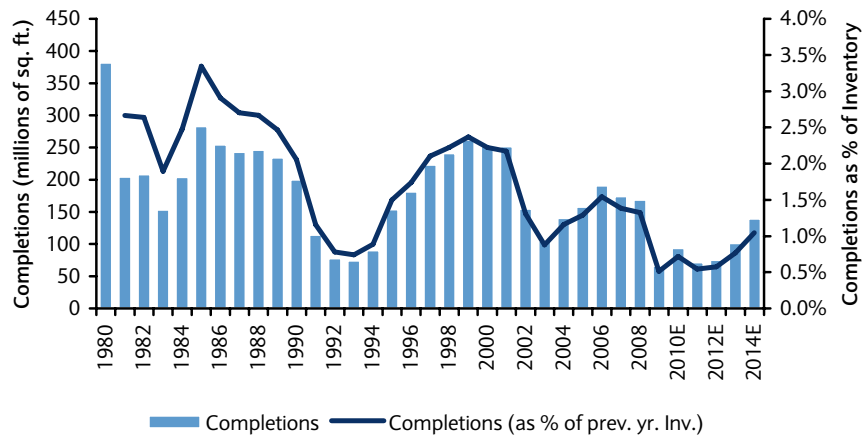
On the supply side, industrial REITs benefit from short development cycles, which tends to prevent overbuilding. Since 1992, only 2.9 billion sq. ft. were added to industrial inventories, representing a 1.5% increase annually. Construction escalated in the late 1990s as the economy was expanding at record 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

Figure 24: U.S. Industrial Market Completions versus Inventory, 1980–2014E



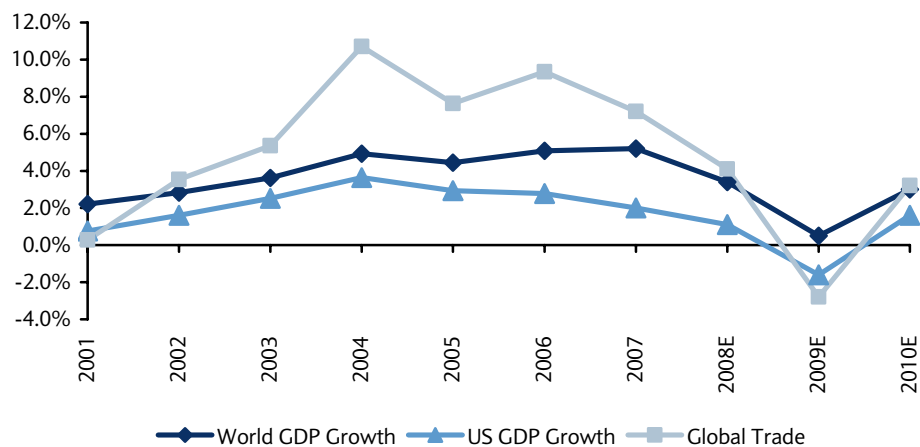
Source: CBRE Econometric Advisors

### 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.

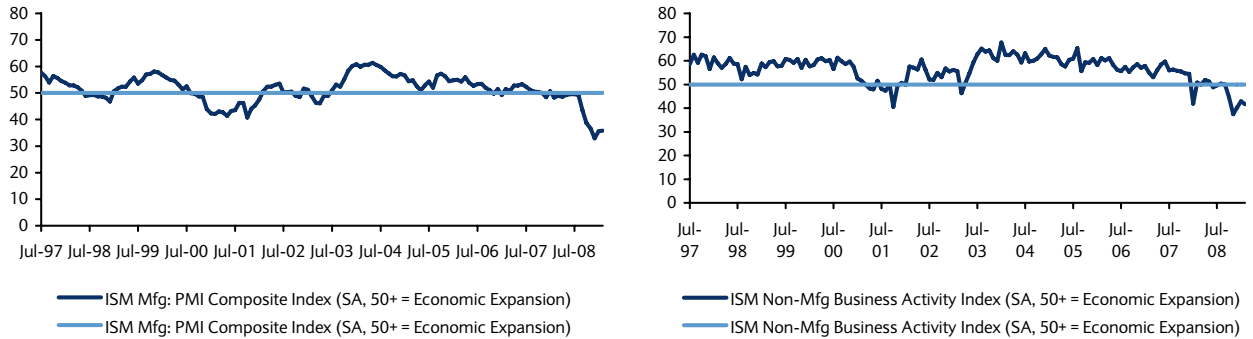
Figure 25: World GDP, U.S. GDP, Global Trade Growth, 2001–2010E



Source: International Monetary Fund, World Economic Outlook Update, January 2009

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.

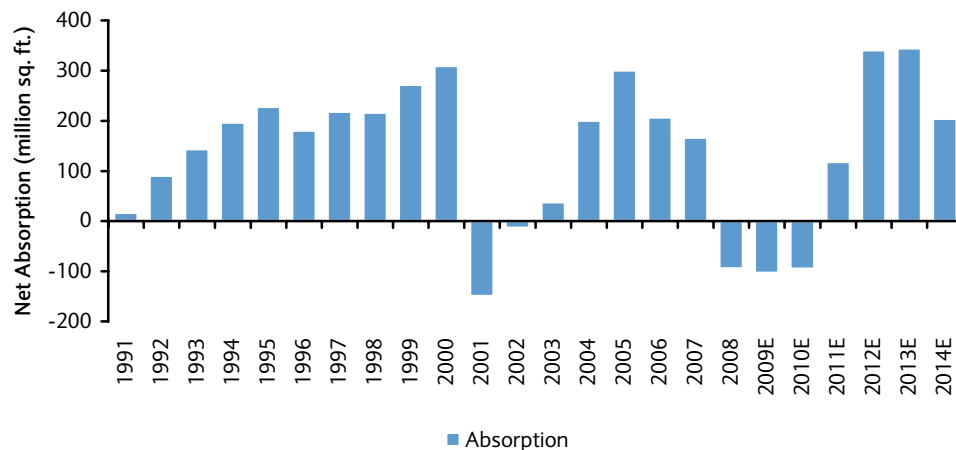
Figure 26: ISM Manufacturing and Non-Manufacturing Indices, July 1997–February 2009



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

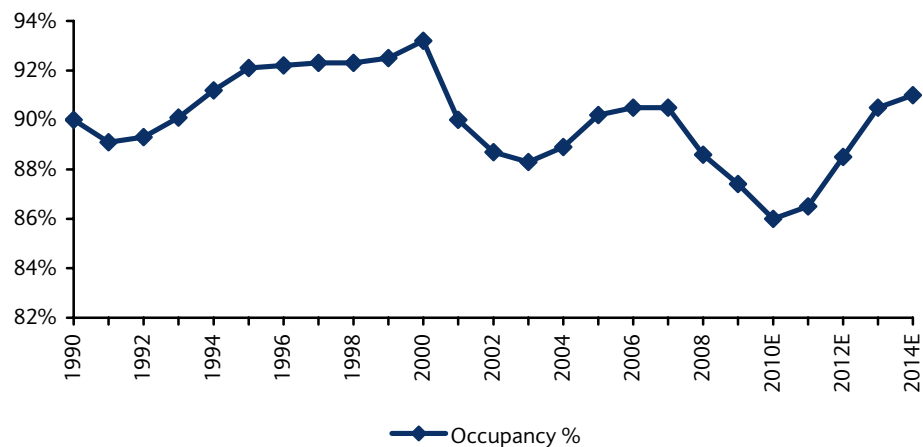


Source: CBRE Econometric Advisors

## Occupancy and Rental Rates Declining

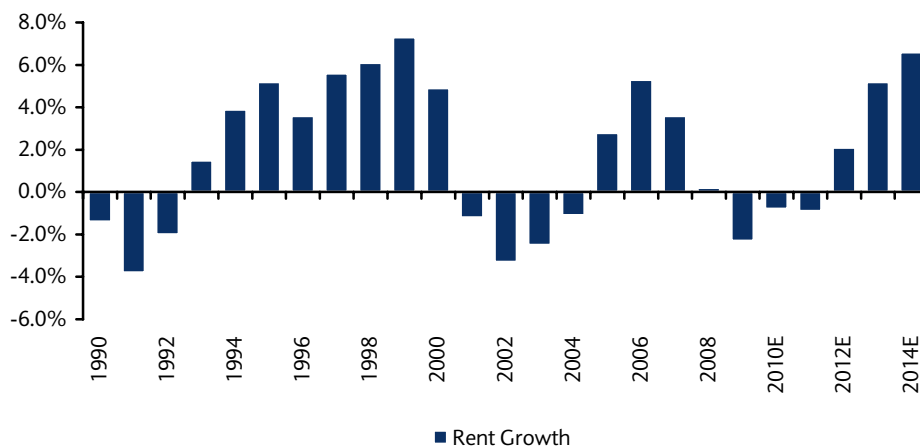
As a result of the weakening industrial demand, U.S. industrial occupancy fell to 88.6% at year-end 2008 from 90.5% at year-end 2007, the first decline since 2003. As would be expected given the expected negative absorption over the next several years, CBRE Econometric Advisors forecasts that occupancy 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.

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



Source: CBRE Econometric Advisors

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



Source: CBRE Econometric Advisors

## Scaling Back Development

During the last up-cycle (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 developers 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.

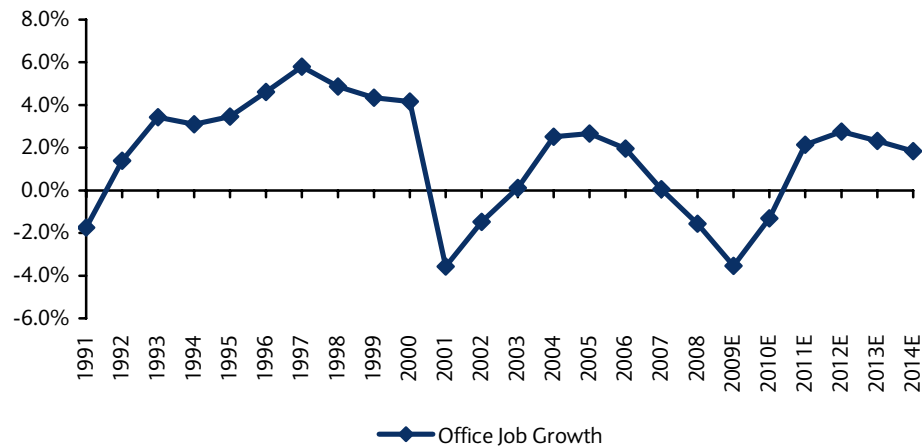
### *Office REITs.*

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 up-cycle 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 up-cycle, are expected to be among the most challenged during the downturn.

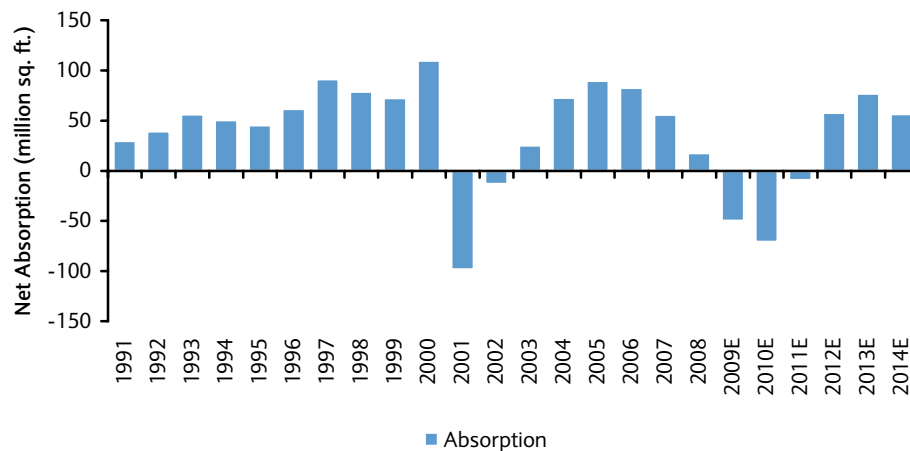


Figure 30: U.S. White Collar Job Growth, 1991–2014E



Source: CBRE Econometric Advisors

Figure 31: U.S. Office Absorption, 1991–2014E



Source: CBRE Econometric Advisors

### New Supply: Not the Problem

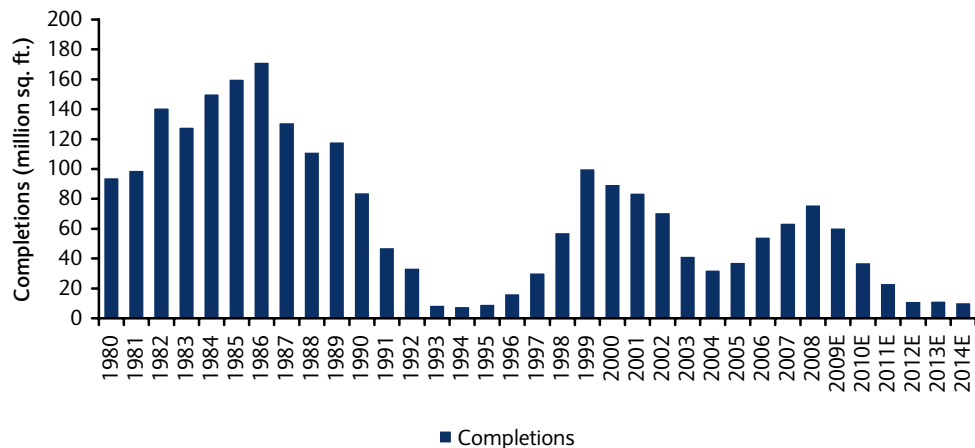
The other key driver for the sector is the amount of office space available to lease in a given market. When there is a steady demand with a balanced amount of supply, the office space is in a state of equilibrium. A spike in demand with stagnant supply will result in higher occupancy, and pricing power 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

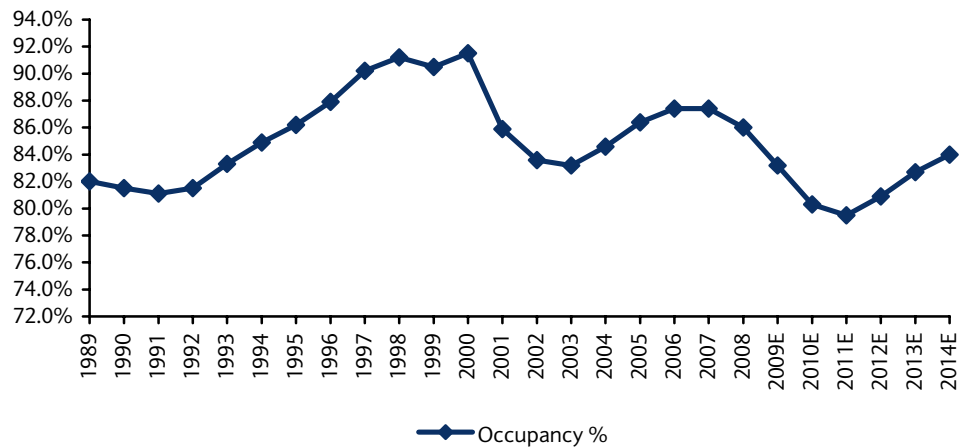


Source: CBRE Econometric Advisors

### Occupancy and Rents Falling

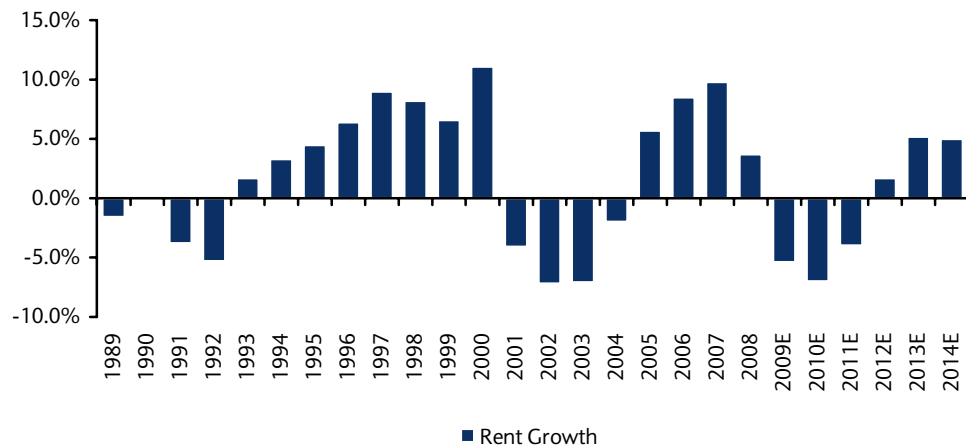
In 2008, 17.8 million sq. ft. of office space was absorbed nationwide, lagging office completions of 76.4 million sq. ft. and therefore driving occupancy down to 86.0% at year-end (a 140-basis-point decline versus 87.4% at year-end 2007; average rental rates grew 3.7% in 2008, down from 9.8% in 2007 (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%.

Figure 33: U.S. Office Occupancy, 1989–2014E



Source: CBRE Econometric Advisors

Figure 34: U.S. Effective Rent Change, 1989–2014E



Source: CBRE Econometric Advisors

### 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 Centro 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

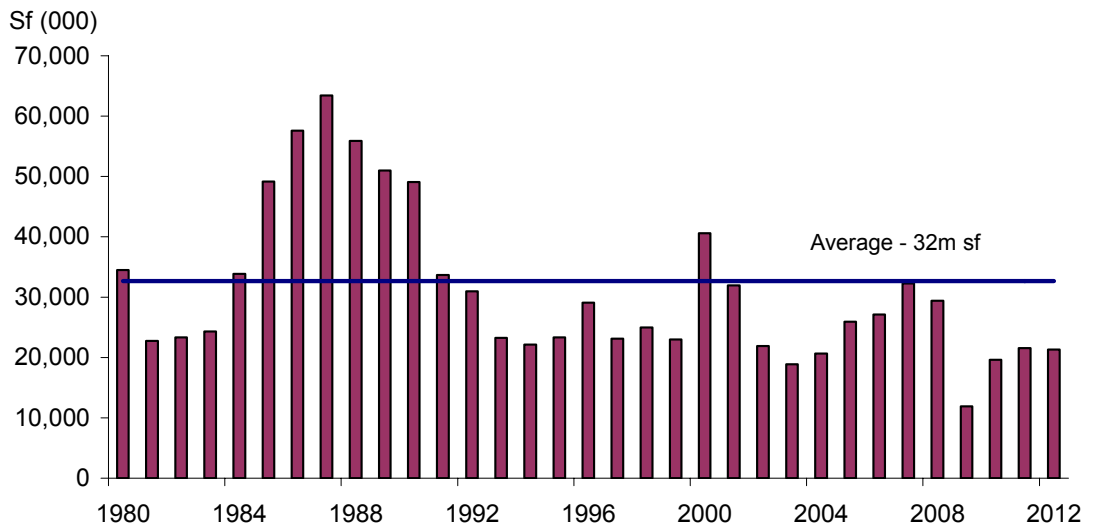
Format	Size (square feet)	Trading Radius	Number of Anchors	Typical Anchors	Economic Sensitivity
Neighborhood Shopping Center	30,000 - 150,000	3 miles	1 or more	Kroger, Publix, Albertsons, Safeway	Least sensitive
Community Shopping Center	100,000 - 350,000	3-6 miles	2	Kohl's, Home Depot, Lowe's, Wal-Mart	Sensitive
Power Center	250,000 - 600,000	5-10 miles	3 or more	Best Buy, Bed Bath & Beyond, Lowe's, Staples, Home Depot, Barnes & Noble, Toys "R" Us, Borders	More Sensitive
Main Street Retail	80,000 - 250,000	5-15 miles	none		Very Sensitive

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

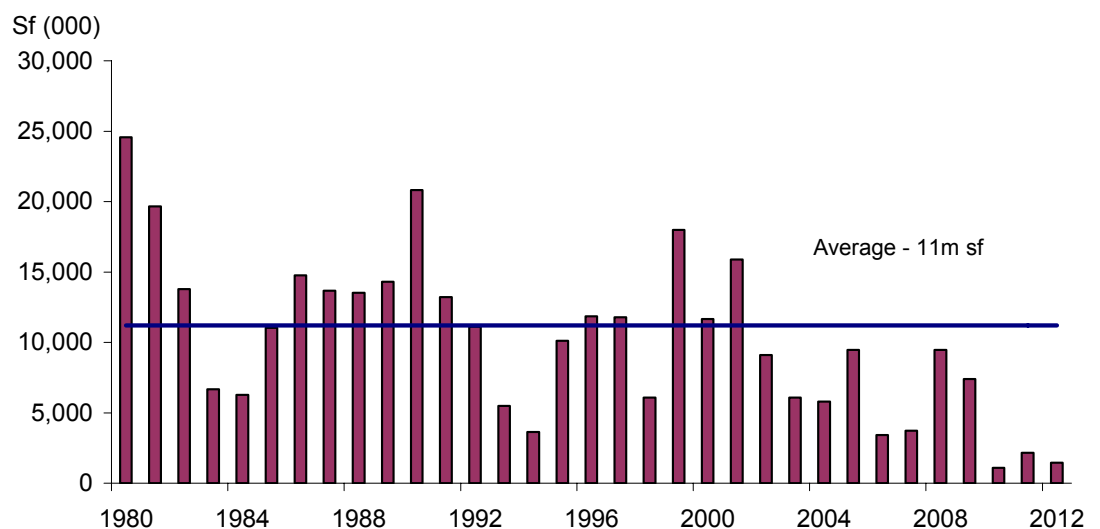
market downturn at the end of the decade. Notably, this phenomenon was not limited to retail real estate, but extended essentially to all property types.

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

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## **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.

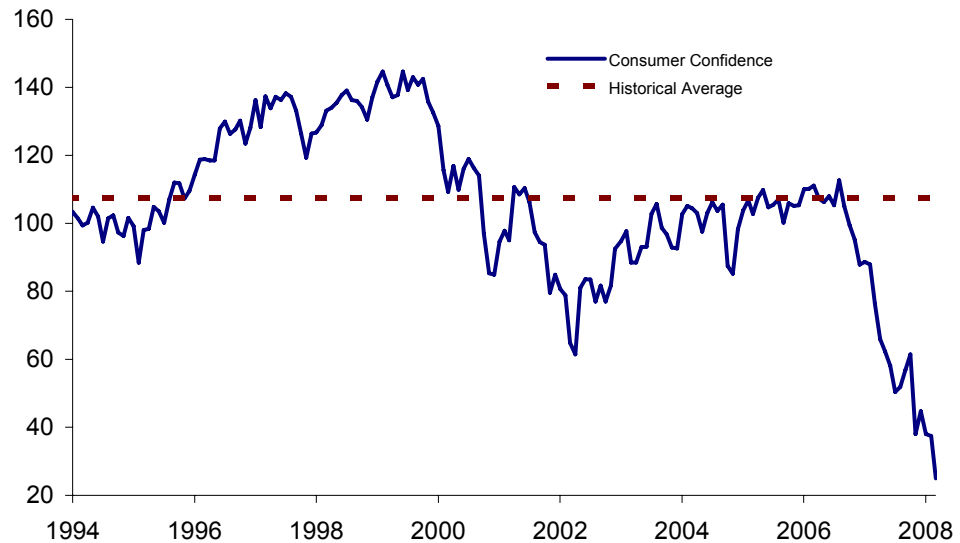
The relationship between consumer spending and the success of a particular center is intuitive. The tenant seeks out a location that will afford it the greatest sales per square foot. When consumer spending is high, average locations will generally afford the retailer a meaningful level of sales and 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 drop-off in retail spending.

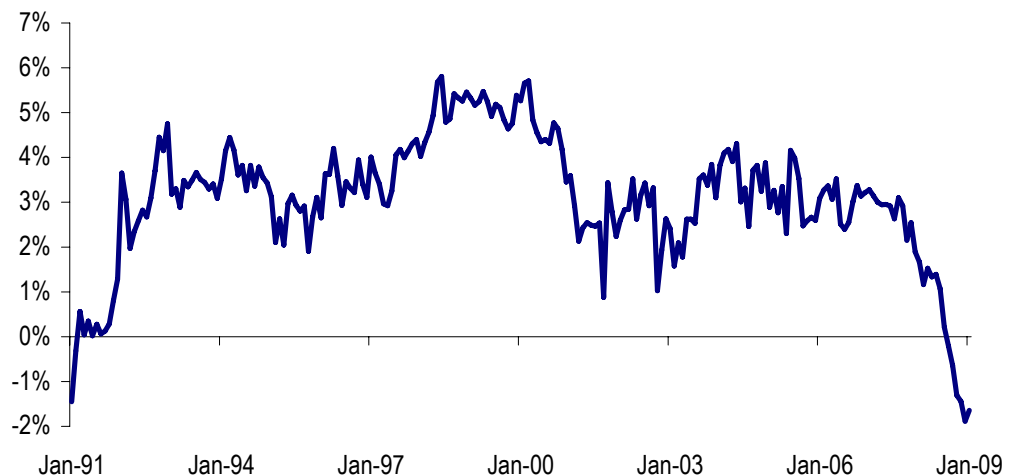
Figure 38: Consumer Confidence, 1995–2009



Source: Conference Board, Barclays Capital

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 39: Real Personal Consumption Expenditures, 1995–2009



Source: The Commerce Department, Barclays Capital



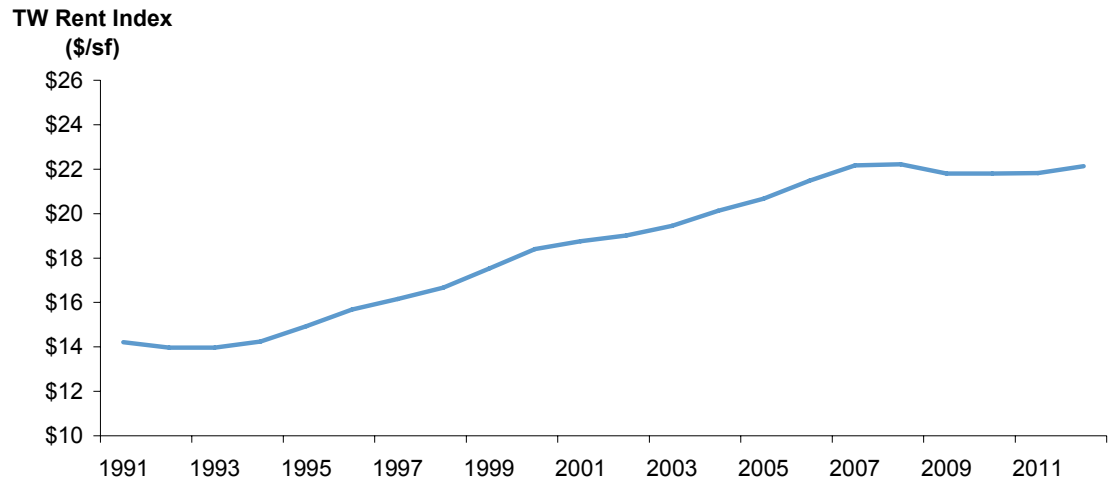
Figure 40: U.S. Retail Sales Losing Share in Real Personal Consumption Expenditures



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



Source: CBRE Econometric Advisors

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.

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## **Part Four: Stock Analysis and Valuation**

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## Part Four: Stock Analysis and Valuation

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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.

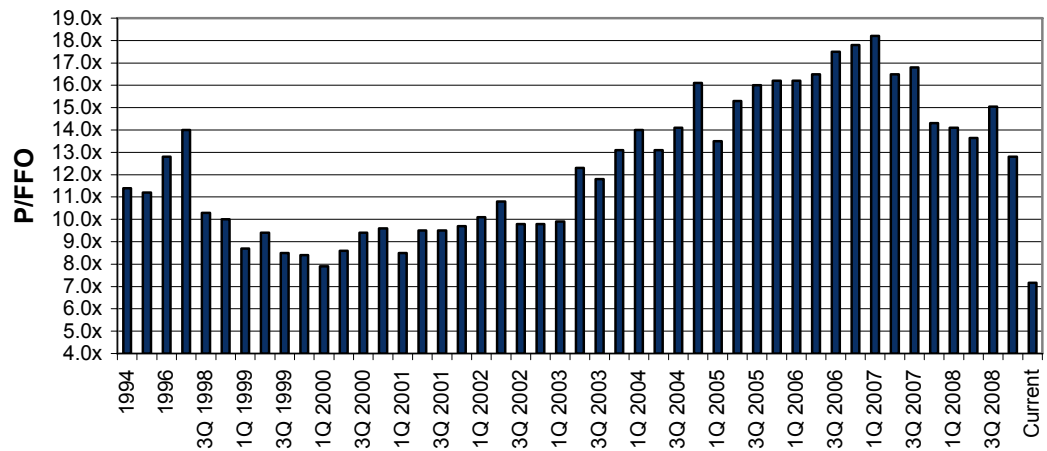
#### **1) Funds from Operations (FFO)**

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.

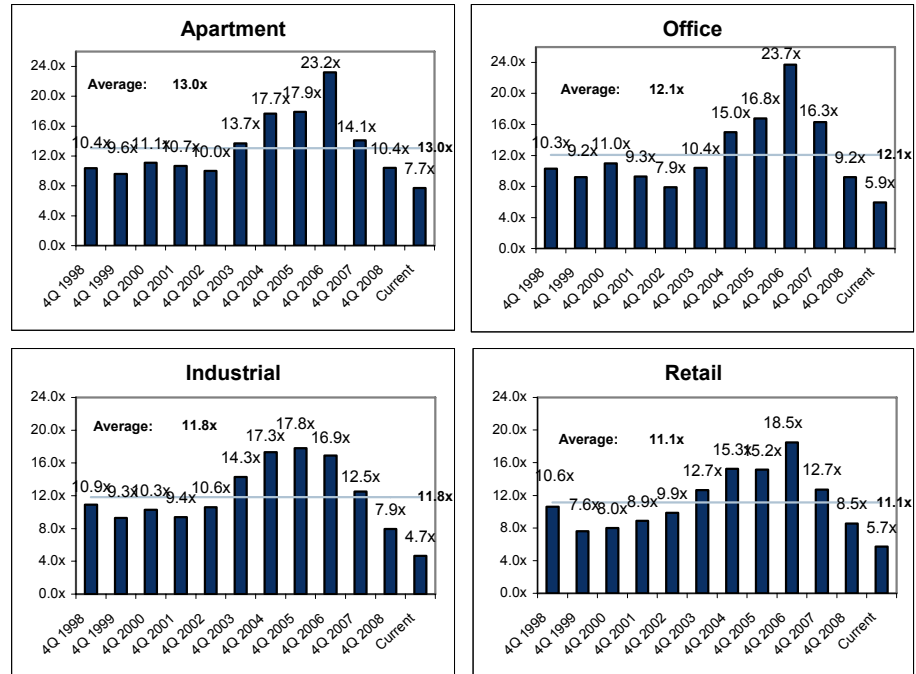
FFO is essentially an operating EPS figure eliminating the impact of real estate depreciation, which is a major noncash charge and should therefore be added back. Historically, FFO multiples have ranged from the high single digits to the high teens. Multiples reached all-time highs in early 2007 due 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

Figure 43: REIT Historical Sector P/FFO Forward Multiples, 1998–2009



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



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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.

Figure 44: Example of a REIT NAV Calculation (Mack-Cali Realty)  
(\$ in thousands, except per share data)

<b>Current Mack-Cali Realty Net Asset Value (1)</b>				
(\$ Thousands)				
	Assumed Nominal Cap Rate	Assumed Economic Cap Rate (2)	NOI Before Interest Expense	Current Value
<b>NOI Contribution from (3):</b>				
Office Properties	7.73%	6.27%	\$284,070	\$4,528,368
Off/Flex Properties	7.50%	7.50%	\$38,310	\$510,804
Industrial Properties	8.00%	8.00%	\$2,346	\$29,319
Third Party Mng't		8.33%	\$17,020	\$204,240
<b>Total NOI</b>				<b>\$5,272,731</b>
<b>Balance Sheet Items:</b>				
		% of Carrying Value (4)	B/S Value	
Cash and Cash Equivalents			34,340	34,340
Investment in Securities and Unconsolidated JVs		115%	138,495	159,269
Construction in Progress		110%	0	0
Land Held For Future Development			0	0
Other Assets			135,663	135,663
<b>Total Assets</b>				<b>\$329,272</b>
<b>Gross Market Value of Assets</b>				<b>\$5,602,003</b>
<b>Total Liabilities Outstanding</b>				
Mortgage Debt and Tax exempt debt				531,126
Line of Credit				161,000
Unsec Debt				1,533,349
Other Liabilities				259,084
Preferred				25,000
<b>Total Liabilities</b>				<b>\$2,509,560</b>
<b>Minority Interest</b>				786
<b>Net Market Value of Assets</b>				<b>\$3,091,657</b>
Common Shares & Units Outstanding				80,857
<b>Current Value Per Share</b>				<b>\$38.24</b>
<b>Valuation Measures:</b>				
Price Per Share			CLI	\$19.56
<b>Price/Current Value</b>				<b>51.2%</b>
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.				
<i>Barclays Capital estimates.</i>				

Source: Barclays Capital

#### 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

Date	NAREIT Equity Yield	S&P 500 Dividend Yield	Ten-Year Treasury Yield	Differential		Date	NAREIT Equity Yield	S&P 500 Dividend Yield	Ten-Year Treasury Yield	Differential	
				NAREIT - S&P	NAREIT - Treasury					NAREIT - S&P	NAREIT - Treasury
Dec-95	7.37%	2.30%	5.57%	5.07%	1.80%	Sep-02	7.01%	1.86%	3.61%	5.15%	3.40%
Mar-96	7.35%	2.14%	6.32%	5.21%	1.03%	Dec-02	7.05%	1.80%	3.82%	5.25%	3.23%
Jun-96	7.28%	2.25%	6.71%	5.03%	0.57%	Mar-03	7.21%	1.87%	3.82%	5.34%	3.39%
Sep-96	7.03%	2.27%	6.70%	4.76%	0.33%	Jun-03	6.42%	1.68%	3.53%	4.74%	2.89%
Dec-96	6.05%	2.04%	6.46%	4.01%	(0.41)%	Sep-03	5.99%	1.65%	3.94%	4.34%	2.05%
Mar-97	6.12%	1.91%	6.91%	4.21%	(0.79)%	Dec-03	5.52%	1.55%	4.26%	3.97%	1.26%
Jun-97	6.06%	1.75%	6.50%	4.31%	(0.44)%	Mar-04	5.01%	1.58%	3.84%	3.43%	1.17%
Sep-97	5.45%	1.71%	5.97%	3.74%	(0.52)%	Jun-04	5.43%	1.65%	4.62%	3.78%	0.82%
Dec-97	5.48%	1.63%	5.68%	3.85%	(0.20)%	Sep-04	5.12%	1.70%	4.12%	3.42%	1.00%
Mar-98	5.55%	1.36%	5.66%	4.18%	(0.12)%	Dec-04	4.66%	1.91%	4.22%	2.75%	0.44%
Jun-98	6.13%	1.48%	5.43%	4.65%	0.70%	Mar-05	5.17%	2.03%	4.48%	3.14%	0.69%
Sep-98	6.88%	1.67%	4.46%	5.21%	2.42%	Jun-05	4.60%	2.06%	3.92%	2.54%	0.69%
Dec-98	7.47%	1.34%	4.64%	6.13%	2.83%	Sep-05	4.56%	2.03%	4.33%	2.53%	0.23%
Mar-99	7.96%	1.29%	5.51%	6.67%	2.44%	Dec-05	4.57%	1.79%	4.39%	2.78%	0.18%
Jun-99	7.34%	1.22%	5.81%	6.12%	1.53%	Mar-06	4.06%	1.77%	4.85%	2.29%	(0.79)%
Sep-99	8.27%	1.30%	5.89%	6.97%	2.39%	Jun-06	4.21%	1.85%	5.14%	2.36%	(0.93)%
Dec-99	8.70%	1.14%	6.44%	7.56%	2.26%	Sep-06	3.93%	1.81%	4.63%	2.12%	(0.70)%
Mar-00	8.30%	1.13%	6.01%	7.18%	2.29%	Dec-06	3.69%	1.79%	4.70%	1.90%	(1.01)%
Jun-00	7.61%	1.14%	6.02%	6.47%	1.59%	Mar-07	3.73%	1.82%	4.65%	1.91%	(0.92)%
Sep-00	7.45%	1.15%	5.80%	6.30%	1.65%	Jun-07	4.19%	1.78%	5.03%	2.41%	(0.84)%
Dec-00	7.52%	1.19%	5.11%	6.33%	2.41%	Sep-07	4.12%	1.82%	4.59%	2.30%	(0.47)%
Mar-01	7.48%	1.36%	4.91%	6.11%	2.57%	Dec-07	4.91%	2.01%	4.03%	2.90%	0.89%
Jun-01	6.84%	1.27%	5.41%	5.57%	1.43%	Mar-08	4.99%	2.35%	3.41%	2.64%	1.58%
Sep-01	7.43%	1.49%	4.58%	5.94%	2.85%	Jun-08	5.30%	2.38%	3.97%	2.92%	1.33%
Dec-01	7.14%	1.36%	5.05%	5.79%	2.09%	Sep-08	5.09%	2.45%	3.83%	2.64%	1.26%
Mar-02	6.44%	1.37%	5.40%	5.07%	1.04%	Dec-08	7.56%	3.16%	2.25%	4.40%	5.31%
Jun-02	6.21%	1.60%	4.81%	4.61%	1.40%	Current	9.92%	3.82%	2.99%	6.10%	6.93%

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 as high a 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

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 respects to its balance sheet (VNO and SPG) also included stock as a part of its 2009 projected dividends.

## *Qualitative Considerations*

### **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.

### ***External Growth — Acquisition and Development***

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.

**Management — The Critical Element**

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.

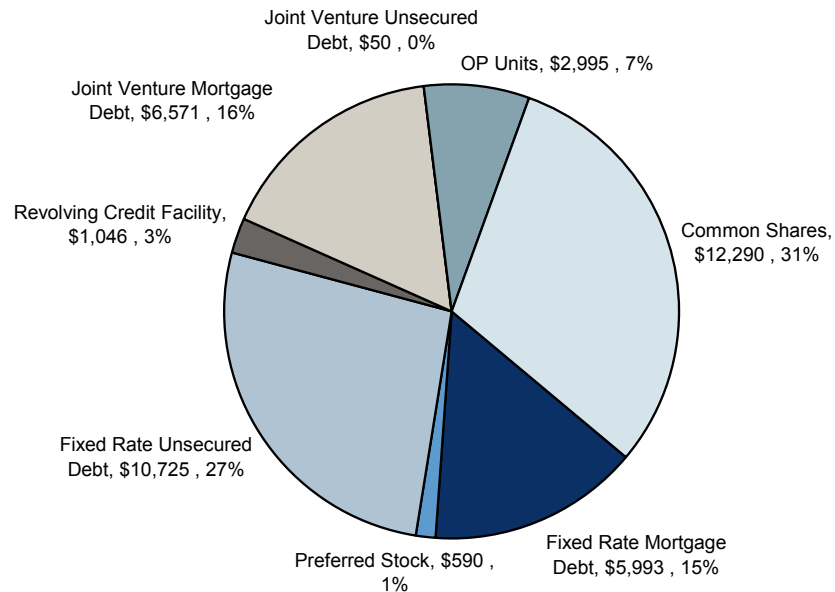
**Capital Structure**

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 150% 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.

Figure 46: Simon Property Group — Capital Structure, as of 12/31/2008 (\$ in millions)



Source: Company documents

### 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**

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## 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"

(Index). 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 "DWRTF" (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).

Figure 47: REIT Indices Comparison

Indice	Ticker	Maximum # of Constituents	Exclusions	Float Adjustments
FTSE NAREIT Equity	FNERTR	None	REOC, OTC, Mortgage REITs	cross holdings, government, employee, family
FTSE NAREIT Composite	FNCOTR	None	REOC, OTC	cross holdings, government, employee, family
RMS	RMS	None	Not part of MSCI 2500, Companies	corporate holdings, government, employee, family
S&P REIT	SPREIT	100	REOC, Mortgage, Hybrid, market cap. under \$100 million	None
C&S Realty Majors	RMP	30	REOC, Mortgage, Hybrid, market cap. under \$500 million, 600 thousand average monthly volume	No more than 8% of total weighted index
D.J. REIT	RCIT	None	Must be a REIT	5% or more held, government, employee, family, restricted
Wilshire REIT	DWRTF	None	Mortgage, Hybrid, market cap. under \$100 million	corporate holdings, government, employee, family
GPR 250	G250GLOB	250	Must rank higher than 250 in terms of monthly trading volume	cross holdings, government holdings in excess of 10% of share outstanding

Source: Bloomberg, S&P, Dow Jones, NAREIT, Wilshire

### 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.

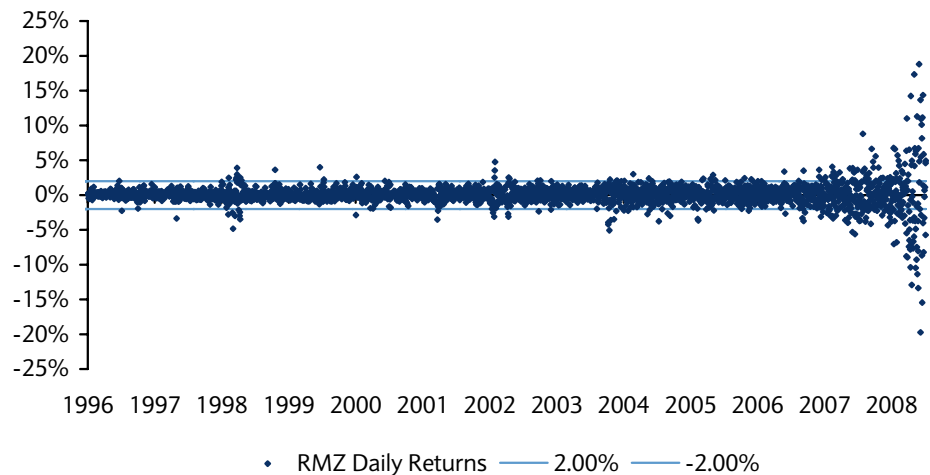
Figure 48: Real Estate ETFs

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

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



Source: FactSet, Barclays Capital

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.

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## **Part Six: Current and Future Trends**

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## Part Six: Current and Future Trends

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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 year-end, 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 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 this year for the significant volatility, including lower liquidity than other sectors, but the two factors that stood at the fore 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.

Figure 50: Global Proliferation of REIT and REIT-Like Structures

Enacted before 2000	Enacted from 2000 to 2008	Under Consideration
Australia	France	China
Brazil	Germany	Finland
Canada	Hong Kong	India
Greece	Italy	Philippines
Spain	Japan	
The Netherlands	Malaysia	
Turkey	Mexico	
United States	Singapore	
	South Korea	
	Taiwan	
	Thailand	
	United Kingdom	

Source: Ernst & Young, EPRA

### 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 re-priced, 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

Company	Ticker	Rating	Price	
			3/31/2009	
<b>RESIDENTIAL</b>				
<b>Apartments</b>				
Apartment Investment and Mgmt	AIV	3-UW	\$5.48	
AvalonBay Communities, Inc.	AVB	1-OW	\$47.06	
Camden Property Trust	CPT	2-EW	\$21.58	
Colonial Properties Trust	CLP	3-UW	\$3.81	
Equity Residential	EQR	2-EW	\$18.35	
Essex Property Trust, Inc.	ESS	2-EW	\$57.34	
Home Properties, Inc.	HME	2-EW	\$30.65	
Post Properties Inc.	PPS	2-EW	\$10.14	
UDR, Inc.	UDR	2-EW	\$8.61	
<b>COMMERCIAL</b>				
<b>Office</b>				
Alexandria Real Estate Equities	ARE	2-EW	\$36.40	
Boston Properties Inc.	BXP	1-OW	\$35.03	
Brandywine Realty Trust	BDN	3-UW	\$2.85	
Mack Cali Realty Corp.	CLI	2-EW	\$19.81	
SL Green Realty Corp.	SLG	2-EW	\$10.80	
Vornado Realty Trust	VNO	1-OW	\$33.24	
<b>Industrial</b>				
AMB Property Corp.	AMB	1-OW	\$14.40	
ProLogis	PLD	1-OW	\$6.50	
<b>RETAIL</b>				
<b>Shopping Centers</b>				
Equity One, Inc.	EQY	3-UW	\$12.19	
Kimco Realty Corp.	KIM	1-OW	\$7.62	
Regency Centers Corp.	REG	1-OW	\$26.57	
<b>Regional Malls</b>				
CBL & Associates	CBL	3-UW	\$2.36	
Simon Property Group	SPG	1-OW	\$34.64	
<b>OTHER SECTORS</b>				
CB Richard Ellis, Inc.	RE Services	CBG	2-EW	\$4.03
Lexington Realty Trust	Net Lease	LXP	2-EW	\$2.38
Winthrop Realty Trust	Diversified	FUR	2-EW	\$6.91

Source: Barclays Capital

## **Part Seven: Glossary of REIT Terms**

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## **Part Seven: Glossary of REIT Terms**

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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](http://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. Straightlining 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.



On 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.

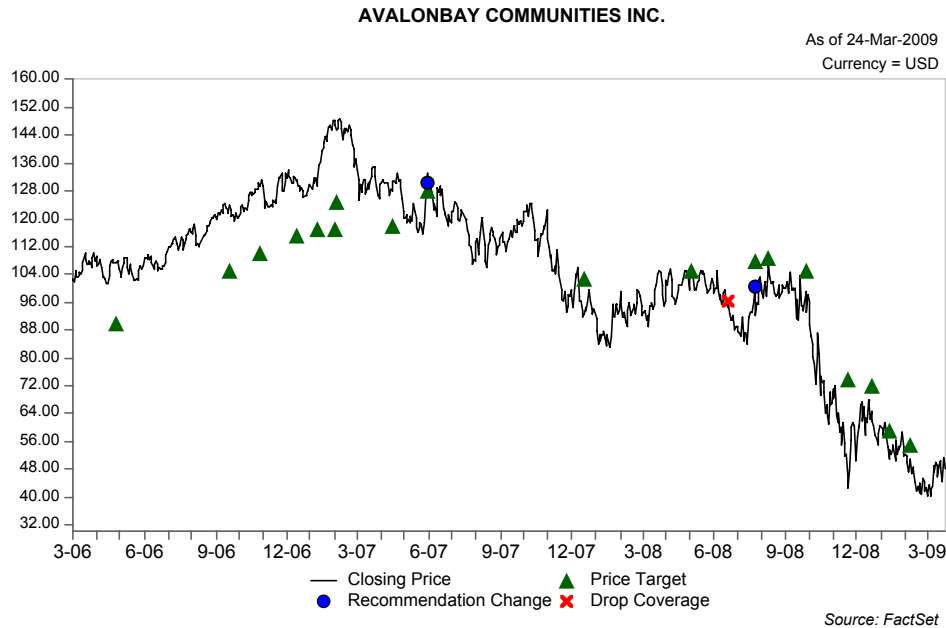
Important Disclosures:

**Avalonbay Communities Inc. (AVB)**

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

**1-Overweight / 1-Positive**

Rating and Price Target Chart:



Currency=US\$

Date	Closing Price	Rating	Price Target
09-Feb-09	51.01		55.00
13-Jan-09	53.68		59.00
22-Dec-08	61.80		72.00
19-Nov-08	45.75		74.00
26-Sep-08	99.26		105.00
08-Aug-08	104.53		109.00
23-Jul-08	100.69		108.00
23-Jul-08	100.69	1-Overweight	
19-Jun-08	96.42	Dropped	
02-May-08	105.37		105.00
18-Dec-07	92.58		103.00

Date	Closing Price	Rating	Price Target
31-May-07	130.39	2-Equal weight	
31-May-07	130.39		128.00
16-Apr-07	128.19		118.00
02-Feb-07	145.59		125.00
01-Feb-07	146.88		117.00
09-Jan-07	129.38		117.00
14-Dec-06	131.45		115.00
27-Oct-06	129.49		110.00
19-Sep-06	123.74		105.00
26-Apr-06	107.41		90.00

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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 trade regularly in the shares of Avalonbay Communities Inc..

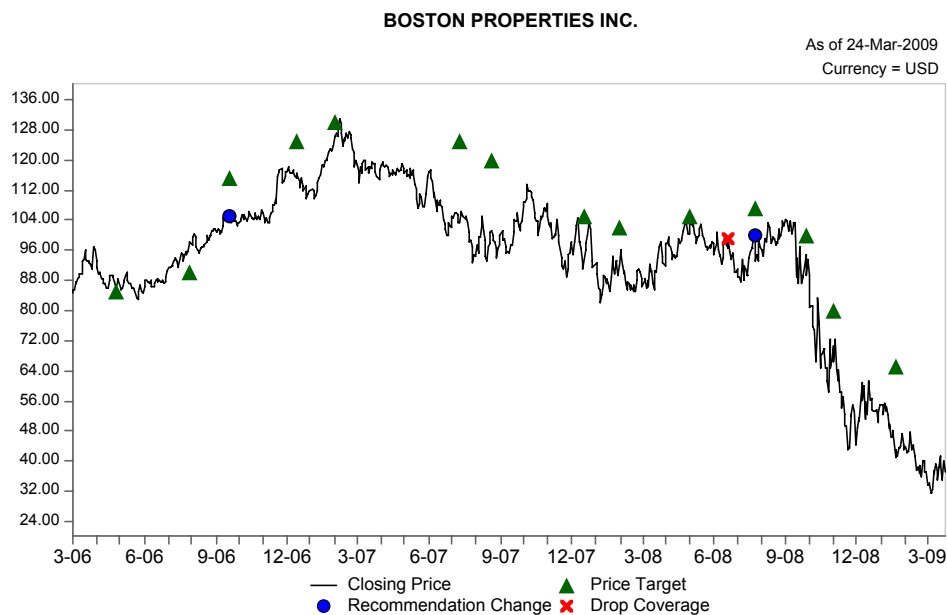
**Risks Which May Impede the Achievement of the Price Target:** Near-term risks to our target price include the ability to finish and lease developments, a prolonged economic slowdown, an increase in job losses, and migration of fund flows away from REITs generally.

**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)****US\$ 31.92 (30-Mar-2009)****1-Overweight / 1-Positive**

Rating and Price Target Chart:



Currency=US\$

Date	Closing Price	Rating	Price Target
20-Jan-09	40.96		65.00
03-Nov-08	66.49		80.00
26-Sep-08	94.71		100.00
23-Jul-08	100.00		107.00
23-Jul-08	100.00	1 -Overweight	
19-Jun-08	98.89	Dropped	
01-May-08	105.04		105.00
31-Jan-08	91.71		102.00
18-Dec-07	93.70		105.00

Date	Closing Price	Rating	Price Target
21-Aug-07	101.01		120.00
11-Jul-07	103.41		125.00
01-Feb-07	126.09		130.00
14-Dec-06	116.30		125.00
19-Sep-06	104.98		115.00
19-Sep-06	104.98	1 -Overweight	
28-Jul-06	97.91		90.00
26-Apr-06	85.90		85.00

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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)**

**US\$ 6.97 (30-Mar-2009)**

**1-Overweight / 1-Positive**

Rating and Price Target Chart:



Currency=US\$

Date	Closing Price	Rating	Price Target
09-Feb-09	13.45		20.00
17-Nov-08	16.99		25.00
26-Sep-08	38.38		42.00
11-Sep-08	38.29		40.00
23-Jul-08	36.97		38.00
23-Jul-08	36.97	1-Overweight	
19-Jun-08	37.24	Dropped	
02-May-08	41.24		40.00
07-Feb-08	36.35		39.00
18-Dec-07	35.93		40.00
21-Aug-07	40.54		45.00

Date	Closing Price	Rating	Price Target
11-Jul-07	38.15		42.00
04-May-07	48.28		52.00
14-Feb-07	52.13		50.00
14-Dec-06	46.16		48.00
31-Oct-06	44.43		42.00
19-Sep-06	41.76		40.00
26-Jul-06	38.57		37.00
11-Jul-06	37.68		36.00
16-Jun-06	36.04		35.00
16-Jun-06	36.04	2-Equal weight	

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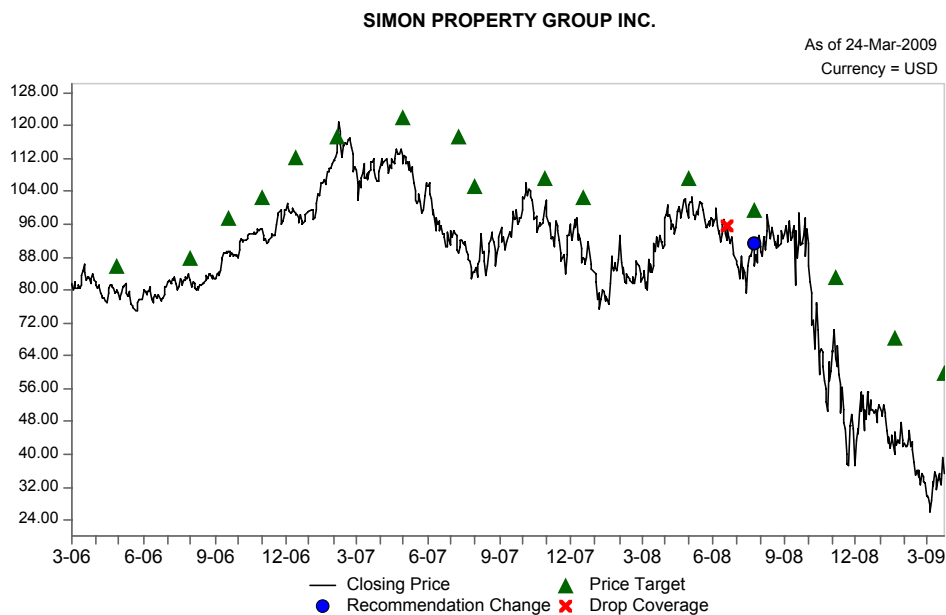
**Risks Which May Impede the Achievement of the Price Target:** Near-term risks to our target price include a slowdown consumer spending, tenant bankruptcy/store closings, inability to lease development projects, risk of financing development projects, and funds flow out of REITs generally.

**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)****US\$ 30.86 (30-Mar-2009)****1-Overweight / 1-Positive**

Rating and Price Target Chart:



Currency=US\$

Date	Closing Price	Rating	Price Target
24-Mar-09	35.20		60.00
20-Jan-09	40.17		68.37
05-Nov-08	63.19		83.02
23-Jul-08	91.36		99.62
23-Jul-08	91.36	1-Overweight	
19-Jun-08	95.58	Dropped	
30-Apr-08	97.53		107.44
18-Dec-07	87.69		102.55
30-Oct-07	100.00		107.44

Date	Closing Price	Rating	Price Target
31-Jul-07	84.51		105.48
11-Jul-07	89.11		117.20
30-Apr-07	112.59		122.09
05-Feb-07	113.56		117.20
14-Dec-06	98.42		112.32
01-Nov-06	94.76		102.55
19-Sep-06	89.46		97.67
01-Aug-06	82.42		87.90
28-Apr-06	79.97		85.95

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.

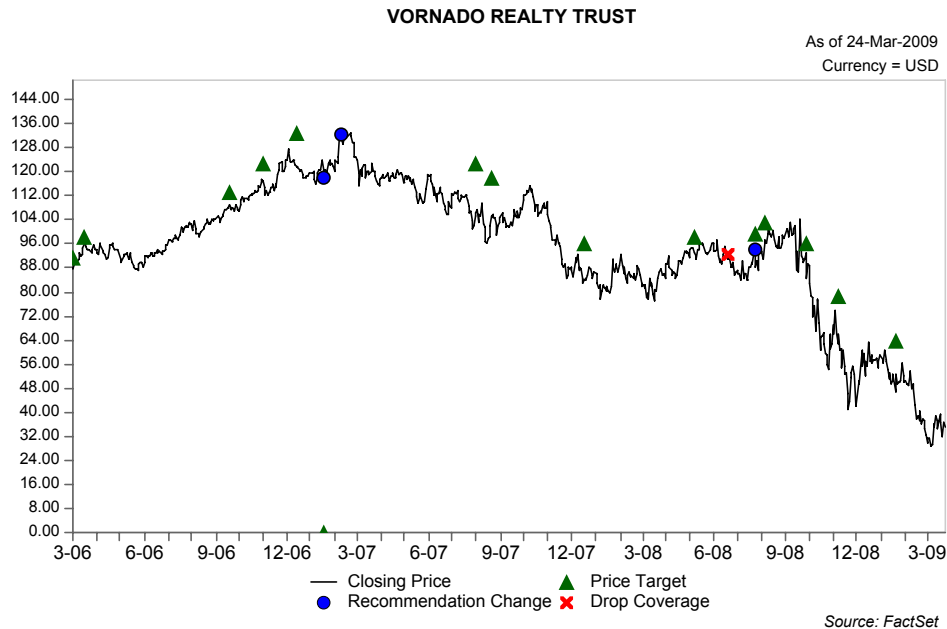
Important Disclosures Continued:

**Vornado Realty Trust (VNO)**

**US\$ 31.21 (30-Mar-2009)**

**1-Overweight / 1-Positive**

Rating and Price Target Chart:



Currency=US\$

Date	Closing Price	Rating	Price Target
20-Jan-09	46.78		63.87
06-Nov-08	62.70		78.60
26-Sep-08	93.06		96.29
06-Aug-08	97.39		103.17
23-Jul-08	94.29		99.24
23-Jul-08	94.29	1-Overweight	
19-Jun-08	92.52	Dropped	
07-May-08	92.81		98.25
18-Dec-07	83.91		96.29
21-Aug-07	105.40		117.90

Date	Closing Price	Rating	Price Target
01-Aug-07	106.07		122.82
08-Feb-07	132.30	1-Overweight	
18-Jan-07	117.81	RS-Rating Suspended	
18-Jan-07	117.81		0.00
14-Dec-06	121.83		132.64
01-Nov-06	117.01		122.82
19-Sep-06	108.89		112.99
16-Mar-06	95.83		98.25
01-Mar-06	88.22		91.38

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

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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.

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Alexandria Real Estate Equities Inc. (ARE)	AMB Property Corp. (AMB)
Apartment Investment & Management Co. (AIV)	Avalonbay Communities Inc. (AVB)
Boston Properties Inc. (BXP)	Brandywine Realty Trust (BDN)
Camden Property Trust (CPT)	CB Richard Ellis Group, Inc. (CBG)
CBL & Associates Properties Inc. (CBL)	Colonial Properties Trust (CLP)
Equity One Inc. (EQY)	Equity Residential (EQR)
Essex Property Trust Inc. (ESS)	Home Properties Inc. (HME)
Kimco Realty Corp. (KIM)	Lexington Realty Trust (LXP)
Mack-Cali Realty Corp. (CLI)	Post Properties Inc. (PPS)
ProLogis (PLD)	Regency Centers Corp. (REG)
Simon Property Group Inc. (SPG)	SL Green Realty Corp. (SLG)
UDR, Inc. (UDR)	Vornado Realty Trust (VNO)
Winthrop Realty Trust, Inc. (FUR)	

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Mentioned Company	Ticker	Price	Price Date	Stock / Sector Rating
Avalonbay Communities Inc.	AVB	US\$ 43.83	30 Mar 2009	1-Overweight / 1-Positive
Boston Properties Inc.	BXP	US\$ 31.92	30 Mar 2009	1-Overweight / 1-Positive
Kimco Realty Corp.	KIM	US\$ 6.97	30 Mar 2009	1-Overweight / 1-Positive
Simon Property Group Inc.	SPG	US\$ 30.86	30 Mar 2009	1-Overweight / 1-Positive
Vornado Realty Trust	VNO	US\$ 31.21	30 Mar 2009	1-Overweight / 1-Positive

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**Exhibit III-B**

**RBC Capital Markets Industry Report**



PRICE TARGET REVISION | COMMENT

FEBRUARY 18, 2009

**RioCan REIT (TSX: REI.UN)**  
**Q4/08 Re-cap; Pro-Actively Approaching 2011 To Expand Asset Management Op's**

**Sector Perform**  
**Average Risk**

<b>Price:</b>	12.47	<b>Price Target:</b>	16.00 ↓ 18.00
<b>Units O/S (MM):</b>	222.0	<b>Implied All-In Return:</b>	39%
<b>Distribution:</b>	1.38	<b>Market Cap (MM):</b>	2,768
<b>NAVPS:</b>	15.50	<b>Yield:</b>	11.1%
<b>BVPS:</b>	7.89	<b>P/NAVPS:</b>	0.8x
<b>Float (MM):</b>	222.0	<b>P/BVPS:</b>	1.6x
<b>Debt to Cap:</b>	55%		

NAV/Unit derived via 7.75% cap.

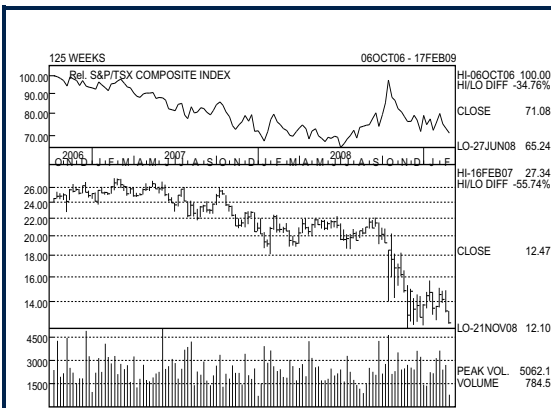
**Event**

RioCan has released Q4/08 and full-year results.

**Investment Opinion**

- **Q4/08 FFO/Unit Misses Expectations** – Q4/08 FFO/unit of \$0.39 was -7% behind Q4/07's \$0.42 and our \$0.42E. Disposition gains and fee income were the primary sources of the shortfall.
- **Holding Up Well Operationally** – Q4/08 same-property NOI growth was a strong +3.6% (2008 was +2.6%). Occupancy shed -70bps through 2008, to 96.9%, with the outlook being 96% at Q4/09. Interestingly, retail industry tenant "fall-out" seems less than we had expected through early '09 (maybe the inevitable has simply been delayed?). RioCan's own stats seem to corroborate with only 81,000 sf of unbudgeted vacancy (ex-Linens 'N Things) through Feb-13 (versus 48,000 sf during the same time frame in '08). Factoring in modest contractual steps, intensification capital and positive re-leasing spreads, RioCan sees 2009 same-property NOI growth of +2%-2.5%.
- **Solid Balance Sheet & Liquidity** – Q4/08 liquidity temporarily declined to \$157MM from \$275MM at Q3/08. Pro-forma \$103MM of mortgage financing (5-yr term @ 4.87%) and a new \$90MM bank facility, liquidity will exceed \$300MM. We see reasonable investment capacity as being ~\$450MM based on a 58% D/GBV ratio.
- **Game Plan For The REIT Rules** – RioCan appears to be leaning towards moving to a stapled structure to ensure compliance with the REIT Exemption by 2011. Current estimates suggest this will result in modest cash-tax leakage in 2011+ (~\$0.05/unit, probably less with some tax planning). Importantly, we note: **i)** that RioCan now has a credible "game plan" upon which to execute this restructuring (it is probably ahead of many); and, **ii)** RioCan's human and financial capital, and institutional relationships leave it best positioned to "grow" its way through the cash tax drag by expanding its asset management operations.
- **Estimates Trimmed; Sector Perform Rating Reiterated** – We have trimmed our 2009E/2010E FFO/unit -\$0.02 each to \$1.50/\$1.54, respectively. We have also fine-tuned our AFFO calculations and cut -\$0.05 from our 2009E/2010E which now stand at \$1.31/\$1.33. Our new \$16 price target is derived via a 12x multiple (13x prior) to our 2010E AFFO/unit. We continue to view RioCan's units as a core holding for income and long-term value appreciation. Relative total return considerations lead us to reiterate our "Sector Perform" rating. Priced as of prior trading day's market close, EST (unless otherwise noted).

For Required Disclosures, please see Page 9.



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FY Dec	2007A	2008A	2009E	2010E
EPU (Op) - FD	0.16	0.67	0.74	0.75
Prev.		0.79	0.78	0.78
P/EPU	77.9x	18.6x	16.9x	16.6x
FFO (Op) - FD	1.51	1.48	1.51	1.54
Prev.		1.51	1.53	1.55
P/FFO	8.3x	8.4x	8.3x	8.1x
AFFO - FD	1.32	1.31	1.31	1.33
Prev.		1.38	1.36	1.38
P/AFFO	9.4x	9.5x	9.5x	9.4x
<b>EPU (Op) - FD</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
2007	0.02A	(0.51)A	0.17A	0.31A
2008	0.14A	0.21A	0.19A	0.14A
Prev.				0.25E
<b>FFO (Op) - FD</b>				
2007	0.35A	0.38A	0.36A	0.42A
2008	0.32A	0.40A	0.37A	0.39A
Prev.				0.42E
2009	0.35E	0.39E	0.38E	0.39E

All values in CAD unless otherwise noted.

## Details

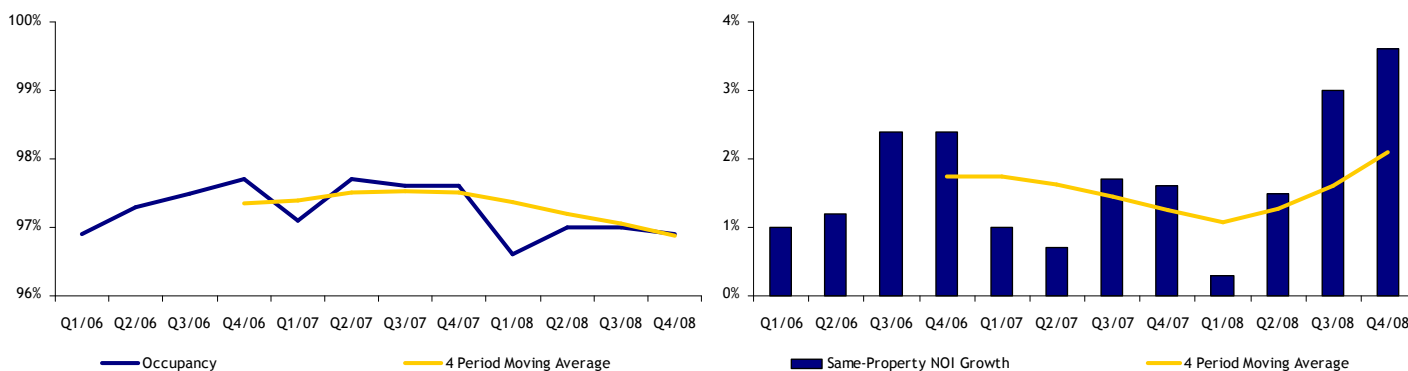
**Q4/08 FFO/Unit Misses Expectations** – Q4/08 FFO/unit (diluted) of \$0.39 was -7% behind Q4/07's \$0.42 and our \$0.42 estimate. Net Operating Income was a tad short of expectations (approximately \$0.5 million light), but this was offset by interest expense which was lower than forecast by nearly the same amount. Elsewhere through the operating cash flow statement there were three notable variances versus our forecast, each of which compounded to create the -\$0.03 shortfall versus our Q4/08 estimate:

- General & Administrative expense was +\$850,000 higher than expected (<\$0.01/unit);
- Fee Income was -\$3.4 million lower than expected (~\$0.015/unit). The shortfall was mostly related to disposition dependent fees, where we had expected \$3 million, but RioCan only generated \$0.3 million in Q4/08; and,
- Disposition gains were -\$2 million lower than our estimates (~\$0.01/unit).

**Same-Property NOI Growth Accelerates In Q4/08** – Q4/08 same-property NOI growth was a strong +3.6%, bringing the annual figure to +2.6%. Same-property growth was the product of rent uplifts on lease renewals, step rents in existing leases and income from intensification and redevelopment projects. These factors were offset by a -70 basis point decline in occupancy. Management has guided toward +2%-2.5% same-property NOI growth for 2009, with assumed year end occupancy of 96%, which would represent a decline of nearly -100 basis points from the 96.9% registered at Q4/08.

Exhibit 1 graphically depicts RioCan's historical occupancy and same-property NOI statistics.

### Exhibit 1: Historical Portfolio Occupancy And Same-Property NOI Statistics (Q1/06 to Q4/08)



Source: RBC Capital Markets and Company reports

**Leasing Activity** – In Q4/08, RioCan leased 874,000 sf, including 632,000 sf of renewals and 242,000 sf new leases. The REIT retained 92.5% of the expiring leases at an average uplift of \$1.75 per sf (+12%). For 2008, the REIT completed 4.1 million sf of leasing, comprised of 2.9 million sf of renewals and 1.2 million sf of new leases. For the full year, RioCan retained approximately 85.8% of the expiring leases, with an average uplift of \$1.56 per sf (+12%). The 2008 renewal percentage was on-par with the previous year.

In 2009, RioCan has 2.2 million sf subject to contractual expiry (less than 7% of its portfolio). Lease expirations accelerate in 2010 and 2011, with 3.2 million (10%) and 3.8 million (11.5%), respectively. Through February 13<sup>th</sup>, 27 leases totaling 145,194 sf were signed at an average rate of \$16.49/sf. This compares to 121,562 sf at \$15.75/sf in the same period of 2008.

**Fewer Tenant Failures Than Expected, So Far** – With the passage of time though this deteriorating economic climate, we anticipate all landlords (retail in particular) to be subject to an increasing volume of tenant failures. Through 2008, RioCan noted that there were 17 small tenant bankruptcies (where space actually went dark), representing approximately \$4.8 million of annualized NOI. This compared to 10 tenancies representing some \$2.1 million in the prior year. As a point of reference, these figures compare to RioCan's annualized gross rental revenue of approximately \$700 million and annualized NOI of approximately \$450 million. In addition to this, there were a handful of situations with more prominent national retailers including:

- **Linens 'N Things:** As we've previously discussed, Linens 'N Things ("Linens") filed for bankruptcy in October 2008. Linens occupied 149,600 sf (RioCan's interest) at 10 locations. This constituted less than 0.5% of the REIT's portfolio (by GLA) and represented approximately \$3.3 million of annual revenues (~\$22/sf gross). On January 16<sup>th</sup>, leases were disclaimed at 9 of the 10 locations, with the tenth lease assigned to Forzani Group Limited to operate a Sport Chek. RioCan received rental revenue for January. Two leases have already been signed with Home Outfitters and Value Village. The REIT has entered into agreements with Bed, Bath & Beyond to occupy 2 properties. Three of the Linens' stores are being subdivided, with letters of intent for five of six units, with tenants including Style Sense and Sport Chek. Management is in discussions with several tenants regarding the last 2 stores. Management is "confident that by the end of the third quarter, all will not only be leased, but will be generating income".

Management took an approach to fill the space quickly, rather than “hold out for the last dollar,” resulting in rents ~\$0.25/sf below Linens’ rents. Management estimated that tenant inducements will amount to ~\$20/sf – hence the actual return on capital employed will decline by a greater percentage than the expected fractional decline in net rent.

- **Other Tenants On Watch:** *The Source By Circuit City* – While the U.S. parent has gone into liquidation, “The Source” remains open in Canada and a search for a purchaser is underway. “The Source” occupies 77,000 sf (RioCan’s interest) at 44 locations and represents approximately \$2.5 million of annual revenues. *Cotton Ginny* – At the end of December 2008, Cotton Ginny emerged from creditor protection. Cotton Ginny occupies 32,500 sf (RioCan’s interest) at 13 locations and contributes approximately \$1.1 million of annual rental revenues.

Interestingly, the tenant “fall-out” that we expected to occur throughout the retail industry has been less than expected. Perhaps we are simply delaying the inevitable? Nevertheless, RioCan’s own statistics seem to corroborate this as the REIT has noted that through February 13<sup>th</sup>, thus far in 2009 the REIT has had 81,000 sf (0.25% of annual revenues) of “unbudgeted vacancies” (excluding Linens ‘N Things). This compares to 48,000 sf (0.2% of annual revenues) in the same period of 2008.

**Urban Intensification & Mixed-Use Potential Continues To Grow; Economic Cycle Is An Unavoidable Set-Back** – RioCan is tireless in its drive to create value throughout its portfolio. In this regard, there is a growing focus upon added retail density, including mixed-use commercial and residential space, particularly within the more urban properties. Specifically 8 properties have been identified and plans have/are being developed for intensification programs. We have summarized these in Exhibit 2 below. Management estimates that the REIT will invest \$20 million to \$25 million in its expansion and redevelopment projects in 2009. Yields on these projects are expected in the range of 10% to 11%, somewhat higher than the average greenfield development, as the RioCan already owns the land/density rights.

#### Exhibit 2: Urban Intensification & Mixed-Use Redevelopment Projects

Property	Location	Existing	Redevelopment Plans
Avenue Road	Toronto, Ontario	A 1.5 acre site at Avenue Road and Fairlawn Avenue. A former 17,373 sf retail facility was demolished.	A mixed-use development featuring a 5.5 storey residential component and 21,000 sf of street-front retail. 65 of 80 residential units have been sold. RioCan has a 50% profit participation right.
Brentwood Village Shopping Centre	Calgary, Alberta	A 321,366 sf shopping centre, on 22.9 acres in Northwest Calgary.	RioCan has sold air rights and residential density on 2.6 acres at north end of the centre. 50,000 sf of existing retail will be replaced with 568,000 sf of residential and 40,000 sf of new retail.
Coulter's Mill Marketplace	Thornhill, Ontario	A 73,667 sf unenclosed, single-storey shopping centre anchored by Staples and Dollarama.	Potential mixed-use facility comprising 675,000 sf of residential space and 10,000 sf of retail.
Lawrence Square	Toronto, Ontario	A 678,246 sf enclosed shopping centre. The main building contains 385,042 sf of retail on 2 levels and 189,478 sf of office. A second building adds 103,725 sf of office.	RioCan is contemplating the addition of 650,000 sf of residential space, in addition to the existing shopping centre.
Markington Square	Scarborough, Ontario	An 114,997 sf strip community shopping centre on 14.89 acres. The centre is anchored by a 51,000 sf Metro.	RioCan negotiated a lease buyout to replace 60,000 sf of retail with a 1.15MM sf residential tower, with 50,000 sf of ground floor retail. Zoning for 1,000 residential units expected by Q3/08.
Queen and Portland	Toronto, Ontario	A one-acre development site in downtown Toronto.	A mixed-use development comprising 4-storeys of residential and 91,000 sf of retail. 55 of 90 residential units have been sold. RioCan has a 40% profit participation right.
Tillicum Centre	Victoria, B.C.	A 472,530 sf enclosed shopping centre, anchored by Zellers, Safeway and Famous Players.	The centre has excess density on which RioCan plans to develop a 300,000 sf mixed-use facility.
Yonge Eglinton Centre	Toronto, Ontario	A 1MM sf mixed-use facility occupying a 4-acre site in mid-town Toronto. YEC is comprised of 750,000 sf of office space in 2 towers and 4 levels of retail totaling 275,000 sf.	RioCan plans to submit a rezoning request in February 2009, to add 46,000 sf of new retail space and 12-storey, 210,000 sf expansion of the office towers.

Source: RBC Capital Markets and Company reports.

Urban intensification projects have become somewhat reliant upon residential condo units in recent years, and this segment of the market appears to be weakening - dramatically. Hence, the economic cycle is becoming an unavoidable setback. RioCan seems undeterred and will remain creative. For instance, the REIT is now contemplating the idea of adding residential rental suites at its Markington Square property (instead of condos). This approach might see the REIT forgo realization gains, in return for a recurring, long-term rental stream. As with all projects of this nature, a partner bringing industry expertise is the key. Lastly, we note that the economic picture and likely project delays really represent only an “opportunity cost,” as opposed to a “ticking time bomb” of any sort, because in most cases, the underlying properties are currently generating durable, recurring rental income while awaiting future intensification.

**No Acquisitions Completed In Q4/08** – RioCan did not complete any acquisitions in Q4/08. In 2008, the REIT acquired interests in 26 properties totaling 856,822 sf for \$162.8 million.

Subsequent to year end, the REIT acquired:

- An additional 2 properties in Cambridge, Ontario and Edmonton, Alberta to complete the Cara portfolio acquired in Q3/08. The 2 properties were acquired for \$7.5 million at an 8.5% cap rate.
- A six-property retail portfolio from ING Real Estate Canada LP for a total investment of \$67.5 million. However, concurrent with the closing of this transaction in Q1/09, the REIT has agreed to sell a 50% in 4 of the 6 properties to a private investor for approximately \$20 million. Thus, RioCan’s investment will be reduced to \$47.5 million. For more details on this portfolio, we refer readers to our January 22<sup>nd</sup> note entitled *Announces 6-Property “Tuck-In” Acquisition Totaling \$67.5MM*.

Management is of the view that now is a better time to be a buyer, and is eager to continue to grow its portfolio. The goal for 2009 is to continue to grow the REIT’s balance sheet through continued growth in its asset management platform.

**Impairment Charges Taken Against Two Tertiary-Market Properties; Indefinite Timeframe For Redevelopment** – In Q4/08, RioCan recorded a \$24.3 million non-cash impairment charge against RioCan Renfrew Mall, in Renfrew, Ontario and Chaleur Centre, in Bathurst, New Brunswick. These properties are smaller, enclosed malls in tertiary markets. According to the portfolio listings on RioCan’s website, Renfrew Mall is 44.2% leased and Chaleur Centre was 12.6% leased. The carrying value of these properties was written down to approximately \$3.4 million, or just under \$100,000/sf. Impairment charges included \$4 million of estimated demolition costs and other expenses required to position the properties for redevelopment as unenclosed centres. In light of the current weakened economy and the state of the tertiary markets where these properties are located, the REIT has not set a fixed timeframe for redevelopment.

**Industry-Leading Liquidity Position Maintained** – At Q4/08, immediate liquidity of \$157 million consisted of \$11 million of cash and \$145 million of availability on the REIT’s undrawn lines. Note, liquidity declined from \$275 million at Q3/08, as a \$110 million bank line used to manage unsecured debenture maturities last year expired in 2008. At year end, the REIT’s leverage ratio (Debt/GBV) was 54.9%. Overall, RioCan continues to enjoy low leverage and exceptional liquidity, which is a function of the fact that Management has very proactively managed its liquidity position.

2009 maturities include \$231 million of mortgages and \$84 million of its Series D unsecured debentures. \$20 million matures in Q1/09, with a further \$34 million in Q2/09.

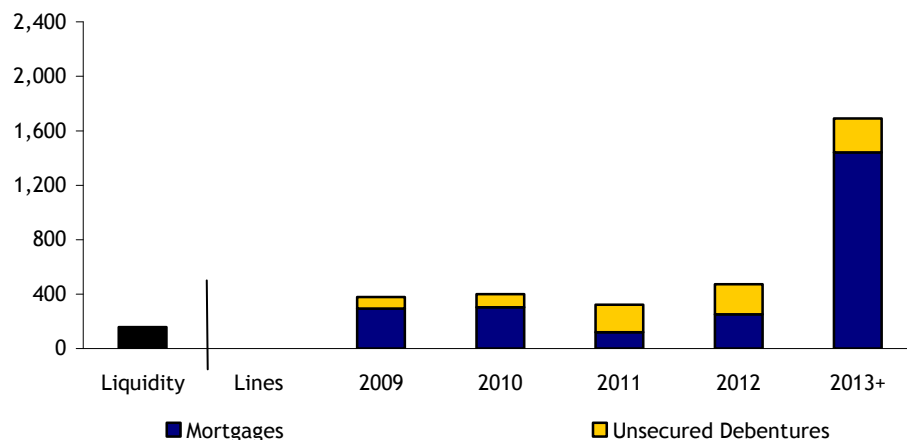
Subsequent to year end, Management has secured:

- A \$102.5 million 5-year mortgage financing on a floating rate basis. The mortgage is secured by 7 properties, 6 unencumbered. The floating rate has been swapped for a fixed rate of 4.87% for the full term. This financing will provide the REIT with approximately \$95 million of incremental cash.
- RioCan is finalizing a new \$90 million secured bank facility.

Pro forma these items, RioCan would have immediate liquidity exceeding \$300 million.

## Exhibit 3: Liquidity And Debt Maturity Profile (\$MM, As At Q4/08)

Cash	11
Undrawn Lines	145
<b>Liquidity</b>	<b>157</b>
Lines	0
Unsecured Debentures	849
Mortgages	2,412
<b>Total Debt</b>	<b>3,261</b>
<hr/>	
Liquidity as a % of Total Debt	5%
% Unsecured	26%
% Secured	74%



Source: RBC Capital Markets and Company reports

Within the confines of its 60% D/GBV limit, theoretical acquisition capacity exceeds \$750 million. From a more practical perspective, we believe that reasonable acquisition/investment capacity is still a formidable \$450 million or so within a 58% D/GBV ratio. Management believes that access to this quantum of debt is available at reasonable rates, but could take some time to fully achieve. This is in part, due to the fact that RioCan has a significant pool of unencumbered assets (approximately 15% of all properties based on area). We continue to note that RioCan's strong capital position could result in mild earnings dilution (versus potential) in the short-term. However, in an environment where capital is *clearly* more constrained, RioCan may prove to be one of the few listed real estate companies truly positioned to react decisively on larger-scale investment opportunities.

**Exploring A Stapled-Structure To Isolate "Tainted" Income Prior To 2011** – With its year-end results and MD&A, RioCan has provided an important update relating to its "REIT Exemption qualification plan" (the "Plan"). The Plan involves:

1. Assessing the impact of the SIFT legislation on the REIT's current structure, assets and activities.
2. Financial modeling to understand the impact of restructuring on business arrangements and accounting.
3. Identify regulatory and compliance requirements.
4. Determine reallocation of internal functions within restructured entity.
5. Develop internal and external communication plans.

**Step # 1: Done** – Thus far Thus far, RioCan has completed the first step of the Plan. At present, the REIT continues to carry out activities not permitted under the REIT exemption. For 2008, Management estimates that non-compliant activities accounted for \$34.8 million of FFO, or approximately \$0.16 per unit. We understand that this is a "net" amount, which includes all sources of non-qualifying income, net of an allocated overhead amount and other directly related expenses such as interest.

**Split Into Two Entities To Isolate Non-Qualifying ("Tainted") Income** – Under the Plan, Management appears to be leaning towards a structure whereby it will see the REIT continue to own all permitted assets and carry out all permitted activity, while a second entity (presumably a taxable corporation) would be established for disallowed assets and activities. The Plan would see RioCan unitholders hold securities in both the REIT and the new entity, which would trade together as a single stapled unit. In the event that RioCan is not able to restructure, either via stapled units or otherwise, to meet the REIT exemption, the REIT would discontinue all disallowed activities and dispose of non-compliant assets.

**Timeline And Process: On Track (And Probably More Advanced Than Many)** – Management and its advisors are confident that a staple-structure is "technically" possible. The currently anticipated timeline involves further internal legal and structuring work through 2009. It is then likely that the proposal, which would be in the form of a Plan of Arrangement, would be put to unitholders for a vote at the annual meeting in Q2/10. Final execution and implementation of the Plan would then occur during the fourth quarter of 2010. Management feels that it is sufficiently "ahead of the curve" on planning and structuring issues and that there is ample time to fine tune, improve and adapt prior to 2011.

**Financial Impact: A Cash Tax Drag of \$0.04-\$0.05/Unit By 2011; Possibly Less With Structuring** – Based on the 2008 non-qualifying FFO of \$34.8 million, we estimate the pro-forma cash-tax impact (based upon a 28% tax rate) would be almost \$10 million, or \$0.04 to \$0.05 per unit. Management indicated that the REIT is reviewing tax planning opportunities to make the separate entity as tax efficient as possible, hence possibly reducing the impact.

**The Game Plan: “Growth Through” The Potential Cash Tax Drag – RioCan Will Probably Not Let-Up In Its Goal To Create Value and Grow Its Asset Management Operations** – RioCan has a lot of highly talented human capital. And, as previously discussed, the REIT also has lots of financial capital. This is a powerful combination for value creation and we have already seen the evidence of substantial fee growth during the last five years. We believe the current environment will allow the REIT to deploy capital over the next several years at *higher rates* of capital than has been possible in recent past. Some of these opportunities may also involve partners, hence generating *increased* non-compliant income (Management commented that it is working toward potentially launching several new funds through 2009). Thus, to the extent that RioCan is already advanced in its understanding of what its future structure will look like, we view this as a positive event, as the REIT can now simultaneously focus upon growing its fee-based and value-add businesses in order attempt to “grow through” any cash-tax drag which materializes in 2011. The bottom line is that this so-called “bad income”, should be viewed as “good income” by investors, particularly to the extent that RioCan can employ its platform and strategic relationships with major institutions and pension funds in order to grow income.

**No Activity On Its Normal Course Issuer Bid** – On October 28<sup>th</sup>, RioCan announced its intention to file with the TSX for a normal course issuer bid. This NCIB allows the REIT to repurchase up to 11 million of its units (approximately 5% of its outstanding units) during a twelve-month period beginning November 7, 2008. RioCan has not yet repurchased any units under the NCIB.

**Estimates Trimmed** – We have trimmed our 2009 and 2010 FFO/unit estimates  $-\$0.02$  each, to  $\$1.50$  and  $\$1.54$ , respectively. We have also fine-tuned our AFFO calculations. Our 2009 and 2010 AFFO/unit estimates have each been reduced by  $-\$0.05$  to  $\$1.31$  and  $\$1.33$ , respectively.

**Price Target Trimmed; “Sector Perform” Rating Reiterated** – Our new  $\$16$  price target (formerly  $\$18$ ) is derived via the application of a 12x multiple (formerly 13x) to our 2010 AFFO/unit estimate. The modest contraction in our target multiple is reflective of declining multiples in retail-oriented REITs specifically, REITs more broadly, and equity markets in general. Our target multiple represents a modest premium to the average that is applied to RioCan’s Canadian peers. We believe this premium is warranted in light of RioCan’s above average market cap, its strategic focus on Canada’s six largest cities and its overall franchise value. We continue to view RioCan’s units as a core holding for income and long-term value appreciation. Based upon expected relative total return prospects, we reiterate our Sector Perform, Average Risk Rating.

## Appendix I – NAV Sensitivity Analysis (\$MM, except per unit amounts)

		Change In Forward 12-Months' Net Operating Income										
		1%	0%	-1%	-2%	-3%	-4%	-5%	-6%	-7%	-8%	
FTM NOI ("Cash Basis")	462	7.25%	\$17.73	\$17.45	\$17.16	\$16.88	\$16.59	\$16.31	\$16.03	\$15.74	\$15.46	\$15.17
Cap Rate Applied By RBC CM	7.75%	7.50%	\$16.77	\$16.50	\$16.22	\$15.95	\$15.67	\$15.40	\$15.12	\$14.85	\$14.57	\$14.30
Gross Property Value	5,959	7.75%	\$15.88	\$15.50	\$15.35	\$15.08	\$14.81	\$14.55	\$14.28	\$14.02	\$13.75	\$13.48
+ PUD	415	8.00%	\$15.04	\$14.78	\$14.52	\$14.27	\$14.01	\$13.75	\$13.49	\$13.23	\$12.98	\$12.72
+ Fee Income	190	8.25%	\$14.25	\$14.00	\$13.75	\$13.50	\$13.25	\$13.00	\$12.75	\$12.50	\$12.25	\$12.00
+ Value Of Other Assets	182	8.50%	\$13.51	\$13.26	\$13.02	\$12.78	\$12.54	\$12.29	\$12.05	\$11.81	\$11.57	\$11.32
= Total Assets	6,746	8.75%	\$12.81	\$12.57	\$12.34	\$12.10	\$11.86	\$11.63	\$11.39	\$11.16	\$10.92	\$10.69
- Debt	(3,249)	9.00%	\$12.15	\$11.92	\$11.69	\$11.46	\$11.23	\$11.00	\$10.77	\$10.54	\$10.31	\$10.08
= NAV	3,497	9.25%	\$11.52	\$11.30	\$11.07	\$10.85	\$10.63	\$10.41	\$10.18	\$9.96	\$9.74	\$9.51
		9.50%	\$10.93	\$10.71	\$10.49	\$10.28	\$10.06	\$9.84	\$9.63	\$9.41	\$9.19	\$8.97
Diluted Units	224											
NAV/unit	\$15.50											
Unit Price	\$12.47											
Premium (Discount) To NAV	-20%											
LTV	48%											

		Change In Forward 12-Months' Net Operating Income										
		1%	0%	-1%	-2%	-3%	-4%	-5%	-6%	-7%	-8%	
		7.25%	-30%	-29%	-27%	-26%	-25%	-24%	-22%	-21%	-19%	-18%
		7.50%	-26%	-24%	-23%	-22%	-20%	-19%	-18%	-16%	-14%	-13%
		7.75%	-21%	-20%	-19%	-17%	-16%	-14%	-13%	-11%	-9%	-8%
		8.00%	-17%	-16%	-14%	-13%	-11%	-9%	-8%	-6%	-4%	-2%
		8.25%	-12%	-11%	-9%	-8%	-6%	-4%	-2%	0%	2%	4%
		8.50%	-8%	-6%	-4%	-2%	-1%	1%	3%	6%	8%	10%
		8.75%	-3%	-1%	1%	3%	5%	7%	9%	12%	14%	17%
		9.00%	3%	5%	7%	9%	11%	13%	16%	18%	21%	24%
		9.25%	8%	10%	13%	15%	17%	20%	22%	25%	28%	31%
		9.50%	14%	16%	19%	21%	24%	27%	30%	33%	36%	39%

Source: RBC Capital Markets

## Appendix II – North American Shopping Centre Companies – Summarized Comparative Valuation Table

Company	Price	Market Cap (\$MM)	Div Yield	P/ FFO Multiple			P/ AFFO Multiple			09E Payout Ratios		NAV	
				2008E	2009E	2010E	2008E	2009E	2010E	FFO	AFFO	Prem/(Disc)	
RioCan REIT	\$12.47	\$2,769	11.1%	8.4x	8.3x	8.2x	9.6x	9.5x	9.4x	91%	105%	-20%	
Acadia Realty Trust	\$9.68	\$319	8.7%	8.1x	8.1x	8.0x	8.6x	9.4x	9.8x	71%	82%	-44%	
Cedar Shopping Centers, Inc.	\$5.73	\$266	7.9%	4.7x	4.7x	4.6x	6.8x	6.9x	6.0x	37%	54%	-40%	
Calloway REIT	\$10.30	\$977	15.0%	5.8x	5.8x	6.1x	6.1x	6.2x	6.5x	88%	93%	-31%	
Developers Diversified Realty Corp.	\$2.85	\$368	0.0%	0.9x	1.0x	1.0x	1.0x	1.1x	1.0x	0%	0%	-75%	
Equity One, Inc.	\$12.21	\$948	9.8%	13.4x	10.3x	9.7x	14.0x	12.2x	11.4x	102%	120%	-34%	
Federal Realty Investment Trust	\$43.48	\$2,581	6.0%	11.2x	11.0x	10.7x	13.3x	12.8x	12.4x	66%	77%	-26%	
Inland Real Estate Corporation	\$8.05	\$535	12.2%	5.6x	6.1x	6.0x	6.1x	6.5x	6.3x	74%	80%	-37%	
Kimco Realty Corporation	\$9.49	\$2,585	18.5%	4.3x	5.2x	5.3x	5.2x	6.0x	6.1x	97%	112%	-55%	
Kite Realty Group Trust	\$3.50	\$148	23.4%	2.9x	3.6x	3.5x	3.6x	5.0x	4.6x	85%	117%	-59%	
Primaris Retail REIT	\$9.33	\$581	13.1%	6.7x	7.2x	7.2x	8.2x	8.8x	8.9x	94%	115%	-35%	
Ramco-Gershenson Properties Trust	\$4.72	\$101	19.6%	1.9x	2.0x	1.9x	2.1x	2.2x	N/A	39%	44%	-76%	
Regency Centers Corporation	\$27.46	\$1,936	10.6%	6.9x	8.0x	8.1x	8.1x	9.2x	9.6x	85%	97%	-34%	
Saul Centers, Inc.	\$28.70	\$668	5.4%	10.7x	10.8x	10.5x	13.2x	12.6x	N/A	59%	69%	-37%	
Urstadt Biddle Properties Inc.	\$12.83	\$234	7.5%	10.2x	10.3x	10.2x	12.8x	13.1x	12.7x	77%	98%	-24%	
Weingarten Realty Investors	\$12.57	\$1,124	16.7%	4.2x	4.3x	4.2x	5.7x	5.6x	5.7x	71%	94%	-51%	
<b>Shopping Center Sector Average</b>				<b>11.6%</b>	<b>7x</b>	<b>7x</b>	<b>7x</b>	<b>8x</b>	<b>8x</b>	<b>8x</b>	<b>71%</b>	<b>85%</b>	<b>-42%</b>

Source: RBC Capital Markets, SNL and Company reports

## Valuation

Our \$16.00 price target is derived via the application of a 12x multiple to our 2010 AFFO/unit estimate. Our target multiple represents a modest premium to that which we apply to RioCan's Canadian peers, which we believe is warranted in light of RioCan's above average market cap, its strategic focus on Canada's six largest cities and its overall franchise value. We continue to view RioCan's units as a core holding and, based upon expected total return prospects, we reiterate our Sector Perform, Average Risk rating.

## Price Target Impediment

Impediments to the achievement of our price objectives primarily relate to the risks associated with the ownership of real property, which include but are not limited to general economic conditions, local real estate markets, credit risk of tenants, supply and demand for leased premises, competition from other leased premises and factors that could impact consumer spending, including interest rates and job growth.

## Company Description

RioCan REIT is Canada's largest REIT. RioCan owns interests in a portfolio of over 59 million sf in 241 income producing retail centres across Canada (RioCan's share ~36 million sf). Approximately 50% of the REIT's portfolio (by area) is represented by "new format" retail centres. The REIT also has an active development pipeline including more than 20 projects encompassing almost 10 million sf of total GLA (RioCan's share ~3.5 million sf). RioCan's stated goal is "the long-term maximization of cash flow and capital appreciation in its portfolio," which it seeks to achieve by proactively managing its assets. RioCan derives over 85% of its annualized gross revenue from national and anchor tenants, with no single tenant accounting for more than 6% of gross revenue.



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**Average Risk (Avg):** Volatility and risk expected to be comparable to sector; average revenue and earnings predictability; no significant cash flow/financing concerns over coming 12-24 months; fairly liquid.

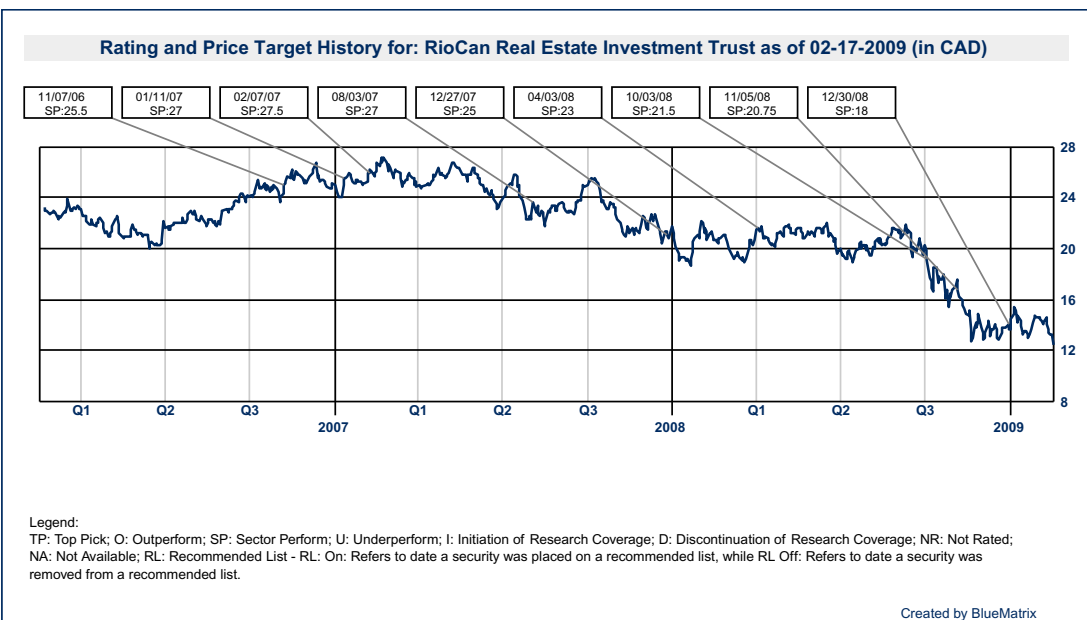
**Above Average Risk (AA):** Volatility and risk expected to be above sector; below average revenue and earnings predictability; may not be suitable for a significant class of individual equity investors; may have negative cash flow; low market cap or float.

**Speculative (Spec):** Risk consistent with venture capital; low public float; potential balance sheet concerns; risk of being delisted.

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**Exhibit III-C**

**Morgan Stanley Industry Report**

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April 6, 2009

Industry View  
Cautious

## Property

### Weekly Pan-European Statistical Supplement

#### Weekly Pan-European Statistical Supplement

We publish the European statistical supplement on a weekly basis. The main items included are as follows:

**Performance statistics.** Our statistical supplement provides regional and stock-specific, absolute and relative performance statistics.

**Stock valuation metrics.** The statistical supplement also comprises key valuation metrics such as discount to NAV, dividend yield and EBITDA/EV yield.

#### Companies Featured

<u>Company</u>	<u>Stock rating</u>
British Land	Equal-Weight
Brixton	Overweight
Castellum	Underweight
Corio	Equal-Weight
Derwent London	Equal-Weight
DIC Asset	Overweight
Fabege	Underweight
GAGFAH	Underweight
Gecina	Underweight
Great Portland Estates	Underweight
Hammerson	Overweight
Icade	Equal-Weight
IVG Immobilien	Underweight
Klepierre	Underweight
Land Securities	Overweight
Liberty International	Overweight
ProLogis Europe	Overweight
PSP Swiss Property	Underweight
Realia Business	Underweight
SEGRO	Overweight
Unibail-Rodamco	Equal-Weight

Morgan Stanley does and seeks to do business with companies covered in Morgan Stanley Research. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of Morgan Stanley Research. Investors should consider Morgan Stanley Research as only a single factor in making their investment decision.

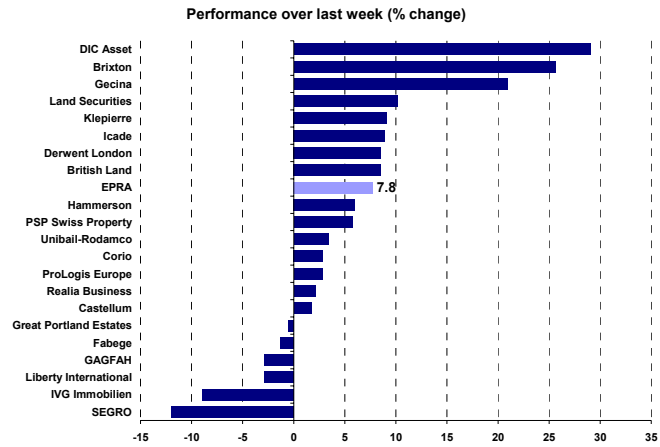
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April 6, 2009  
Property

Exhibit 1

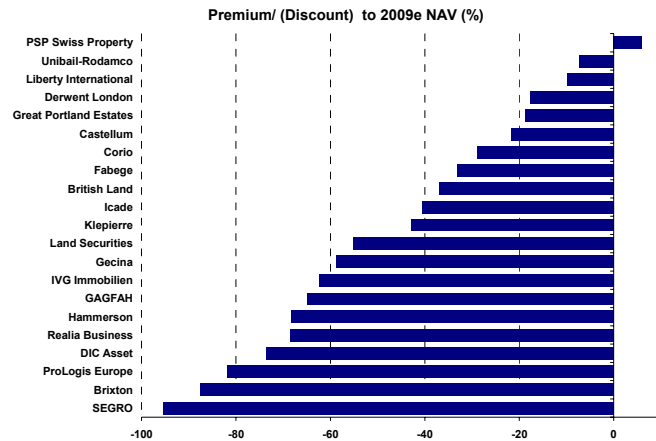
## Performance over last week (% change)



Source: Datastream, Morgan Stanley Research

Exhibit 2

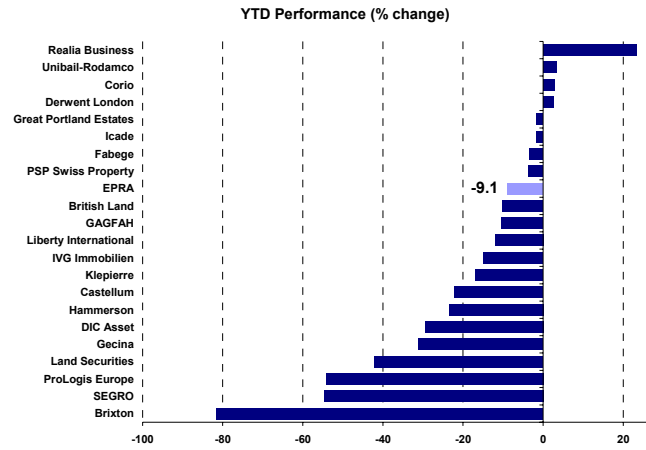
## Premium/(discount) to NAV (%)



Source: Datastream, Morgan Stanley Research

Exhibit 3

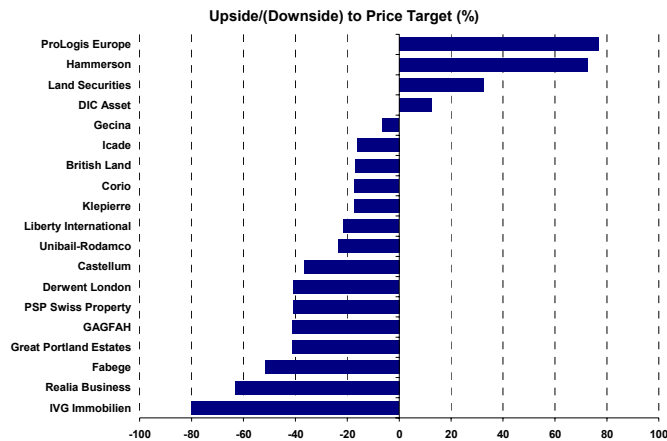
## Performance year to date (% change)



Source: Datastream, Morgan Stanley Research

Exhibit 4

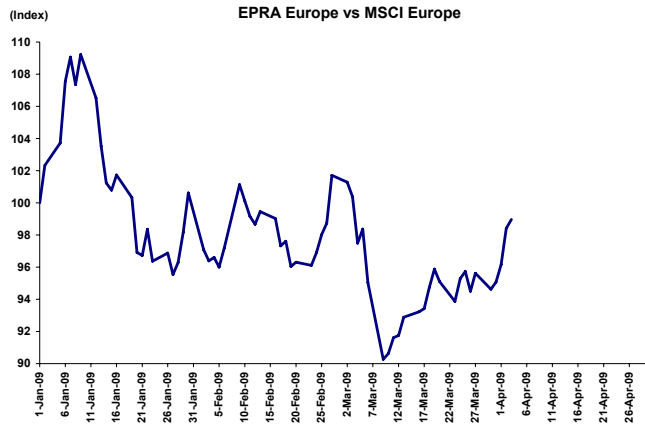
## Upside/(downside) to price target (%) – Core Europe



Source: Datastream, Morgan Stanley Research

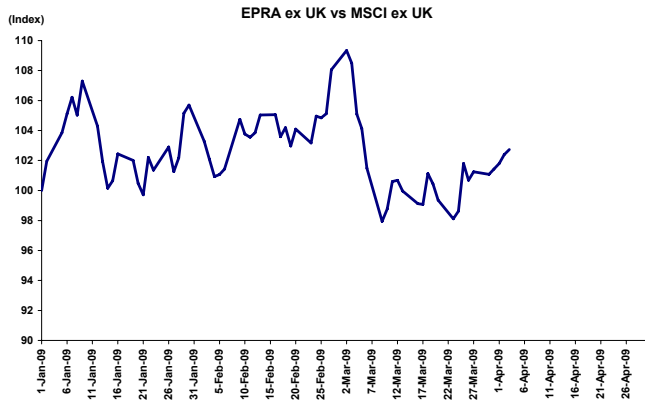
April 6, 2009  
Property

**Exhibit 5**  
**Pan-European performance relative to broader equity market**



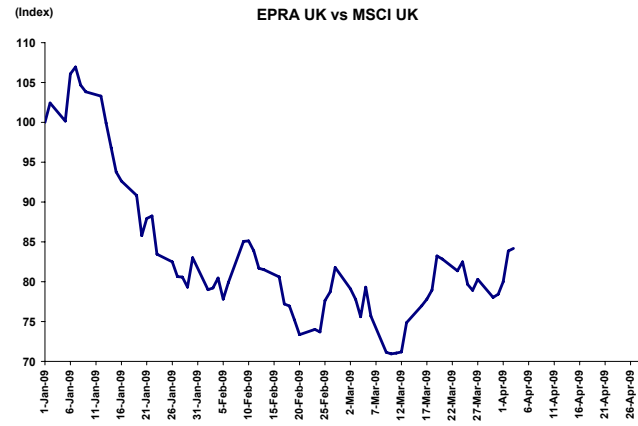
Source: Datastream, Morgan Stanley Research

**Exhibit 6**  
**Continental European performance relative to broader equity market**



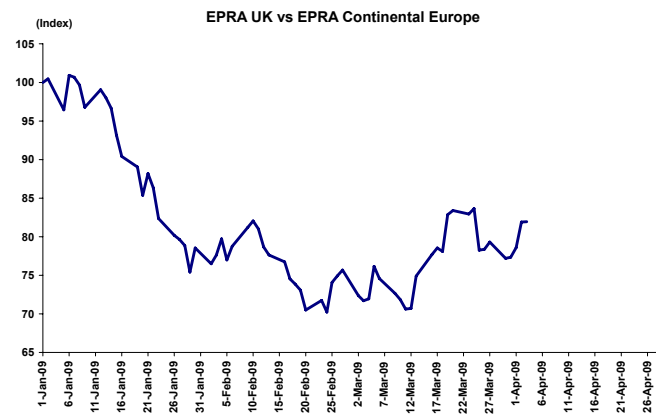
Source: Datastream, Morgan Stanley Research

**Exhibit 7**  
**UK performance relative to broader equity market**



Source: Datastream, Morgan Stanley Research

**Exhibit 8**  
**UK performance relative to continental Europe**



Source: Datastream, Morgan Stanley Research

April 6, 2009

Property

Exhibit 9

## Pan-European Property: Stock ratings and other statistics

Company	Latest	Stock rating	Share price	Price target	Upside to price target (%)	52-week high	52-week low	Avg Daily Trade volume (€mn)	Market capitalisation		
	year end									(mn)	(€mn)
British Land	31-Mar-08	Equal-Weight	p 410	340	-17	743	301	30.6	£	2,161	2,901
Brixton	31-Dec-07	Overweight	p 25	110	349	334	14	1.9	£	66	89
Castellum	31-Dec-07	Underweight	SKr 47.3	30.0	-37	77	43	4.1	SKr	7,757	653
Corio	31-Dec-07	Equal-Weight	€ 33.8	28.0	-17	60.0	24.4	12.3	€	2,227	2,227
Derwent London	31-Dec-07	Equal-Weight	p 743	440	-41	1,453	460	4.7	£	749	1,006
DIC Asset	31-Dec-07	Overweight	€ 4.4	5.0	13	22.8	2.7	0.4	€	139	139
Fabege	31-Dec-07	Underweight	SKr 29.0	14.0	-52	64.3	19.3	3.0	SKr	4,985	419
GAGFAH	31-Dec-07	Underweight	€ 3.8	2.2	-41	11.9	2.1	1.5	€	843	843
Gecina	31-Dec-07	Underweight	€ 34.2	32.0	-6	96	27	5.5	€	2,098	2,098
Great Portland Estates	31-Mar-08	Underweight	p 256	150	-41	497	173	2.7	£	463	621
Hammerson	31-Dec-07	Overweight	p 278	480	73	761	211	18.6	£	794	1,065
Icade	31-Dec-07	Equal-Weight	€ 58.5	49.0	-16	99	38	4.0	€	2,866	2,866
IVG Immobilien	31-Dec-07	Underweight	€ 5.0	1.0	-80	17.8	3.3	2.2	€	623	623
Klepierre	31-Dec-07	Underweight	€ 14.5	12.0	-17	39.1	10.0	10.0	€	1,991	1,991
Land Securities	31-Mar-08	Overweight	p 483	640	33	1,420	341	36.8	£	2,270	3,047
Liberty International	31-Dec-07	Overweight	p 421	330	-22	1,032	281	10.7	£	1,586	2,129
ProLogis Europe	31-Dec-07	Overweight	€ 1.5	2.6	77	10.9	0.8	0.6	€	280	280
PSP Swiss Property	31-Dec-07	Underweight	SFr 50.8	30.0	-41	70.5	41.5	4.4	SFr	2,154	1,415
Realia Business	31-Dec-07	Underweight	€ 1.9	0.7	-63	4.7	1.4	0.3	€	519	519
SEGRO	31-Dec-07	Overweight	p 20	250	1,135	93	15	10.2	£	95	128
Unibail-Rodamco	31-Dec-07	Equal-Weight	€ 110	84	-24	172	87	46.1	€	10,261	10,261

Share prices as at close of April 3rd, 2009

Source: Datastream, Factset, Morgan Stanley Research



April 6, 2009

Property

Exhibit 10

## Pre-tax income-based parameters, 2007-10e

Company		EBITDA					Pre-tax ModelWare EPS					Pre-tax Adjusted EPRA EPS			
		2007	2008e	2009e	2010e		2007	2008e	2009e	2010e		2007	2008e	2009e	2010e
British Land	£mn	619	589	629	638	p	48.1	57.6	59.4	59.7	p	37.6	49.6	57.3	59.69
Brixton	£mn	74	76	83	88	p	17.0	15.4	16.2	17.7	p	14.4	13.5	15.2	16.9
Castellum	SKr mn	1,419	1,599	1,669	1,651	SKr	5.6	6.0	5.9	5.6	SKr	5.6	6.0	5.9	5.6
Corio	€mn	293	325	343	346	€	2.91	2.97	3.17	3.06	€	2.73	2.87	3.03	2.93
Derwent London	£mn	88	82	89	95	p	33.6	34.4	24.8	28.7	p	33.6	34.4	24.8	28.7
DIC Asset	€mn	89	130	134	128	€	0.86	1.01	1.10	1.21	€	1.55	1.89	2.02	2.12
Fabege	SKr mn	1,327	1,506	1,578	1,614	SKr	3.81	3.62	3.39	2.84	SKr	3.77	3.58	3.34	2.80
GAGFAH	€mn	364	443	478	500	€	0.20	0.57	0.72	0.80	€	0.20	0.57	0.72	0.80
Gecina	€mn	497	518	514	503	€	5.10	5.29	4.55	4.04	€	5.14	5.34	4.59	4.08
Great Portland Estates	£mn	56	52	60	63	p	11.8	12.2	14.3	15.2	p	10.0	9.4	13.8	15.1
Hammerson	£mn	234	241	279	307	p	33.8	33.1	37.8	45.9	p	24.8	26.0	30.8	29.0
Icade	€mn	291	322	352	368	€	-1.34	0.14	-0.10	-0.29	€	0.61	2.39	2.48	2.62
IVG Immobilien	€mn	230	260	247	240	€	0.74	0.59	0.07	0.43	€	0.77	0.59	0.07	0.43
Klepierre	€mn	543	634	790	787	€	1.26	1.18	0.74	0.85	€	2.53	2.74	2.65	2.74
Land Securities	£mn	642	558	601	627	p	70.9	63.0	65.8	68.4	p	61.9	55.2	64.3	68.4
Liberty International	£mn	308	306	314	319	p	35.6	34.5	35.3	32.2	p	32.2	30.4	29.7	29.2
ProLogis Europe	€mn	269	265	261	229	€	0.90	0.83	0.84	0.77	€	0.90	0.83	0.84	0.77
PSP Swiss Property	SFr mn	191	207	207	207	SFr	3.12	3.38	3.12	3.33	SFr	3.18	3.40	3.11	3.36
Realia Business	€mn	333	166	121	132	€	0.63	0.14	-0.07	-0.10	€	0.77	0.19	0.01	0.03
SEGRO	£mn	232	258	284	305	p	31.7	40.4	45.7	49.8	p	28.1	37.0	43.6	48.3
Unibail-Rodamco	€mn	754	1,176	1,227	1,349	€	7.10	8.76	8.39	8.81	€	6.93	8.55	8.33	8.73

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 11

## Pan-European Property: Post-tax income-based valuation parameters, 2007-10e

Company		ModelWare EPS <sup>1</sup>					Adjusted EPRA EPS					Net dividends per share			
		2007	2008e	2009e	2010e		2007	2008e	2009e	2010e		2007	2008e	2009e	2010e
British Land	p	49.8	60.1	62.2	62.6	p	39.3	52.1	60.1	62.6	p	32.3	36.1	37.1	38.2
Brixton	p	17.0	15.4	16.2	17.7	p	14.4	13.5	15.2	16.9	p	13.6	14.1	14.6	15.1
Castellum	SKr	5.5	5.9	5.8	5.5	SKr	5.5	5.9	5.8	5.5	SKr	3.0	3.2	3.2	3.2
Corio	€	2.94	3.00	3.20	3.09	€	2.75	2.90	3.06	2.95	€	2.60	2.60	2.70	2.70
Derwent London	p	35.1	33.7	27.8	31.7	p	35.1	33.7	27.8	31.7	p	18.0	18.1	18.7	19.4
DIC Asset	€	0.65	0.74	0.84	0.89	€	1.34	1.62	1.75	1.81	€	1.65	1.25	1.00	1.50
Fabege	SKr	3.85	3.66	3.42	2.87	SKr	3.81	3.61	3.38	2.83	SKr	4.00	4.00	4.00	4.00
GAGFAH	€	0.27	0.62	0.81	0.90	€	0.27	0.62	0.81	0.90	€	0.77	0.83	0.86	0.93
Gecina	€	4.81	5.00	4.29	3.81	€	4.86	5.04	4.34	3.85	€	5.01	5.00	5.00	5.00
Great Portland Estates	p	12.4	12.2	14.3	15.2	p	10.6	9.4	13.8	15.1	p	11.9	11.9	12.6	14.3
Hammerson	p	32.7	31.2	35.6	43.4	p	23.7	24.1	28.6	26.4	p	27.1	29.0	31.0	14.7
Icade	€	0.73	1.04	0.81	0.52	€	2.68	3.29	3.39	3.43	€	3.25	3.40	3.60	3.80
IVG Immobilien	€	0.48	0.53	0.06	0.39	€	0.52	0.53	0.06	0.39	€	0.70	0.70	0.70	0.70
Klepierre	€	1.16	1.03	0.63	0.74	€	2.43	2.60	2.55	2.63	€	1.22	1.25	1.25	1.25
Land Securities	p	66.9	59.9	62.5	65.0	p	58.0	52.1	61.0	65.0	p	64.0	64.0	64.0	64.0
Liberty International	p	35.5	34.4	35.2	32.1	p	32.2	30.4	29.7	29.2	p	32.2	32.2	32.2	32.2
ProLogis Europe	€	0.79	0.72	0.75	0.69	€	0.79	0.72	0.75	0.69	€	0.87	0.56	0.00	0.35
PSP Swiss Property	SFr	2.98	2.75	2.54	2.71	SFr	3.05	2.77	2.53	2.74	SFr	2.40	2.50	2.54	2.60
Realia Business	€	0.40	0.08	-0.07	-0.10	€	0.54	0.13	0.01	0.03	€	0.28	0.30	0.15	0.15
SEGRO	p	25.2	36.3	41.1	44.7	p	21.7	32.9	39.0	43.3	p	22.8	24.7	26.7	26.7
Unibail-Rodamco	€	7.08	8.52	8.25	8.61	€	6.91	8.32	8.19	8.53	€	7.00	7.50	7.50	7.75

1. Depreciation nil or negligible except for DIC Asset, Klepierre

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009  
Property

Exhibit 12

## Pan-European Property: NAVs, 2007-10e

Company		Headline NAV				NAV net of 'mark-to-market' on debt				'Triple net' NAV			
		2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	p	1,330	837	651	670	1,398	905	719	739	1,372	879	693	713
Brixton	p	545	331	198	169	527	314	181	151	527	314	181	151
Castellum	SKr	89	78	60	50	87	77	59	48	80	74	56	48
Corio	€	61.8	58.4	47.6	43.5	61.8	58.4	47.6	43.5	61.8	58.4	47.6	43.5
Derwent London	p	1,801	1,313	902	980	1,781	1,301	890	968	1,770	1,301	890	968
DIC Asset	€	23.0	21.9	16.8	15.4	23.3	22.4	17.4	16.0	22.6	21.8	16.7	15.3
Fabege	SKr	76.0	67.7	43.4	32.0	76.0	67.7	43.4	32.0	66.7	60.6	42.9	32.0
GAGFAH	€	14.3	12.9	10.7	8.8	16.4	14.6	11.7	9.6	14.4	12.5	9.6	7.5
Gecina	€	142	128	83	71	142	129	84	72	142	129	84	72
Great Portland Estates	p	582	404	315	296	582	404	315	296	572	394	305	286
Hammerson	p	1,545	1,103	875	804	1,546	1,104	876	805	1,540	1,195	1,013	948
Icade	€	110	108	98	93	110	108	98	93	109	107	97	92
IVG Immobilien	€	29.0	20.8	13.3	11.4	29.0	20.8	13.3	11.4	29.0	20.8	13.3	11.4
Klepierre	€	40.9	34.4	25.5	22.4	41.5	35.9	27.0	24.0	38.6	34.3	25.4	22.4
Land Securities	p	1,956	1,348	1,079	1,041	1,886	1,277	1,008	970	1,886	1,277	1,008	970
Liberty International	p	1,264	734	467	437	1,218	686	419	389	1,204	672	405	374
ProLogis Europe	€	12.7	9.2	8.1	7.6	12.7	9.2	8.1	7.6	11.7	8.8	8.1	7.6
PSP Swiss Property	SFr	68.9	69.1	47.9	35.5	68.9	69.1	47.9	35.5	59.7	60.0	42.7	32.6
Realia Business	€	10.1	8.6	6.1	4.6	10.1	8.6	6.1	4.6	8.3	6.9	4.3	2.8
SEGRO	p	704	543	446	442	680	519	422	418	680	519	422	418
Unibail-Rodamco	€	163	144	119	107	163	146	120	109	169	151	125	114

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 13

## Pan-European Property: Growth in income-based parameters, 2007-10e

Company	Growth in EBITDA (%)				Growth in Adjusted EPRA EPS (%)				Growth in DPS (%)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	-2	-5	7	1	0	33	15	4	58	12	3	3
Brixton	-9	2	9	6	28	-6	13	11	12	3	4	3
Castellum	14	13	4	-1	5	7	-2	-5	5	5	0	0
Corio	N/AV	11	6	1	N/AV	5	6	-3	N/AV	0	4	0
Derwent London	71	-7	9	7	28	-4	-17	14	29	0	4	4
DIC Asset	159	45	3	-4	8	21	8	3	120	-24	-20	50
Fabege	NA	13	5	2	NM	-5	-7	-16	NA	0	0	0
GAGFAH	NA	22	8	5	NA	131	30	11	NA	8	4	8
Gecina	19	4	-1	-2	14	4	-14	-11	19	0	0	0
Great Portland Estates	39	-7	15	4	14	-12	47	10	5	0	6	13
Hammerson	16	3	16	10	14	2	19	-8	25	7	7	-53
Icade	NA	11	9	5	NA	23	3	1	NA	5	6	6
IVG Immobilien	89	13	-5	-3	NM	2	-89	544	40	0	0	0
Klepierre	17	17	25	0	20	7	-2	3	17	3	0	0
Land Securities	-2	-13	8	4	-11	-10	17	7	21	0	0	0
Liberty International	-1	-1	3	1	3	-6	-2	-2	11	0	0	0
ProLogis Europe	7	-2	-2	-12	-2	-9	4	-8	-2	-36	-100	NA
PSP Swiss Property	-5	9	0	0	0	-9	-9	8	9	4	2	2
Realia Business	36	-50	-27	9	32	-76	-90	153	1	6	-50	0
SEGRO	-5	11	10	7	-11	52	19	11	20	8	8	0
Unibail-Rodamco	68	56	4	10	8	20	-2	4	40	7	0	3
<b>Continental Europe</b>	<b>36</b>	<b>29</b>	<b>5</b>	<b>5</b>	<b>7</b>	<b>15</b>	<b>-5</b>	<b>18</b>	<b>22</b>	<b>4</b>	<b>-1</b>	<b>3</b>
<b>United Kingdom</b>	<b>9</b>	<b>-6</b>	<b>8</b>	<b>4</b>	<b>2</b>	<b>4</b>	<b>12</b>	<b>4</b>	<b>29</b>	<b>4</b>	<b>2</b>	<b>-3</b>
<b>Pan-Europe</b>	<b>27</b>	<b>18</b>	<b>6</b>	<b>4</b>	<b>6</b>	<b>12</b>	<b>0</b>	<b>14</b>	<b>24</b>	<b>4</b>	<b>0</b>	<b>1</b>

NA = Not applicable, NM = Not meaningful

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 14

## Pan-European Property: Growth in NAVs, 2007-10e

Company	Growth in headline NAV (%)				Growth in NAV net of 'mark-to-market' on debt (%)				Growth in 'triple net' NAV (%)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	-21	-37	-22	3	-18	-35	-21	3	-18	-36	-21	3
Brixton	2	-39	-40	-15	1	-40	-42	-16	5	-40	-42	-16
Castellum	13	-12	-23	-17	13	-12	-23	-18	10	-8	-23	-15
Corio	22	-6	-18	-9	22	-6	-18	-9	22	-6	-18	-9
Derwent London	2	-27	-31	9	1	-27	-32	9	19	-26	-32	9
DIC Asset	8	-5	-23	-9	10	-4	-22	-8	12	-4	-23	-9
Fabege	NM	-11	-36	-26	NM	-11	-36	-26	NM	-9	-29	-25
GAGFAH	NA	-10	-17	-18	NA	-11	-20	-18	NA	-13	-23	-22
Gecina	14	-10	-35	-14	14	-10	-35	-14	14	-10	-35	-14
Great Portland Estates	-2	-31	-22	-6	-2	-31	-22	-6	-2	-31	-23	-6
Hammerson	3	-29	-21	-8	5	-29	-21	-8	7	-22	-15	-6
Icade	NA	-2	-9	-5	NA	-2	-9	-5	NA	-2	-9	-5
IVG Immobilien	23	-28	-36	-14	23	-28	-36	-14	23	-28	-36	-14
Klepierre	22	-16	-26	-12	23	-13	-25	-11	27	-11	-26	-12
Land Securities	-10	-31	-20	-4	-9	-32	-21	-4	-9	-32	-21	-4
Liberty International	-5	-42	-36	-6	-5	-44	-39	-7	-5	-44	-40	-7
ProLogis Europe	-1	-27	-12	-6	-1	-27	-12	-6	-1	-25	-8	-6
PSP Swiss Property	9	0	-31	-26	9	0	-31	-26	6	0	-29	-24
Realia Business	-8	-14	-30	-25	-8	-14	-30	-25	-5	-17	-38	-35
SEGRO	-9	-23	-18	-1	-10	-24	-19	-1	7	-24	-19	-1
Unibail-Rodamco	21	-11	-18	-9	21	-11	-18	-9	20	-11	-17	-9
<b>Continental Europe</b>	<b>15</b>	<b>-10</b>	<b>-21</b>	<b>-12</b>	<b>15</b>	<b>-9</b>	<b>-21</b>	<b>-12</b>	<b>15</b>	<b>-9</b>	<b>-21</b>	<b>-12</b>
<b>United Kingdom</b>	<b>-9</b>	<b>-34</b>	<b>-25</b>	<b>-2</b>	<b>-8</b>	<b>-34</b>	<b>-26</b>	<b>-2</b>	<b>-6</b>	<b>-34</b>	<b>-25</b>	<b>-2</b>
<b>Pan-Europe</b>	<b>7</b>	<b>-17</b>	<b>-22</b>	<b>-9</b>	<b>8</b>	<b>-17</b>	<b>-22</b>	<b>-9</b>	<b>9</b>	<b>-17</b>	<b>-22</b>	<b>-9</b>

NA = Not applicable, NM = Not meaningful

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 15

## Pan-European Property: Pre-tax income-based valuation, 2007-10e

Company	EBITDA/EV Yield (%)				Pre-tax ModelWare EPS Yield (%)				Pre-tax Adjusted EPRA EPS yield (%)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	4.7	6.0	7.1	7.3	3.4	14.1	14.5	14.6	2.6	12.1	14.0	14.6
Brixton	4.2	6.0	8.4	9.7	3.9	63.0	66.0	72.3	3.3	55.0	62.2	69.2
Castellum	5.7	6.6	6.7	6.5	6.8	12.6	12.4	11.8	6.8	12.6	12.4	11.8
Corio	5.1	6.7	8.0	7.7	4.3	8.8	9.4	9.1	4.0	8.5	9.0	8.6
Derwent London	4.7	4.2	5.5	6.0	1.8	4.6	3.3	3.9	1.8	4.6	3.3	3.9
DIC Asset	5.2	7.3	8.9	10.0	3.2	22.7	24.8	27.2	5.8	42.6	45.4	47.8
Fabege	5.3	5.7	6.2	6.0	5.1	12.5	11.7	9.8	5.0	12.3	11.5	9.7
GAGFAH	3.6	5.2	6.3	6.8	1.2	15.2	19.1	21.3	1.2	15.2	19.1	21.3
Gecina	4.2	5.7	7.0	6.8	4.0	15.5	13.3	11.8	4.1	15.6	13.4	11.9
Great Portland Estates	3.4	4.2	6.1	6.3	2.0	4.8	5.6	5.9	1.7	3.7	5.4	5.9
Hammerson	3.9	5.1	6.6	6.7	2.5	11.9	13.6	16.5	1.8	9.4	11.1	10.4
Icade	3.6	5.5	6.7	6.5	-1.1	0.2	-0.2	-0.5	0.5	4.1	4.2	4.5
IVG Immobilien	3.8	4.4	5.0	5.1	2.4	11.7	1.3	8.6	2.6	11.7	1.3	8.6
Klepierre	5.3	6.1	7.4	7.7	0.3	8.1	5.1	5.8	0.6	18.9	18.3	18.8
Land Securities	4.4	5.3	7.2	7.4	3.5	13.0	13.6	14.2	3.1	11.4	13.3	14.2
Liberty International	4.0	4.8	6.0	6.2	3.0	8.2	8.4	7.7	2.7	7.2	7.1	6.9
ProLogis Europe	6.5	8.6	11.4	11.7	6.9	56.1	56.9	52.3	6.9	56.1	56.9	52.3
PSP Swiss Property	4.2	4.7	4.7	4.7	5.1	6.7	6.1	6.6	5.2	6.7	6.1	6.6
Realia Business	8.8	4.8	3.9	4.1	3.2	7.3	-3.5	-5.0	3.9	9.9	0.7	1.7
SEGRO	5.1	8.9	12.6	14.6	5.2	199.7	225.6	245.7	4.6	182.5	215.5	238.7
Unibail-Rodamco	4.3	5.6	6.3	6.5	3.8	8.0	7.6	8.0	3.7	7.8	7.6	7.9
<b>Continental Europe</b>	<b>4.5</b>	<b>5.7</b>	<b>6.5</b>	<b>6.6</b>	<b>3.1</b>	<b>8.9</b>	<b>7.9</b>	<b>8.1</b>	<b>3.3</b>	<b>10.3</b>	<b>9.7</b>	<b>10.0</b>
<b>United Kingdom</b>	<b>4.3</b>	<b>5.2</b>	<b>6.8</b>	<b>7.0</b>	<b>3.1</b>	<b>13.6</b>	<b>14.3</b>	<b>15.0</b>	<b>2.6</b>	<b>11.9</b>	<b>13.5</b>	<b>14.2</b>
<b>Pan-Europe</b>	<b>4.5</b>	<b>5.6</b>	<b>6.6</b>	<b>6.7</b>	<b>3.1</b>	<b>10.4</b>	<b>9.9</b>	<b>10.3</b>	<b>3.0</b>	<b>10.8</b>	<b>10.9</b>	<b>11.3</b>

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 16

## Pan-European Property: Post-tax income-based valuation, 2007-10e

Company	ModelWare EPS yield (%) <sup>1</sup>				Adjusted EPRA EPS yield (%)				Dividend yield (%)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	3.5	14.7	15.2	15.3	2.8	12.7	14.7	15.3	2.3	8.8	9.1	9.3
Brixton	3.9	63.0	66.0	72.3	3.3	55.0	62.2	69.2	3.2	57.7	59.7	61.8
Castellum	6.6	12.4	12.2	11.6	6.6	12.4	12.2	11.6	3.6	6.7	6.7	6.7
Corio	4.3	8.9	9.4	9.1	4.0	8.6	9.0	8.7	3.8	7.7	8.0	8.0
Derwent London	1.9	4.5	3.7	4.3	1.9	4.5	3.7	4.3	1.0	2.4	2.5	2.6
DIC Asset	2.4	16.6	18.8	20.1	5.0	36.5	39.4	40.7	6.2	28.2	22.5	33.8
Fabege	5.1	12.6	11.8	9.9	5.1	12.5	11.6	9.8	5.3	13.8	13.8	13.8
GAGFAH	1.6	16.6	21.6	24.0	1.6	16.6	21.6	24.0	4.5	22.1	22.9	24.8
Gecina	3.8	14.6	12.6	11.1	3.8	14.7	12.7	11.3	4.0	14.6	14.6	14.6
Great Portland Estates	2.1	4.8	5.6	5.9	1.8	3.7	5.4	5.9	2.0	4.7	4.9	5.6
Hammerson	2.4	11.2	12.8	15.6	1.7	8.7	10.3	9.5	2.0	10.4	11.2	5.3
Icade	0.6	1.8	1.4	0.9	2.3	5.6	5.8	5.9	2.8	5.8	6.2	6.5
IVG Immobilien	1.6	10.6	1.2	7.8	1.7	10.6	1.2	7.8	2.3	14.0	14.0	14.0
Klepierre	0.3	7.1	4.4	5.1	0.6	17.9	17.6	18.1	0.3	8.6	8.6	8.6
Land Securities	3.3	12.4	12.9	13.5	2.9	10.8	12.6	13.5	3.2	13.3	13.3	13.3
Liberty International	3.0	8.2	8.4	7.6	2.7	7.2	7.1	6.9	2.7	7.7	7.7	7.7
ProLogis Europe	6.0	49.0	51.2	47.1	6.0	49.0	51.2	47.1	6.6	38.1	0.0	23.5
PSP Swiss Property	4.9	5.4	5.0	5.3	5.0	5.5	5.0	5.4	3.9	4.9	5.0	5.1
Realia Business	2.0	4.3	-3.5	-5.0	2.7	6.8	0.7	1.7	1.4	15.7	7.9	7.9
SEGRO	4.1	179.4	202.8	220.8	3.5	162.3	192.7	213.8	3.7	122.0	131.9	131.9
Unibail-Rodamco	3.8	7.7	7.5	7.8	3.7	7.6	7.4	7.8	3.7	6.8	6.8	7.0
<b>Continental Europe</b>	<b>3.2</b>	<b>8.6</b>	<b>7.9</b>	<b>8.0</b>	<b>3.4</b>	<b>10.0</b>	<b>9.6</b>	<b>9.8</b>	<b>3.4</b>	<b>9.0</b>	<b>8.5</b>	<b>9.0</b>
<b>United Kingdom</b>	<b>3.0</b>	<b>13.3</b>	<b>14.0</b>	<b>14.6</b>	<b>2.6</b>	<b>11.5</b>	<b>13.1</b>	<b>13.8</b>	<b>2.5</b>	<b>10.9</b>	<b>11.2</b>	<b>10.7</b>
<b>Pan-Europe</b>	<b>3.1</b>	<b>10.0</b>	<b>9.8</b>	<b>10.1</b>	<b>3.1</b>	<b>10.5</b>	<b>10.7</b>	<b>11.1</b>	<b>3.1</b>	<b>9.6</b>	<b>9.3</b>	<b>9.5</b>

1. Depreciation nil or negligible except for IVG Immobilien, Klepierre

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 17

## Pan-European Property: Discounts to NAV, 2007-10e

Company	Discount to headline NAV (%)				Discount to NAV net of 'mark-to-market' on debt (%)				Discount to 'triple net' NAV (%)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	-31	-51	-37	-39	-34	-55	-43	-45	-33	-53	-41	-42
Brixton	-46	-93	-88	-85	-44	-92	-86	-84	-44	-92	-86	-84
Castellum	-24	-40	-22	-5	-23	-38	-20	-2	-16	-36	-16	-2
Corio	10	-42	-29	-22	10	-42	-29	-22	10	-42	-29	-22
Derwent London	-21	-43	-18	-24	-21	-43	-16	-23	-20	-43	-16	-23
DIC Asset	-8	-80	-74	-71	-9	-80	-75	-72	-6	-80	-73	-71
Fabege	-13	-57	-33	-9	-13	-57	-33	-9	-1	-52	-32	-9
GAGFAH	-17	-71	-65	-57	-28	-74	-68	-61	-18	-70	-61	-50
Gecina	-24	-73	-59	-52	-25	-73	-59	-53	-25	-73	-59	-53
Great Portland Estates	-9	-37	-19	-13	-9	-37	-19	-13	-7	-35	-16	-11
Hammerson	-34	-75	-68	-65	-34	-75	-68	-65	-33	-77	-73	-71
Icade	-7	-46	-40	-37	-7	-46	-41	-37	-6	-45	-40	-36
IVG Immobilien	-22	-76	-62	-56	-22	-76	-62	-56	-22	-76	-62	-56
Klepierre	-15	-58	-43	-35	-16	-60	-46	-39	-10	-58	-43	-35
Land Securities	-23	-64	-55	-54	-20	-62	-52	-50	-20	-62	-52	-50
Liberty International	-15	-43	-10	-4	-12	-39	0	8	-11	-37	4	12
ProLogis Europe	-22	-84	-82	-81	-22	-84	-82	-81	-15	-83	-82	-81
PSP Swiss Property	-11	-27	6	43	-11	-27	6	43	2	-15	19	56
Realia Business	-36	-78	-68	-58	-36	-78	-68	-58	-22	-72	-55	-31
SEGRO	-33	-96	-95	-95	-31	-96	-95	-95	-31	-96	-95	-95
Unibail-Rodamco	-8	-24	-7	2	-8	-25	-8	1	-11	-27	-12	-4
<b>Continental Europe</b>	<b>-10</b>	<b>-41</b>	<b>-27</b>	<b>-17</b>	<b>-11</b>	<b>-42</b>	<b>-27</b>	<b>-18</b>	<b>-10</b>	<b>-42</b>	<b>-27</b>	<b>-17</b>
<b>United Kingdom</b>	<b>-24</b>	<b>-55</b>	<b>-38</b>	<b>-37</b>	<b>-23</b>	<b>-54</b>	<b>-37</b>	<b>-35</b>	<b>-23</b>	<b>-54</b>	<b>-36</b>	<b>-34</b>
<b>Pan-Europe</b>	<b>-14</b>	<b>-46</b>	<b>-30</b>	<b>-23</b>	<b>-15</b>	<b>-46</b>	<b>-30</b>	<b>-23</b>	<b>-14</b>	<b>-46</b>	<b>-30</b>	<b>-23</b>

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research



April 6, 2009  
Property

Exhibit 18

## Pan European Property: Valuation metrics implied by our price targets

Company	EBITDA/EV yield (%)		Margin over 5-year swap rate		Adjusted EPRA EPS yield (%)		Dividend yield (%)		Discount to headline NAV		Discount to 'Triple Net' NAV	
	2009e	2010e	2009e	2010e	2009e	2010e	2009e	2010e	2009e	2010e	2009e	2010e
British Land	8.5	8.7	522	549	17.7	18.4	10.9	11.2	-48	-49	-51	-52
Brixton	8.1	8.6	486	540	13.9	15.4	13.3	13.8	-44	-35	-39	-27
Castellum	8.3	8.0	554	520	19.3	18.3	10.5	10.5	-50	-40	-47	-38
Corio	7.8	7.5	486	454	10.9	10.6	9.6	9.6	-41	-36	-41	-36
Derwent London	6.6	6.9	340	370	6.3	7.2	4.2	4.4	-51	-55	-51	-55
DIC Asset	9.2	10.3	624	735	35.0	36.1	20.0	30.0	-70	-67	-70	-67
Fabege	6.9	6.6	418	384	24.1	20.2	28.6	28.6	-68	-56	-67	-56
GAGFAH	6.7	7.0	373	406	36.8	41.0	39.1	42.3	-79	-75	-77	-71
Gecina	7.6	7.2	462	428	13.6	12.0	15.6	15.6	-61	-55	-62	-56
Great Portland Estates	7.2	7.5	393	423	9.2	10.1	8.4	9.5	-52	-49	-51	-48
Hammerson	6.2	6.0	296	271	6.0	5.5	6.5	3.1	-45	-40	-53	-49
Icade	7.1	6.9	414	390	6.9	7.0	7.3	7.8	-50	-47	-50	-47
IVG Immobilien	4.7	4.5	174	158	6.0	38.7	70.0	70.0	-92	-91	-92	-91
Klepierre	8.9	9.2	593	623	21.3	21.9	10.4	10.4	-53	-47	-53	-46
Land Securities	7.1	7.4	388	412	9.5	10.2	10.0	10.0	-41	-39	-37	-34
Liberty International	6.5	6.5	322	323	9.0	8.8	9.8	9.8	-29	-24	-18	-12
ProLogis Europe	12.1	11.5	912	852	29.0	26.6	0.0	13.3	-68	-66	-68	-66
PSP Swiss Property	5.7	5.6	279	261	8.4	9.1	8.5	8.7	-37	-15	-30	-8
Realia Business	4.4	4.6	146	168	1.8	4.5	21.4	21.4	-88	-85	-84	-75
SEGRO	10.8	11.4	756	811	15.6	17.3	10.7	10.7	-44	-43	-41	-40
Unibail-Rodamco	7.5	7.2	459	428	9.7	10.2	8.9	9.2	-29	-22	-33	-26
<b>Continental Europe</b>	<b>7.4</b>	<b>7.2</b>	<b>448</b>	<b>427</b>	<b>12.3</b>	<b>13.3</b>	<b>12.7</b>	<b>13.2</b>	<b>-44</b>	<b>-37</b>	<b>-45</b>	<b>-38</b>
<b>United Kingdom</b>	<b>7.3</b>	<b>7.4</b>	<b>403</b>	<b>420</b>	<b>11.0</b>	<b>11.5</b>	<b>9.3</b>	<b>9.1</b>	<b>-42</b>	<b>-41</b>	<b>-41</b>	<b>-39</b>
<b>Pan-Europe</b>	<b>7.4</b>	<b>7.3</b>	<b>434</b>	<b>425</b>	<b>11.9</b>	<b>12.7</b>	<b>11.6</b>	<b>11.9</b>	<b>-44</b>	<b>-39</b>	<b>-44</b>	<b>-39</b>

Source: Morgan Stanley Research estimates

April 6, 2009

Property

Exhibit 19

## Pan-European Property: Income-based ratios, 2007-2010e

Company	Interest cover (x)				Cover of net dividend by ModelWare EPS (x)				Cover of net dividend by adjusted EPRA EPS (x)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	1.8	2.2	2.1	2.1	1.5	1.7	1.7	1.6	1.2	1.4	1.6	1.6
Brixton	2.6	2.2	2.1	2.2	1.2	1.1	1.1	1.2	1.1	1.0	1.0	1.1
Castellum	2.9	2.6	2.4	2.2	1.8	1.9	1.8	1.7	1.8	1.9	1.8	1.7
Corio NV	3.0	2.6	2.7	2.5	1.1	1.2	1.2	1.1	0.0	1.1	1.1	1.1
Derwent London	1.8	1.6	1.6	1.7	1.9	1.9	1.5	1.6	1.9	1.9	1.5	1.6
DIC Asset	2.0	1.8	1.9	2.1	0.4	0.6	0.8	0.6	0.8	1.3	1.8	1.2
Fabege	2.1	1.8	1.7	1.5	NA	0.9	0.9	0.7	1.0	0.9	0.8	0.7
GAGFAH	1.4	1.6	1.8	1.9	NA	0.8	0.9	1.0	0.0	0.8	0.9	1.0
Gecina	2.8	2.8	2.2	2.0	1.0	1.0	0.9	0.8	1.0	1.0	0.9	0.8
Great Portland Estates	1.7	1.7	1.8	1.8	1.0	1.0	1.1	1.1	0.9	0.8	1.1	1.1
Hammerson	1.9	1.9	1.8	1.9	1.2	1.1	1.1	3.0	0.9	0.8	0.9	1.8
Icade	5.5	3.1	2.8	2.5	0.2	0.3	0.2	0.1	0.8	1.0	0.9	0.9
IVG Immobilien	2.1	1.4	1.0	1.3	0.7	0.8	0.1	0.6	0.7	0.8	0.1	0.6
Klepierre	3.3	2.9	2.5	2.6	1.0	0.8	0.5	0.6	2.0	2.1	2.0	2.1
Land Securities	2.1	2.2	2.1	2.1	1.0	0.9	1.0	1.0	0.9	0.8	1.0	1.0
Liberty International	1.7	1.6	1.6	1.5	1.1	1.1	1.1	1.0	1.0	0.9	0.9	0.9
ProLogis Europe	2.8	2.5	2.6	2.8	0.9	1.3	NA	2.0	0.9	1.3	NA	2.0
PSP Swiss Property	3.7	3.3	2.8	3.2	1.2	1.1	1.0	1.0	1.3	1.1	1.0	1.1
Realia Business	3.7	2.1	1.2	1.1	1.4	0.3	-0.5	-0.6	1.9	0.4	0.1	0.2
SEGRO	2.8	3.3	3.4	3.6	1.1	1.5	1.5	1.7	1.0	1.3	1.5	1.6
Unibail-Rodamco	4.8	4.3	3.6	3.2	1.0	1.1	1.1	1.1	1.0	1.1	1.1	1.1
<b>Continental Europe</b>	<b>4.0</b>	<b>3.4</b>	<b>2.9</b>	<b>2.7</b>	<b>0.9</b>	<b>1.0</b>	<b>0.9</b>	<b>0.9</b>	<b>1.0</b>	<b>1.1</b>	<b>1.1</b>	<b>1.1</b>
<b>United Kingdom</b>	<b>1.9</b>	<b>2.0</b>	<b>1.9</b>	<b>1.9</b>	<b>1.3</b>	<b>1.3</b>	<b>1.3</b>	<b>1.4</b>	<b>1.1</b>	<b>1.1</b>	<b>1.2</b>	<b>1.3</b>
<b>Pan-Europe</b>	<b>3.4</b>	<b>2.9</b>	<b>2.6</b>	<b>2.5</b>	<b>1.0</b>	<b>1.1</b>	<b>1.0</b>	<b>1.1</b>	<b>1.0</b>	<b>1.1</b>	<b>1.1</b>	<b>1.2</b>

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 20

## Pan-European Property: Balance sheet-based ratios, 2007-10e

Company	Property value to ordinary shareholders' funds (x)				Net debt to gross assets (less cash) (%)				Net debt to net assets (%)			
	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e	2007	2008e	2009e	2010e
British Land	2.1	2.5	2.6	2.6	45	54	59	58	91	134	171	162
Brixton	1.6	2.1	2.8	3.1	29	40	51	54	45	78	135	157
Castellum	2.2	2.6	3.0	3.3	40	45	54	60	87	114	153	193
Corio NV	1.6	1.7	1.9	2.0	33	35	41	45	56	62	80	96
Derwent London	1.5	1.7	2.0	2.0	28	37	46	45	42	65	99	93
DIC Asset	2.7	3.0	3.4	3.1	63	66	69	67	179	207	246	225
Fabege	2.6	2.9	4.0	5.3	51	56	66	72	132	161	274	403
GAGFAH	3.2	3.6	4.1	4.8	59	62	65	67	200	230	276	333
Gecina	1.5	1.6	1.9	2.1	34	36	47	51	54	61	97	117
Great Portland Estates	1.7	1.9	2.0	2.1	34	41	47	49	55	77	99	106
Hammerson	1.8	2.1	2.5	3.2	31	43	53	60	51	84	123	162
Icade	1.3	1.4	1.5	1.6	20	24	29	33	33	41	53	65
IVG Immobilien	2.6	3.3	4.5	5.1	52	59	64	66	151	221	335	392
Klepierre	2.0	2.8	3.3	3.5	41	48	52	53	84	128	168	182
Land Securities	1.5	1.7	2.0	2.0	37	41	47	48	66	84	109	115
Liberty International	1.8	2.6	3.5	3.6	39	52	61	63	73	134	217	236
ProLogis Europe	1.8	2.1	2.1	2.0	40	49	50	49	75	109	108	103
PSP Swiss Property	1.9	1.9	2.3	2.8	37	38	48	55	70	73	115	162
Realia Business	2.1	2.5	3.1	3.7	34	41	48	53	72	101	155	214
SEGRO	1.5	1.6	1.6	1.6	30	38	46	48	47	62	79	83
Unibail-Rodamco	1.7	1.8	2.0	2.4	29	33	36	44	49	62	76	107
<b>Continental Europe</b>	<b>1.8</b>	<b>2.0</b>	<b>2.3</b>	<b>2.6</b>	<b>33</b>	<b>37</b>	<b>42</b>	<b>48</b>	<b>64</b>	<b>81</b>	<b>107</b>	<b>137</b>
<b>United Kingdom</b>	<b>1.7</b>	<b>2.1</b>	<b>2.5</b>	<b>2.6</b>	<b>38</b>	<b>46</b>	<b>53</b>	<b>54</b>	<b>69</b>	<b>104</b>	<b>146</b>	<b>153</b>
<b>Pan-Europe</b>	<b>1.8</b>	<b>2.0</b>	<b>2.4</b>	<b>2.6</b>	<b>34</b>	<b>40</b>	<b>46</b>	<b>50</b>	<b>66</b>	<b>88</b>	<b>119</b>	<b>142</b>

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 21

## Pan-European Property: Historical sectoral breakdown of investment portfolio by value

Company	CBD offices	Other offices	Unit shops	Shopping centres	Other retail	Industrial /Logistics	Hotels	Other Commercial	Total Commercial	Resi- dential	Overall Total	Overall Total (€mn)
British Land	36.1	1.5	1.8	14.2	43.4	0.0	0.0	3.0	100.0	0.0	100.0	13,560
Brixton	0.0	10.6	0.0	0.0	0.0	89.4	0.0	0.0	100.0	0.0	100.0	1,533
Castellum	0.0	60.0	0.0	0.0	0.0	40.0	0.0	0.0	100.0	0.0	100.0	2,453
Corio	5.0	0.0	0.0	94.0	0.0	1.0	0.0	0.0	100.0	0.0	100.0	6,052
Derwent London	100.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	1,988
DIC Asset	19.0	45.0	29.0	0.0	0.0	0.0	0.0	3.0	96.0	4.0	100.0	1,971
Fabege	56.0	27.0	0.0	0.0	0.0	9.0	0.0	5.0	97.0	3.0	100.0	2,605
GAGFAH	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	100.0	9,927
Gecina	40.0	10.0	0.0	4.0	0.0	0.0	0.0	0.0	54.0	46.0	100.0	11,786
Great Portland Estates	77.9	0.0	0.0	0.0	22.1	0.0	0.0	0.0	100.0	0.0	100.0	1,193
Hammerson	22.2	0.0	0.0	64.1	13.7	0.0	0.0	0.0	100.0	0.0	100.0	4,567
Icade	6.9	46.1	0.0	1.0	0.0	0.0	0.0	5.0	59.0	41.0	100.0	6,040
IVG Immobilien	79.0	0.0	0.0	4.0	0.0	13.0	0.0	4.0	100.0	0.0	100.0	5,869
Klepierre	10.0	4.0	0.0	86.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	14,204
Land Securities	40.0	0.6	10.4	28.5	16.8	0.0	0.0	3.7	100.0	0.0	100.0	10,009
Liberty International	6.2	1.3	13.2	79.3	0.0	0.0	0.0	0.0	100.0	0.0	100.0	5,772
ProLogis Europe	0.0	0.0	0.0	0.0	0.0	100.0	0.0	0.0	100.0	0.0	100.0	3,332
PSP Swiss Property	66.0	0.0	14.0	0.0	0.0	0.0	0.0	17.0	97.0	3.0	100.0	4,557
Realia Business	87.0	0.0	0.0	13.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	3,119
SEGRO	0.0	16.0	0.0	0.0	16.0	61.0	0.0	7.0	100.0	0.0	100.0	3,234
Unibail-Rodamco	21.0	0.0	0.0	73.0	0.0	0.0	0.0	6.0	100.0	0.0	100.0	22,855
<b>Continental Europe</b>	<b>25.5</b>	<b>1.7</b>	<b>1.2</b>	<b>56.2</b>	<b>0.0</b>	<b>1.9</b>	<b>0.0</b>	<b>4.3</b>	<b>90.9</b>	<b>9.1</b>	<b>100.0</b>	<b>94,771</b>
<b>United Kingdom</b>	<b>38.1</b>	<b>0.9</b>	<b>7.4</b>	<b>40.1</b>	<b>10.1</b>	<b>1.9</b>	<b>0.0</b>	<b>1.5</b>	<b>100.0</b>	<b>0.0</b>	<b>100.0</b>	<b>41,856</b>
<b>Pan-Europe</b>	<b>29.1</b>	<b>1.5</b>	<b>2.9</b>	<b>51.7</b>	<b>2.9</b>	<b>1.9</b>	<b>0.0</b>	<b>3.5</b>	<b>93.5</b>	<b>6.5</b>	<b>100.0</b>	<b>136,627</b>

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 22

## Pan-European Property: Historical geographical breakdown of investment portfolio by value

Company	Capital city-centre	Capital city-periphery	Capital city-Total	Provinces	Home Country	Other Europe (incl. UK)	Total Europe	North America	Asia	Other	Overall Total	Overall Total (€mn)
British Land	35.0	0.0	35.0	65.0	100.0	0.0	100.0	0.0	0.0	0.0	100.0	13,560
Brixton	0.0	56.8	56.8	43.2	100.0	0.0	100.0	0.0	0.0	0.0	100.0	1,533
Castellum	0.0	0.0	0.0	100.0	100.0	0.0	100.0	0.0	0.0	0.0	100.0	2,453
Corio	N/AV	N/AV	N/AV	N/AV	31.4	68.6	100.0	0.0	0.0	0.0	100.0	6,052
Derwent London	94.0	0.0	94.0	6.0	100.0	0.0	100.0	0.0	0.0	0.0	100.0	1,988
DIC Asset	0.0	3.5	3.5	96.5	100.0	0.0	100.0	0.0	0.0	0.0	100.0	1,971
Fabege	56.0	34.0	90.0	10.0	100.0	0.0	100.0	0.0	0.0	0.0	100.0	2,605
GAGFAH	0.0	3.5	3.5	96.5	100.0	0.0	100.0	0.0	0.0	0.0	100.0	9,927
Gecina	65.4	31.4	96.8	3.2	100.0	0.0	100.0	0.0	0.0	0.0	100.0	11,786
Great Portland Estates	100.0	0.0	100.0	0.0	100.0	0.0	100.0	0.0	0.0	0.0	100.0	1,193
Hammerson	13.6	0.0	13.6	55.8	69.4	30.6	100.0	0.0	0.0	0.0	100.0	4,567
Icade	20.5	69.5	90.0	3.8	93.8	6.2	100.0	0.0	0.0	0.0	100.0	6,040
IVG Immobilien	5.0	0.0	5.0	55.0	60.0	40.0	100.0	0.0	0.0	0.0	100.0	5,869
Klepierre	14.0	0.0	14.0	44.0	58.0	42.0	100.0	0.0	0.0	0.0	100.0	14,204
Land Securities	50.0	4.0	54.0	46.0	100.0	0.0	100.0	0.0	0.0	0.0	100.0	10,009
Liberty International	3.7	0.0	3.7	91.8	95.5	0.0	95.5	4.5	0.0	0.0	100.0	5,772
ProLogis Europe	0.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0	0.0	100.0	3,332
PSP Swiss Property	60.0	0.0	60.0	40.0	0.0	0.0	100.0	0.0	0.0	0.0	100.0	4,557
Realia Business	22.0	0.0	22.0	34.0	56.0	44.0	100.0	0.0	0.0	0.0	100.0	3,119
SEGRO	0.0	0.0	0.0	75.5	75.5	24.5	100.0	0.0	0.0	0.0	100.0	3,234
Unibail-Rodamco	0.0	0.0	0.0	0.0	60.0	40.0	100.0	0.0	0.0	0.0	100.0	22,855
<b>Continental Europe (Investment Cos.)</b>	<b>13.8</b>	<b>3.8</b>	<b>17.6</b>	<b>12.0</b>	<b>29.7</b>	<b>35.8</b>	<b>65.4</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>65.4</b>	<b>94,771</b>
<b>United Kingdom (Investment Cos.)</b>	<b>37.4</b>	<b>2.5</b>	<b>39.9</b>	<b>52.3</b>	<b>92.2</b>	<b>6.9</b>	<b>99.1</b>	<b>0.9</b>	<b>0.0</b>	<b>0.0</b>	<b>100.0</b>	<b>41,856</b>
<b>Pan-Europe (Investment Cos.)</b>	<b>21.2</b>	<b>3.4</b>	<b>24.6</b>	<b>24.6</b>	<b>49.3</b>	<b>26.7</b>	<b>76.0</b>	<b>0.3</b>	<b>0.0</b>	<b>0.0</b>	<b>76.3</b>	<b>136,627</b>
<b>Core Europe (Other Business Models)</b>	<b>13.0</b>	<b>0.0</b>	<b>13.0</b>	<b>45.2</b>	<b>58.1</b>	<b>41.9</b>	<b>100.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>100.0</b>	<b>13,560</b>
<b>Pan-Europe (All)</b>	<b>20.9</b>	<b>3.3</b>	<b>24.2</b>	<b>25.4</b>	<b>49.6</b>	<b>27.2</b>	<b>76.8</b>	<b>0.3</b>	<b>0.0</b>	<b>0.0</b>	<b>77.1</b>	<b>1,533</b>

Source: Company data, Morgan Stanley Research

April 6, 2009

Property

Exhibit 23

## Pan-European Property: Historical regional breakdown of investment portfolio by value

Company	Bene- lux	UK & Eire	Ger- many	France	Italy	Scandi- navia	Spain	Austria & Switz	Other Europe	Total Europe	Other	Overall Total	Overall Total (€mn)
British Land	0.0	100.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	100.0	0.0	100.0	13,560
Brixton	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	1,533
Castellum	0.0	0.0	0.0	0.0	0.0	100.0	0.0	0.0	0.0	100.0	0.0	100.0	2,453
Corio	31.4	0.0	0.2	34.7	18.5	0.0	9.7	0.0	5.4	100.0	0.0	100.0	6,052
Derwent London	0.0	100.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	100.0	0.0	100.0	1,988
DIC Asset	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	1,971
Fabege	0.0	0.0	0.0	0.0	0.0	100.0	0.0	0.0	0.0	100.0	0.0	100.0	2,605
GAGFAH	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	9,927
Gecina	0.0	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	11,786
Great Portland Estates	0.0	100.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	100.0	0.0	100.0	1,193
Hammerson	0.0	69.3	0.0	30.7	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	4,567
Icade	0.0	0.0	6.0	94.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	6,040
IVG Immobilien	15.0	5.0	60.0	10.0	0.0	5.0	0.0	0.0	5.0	100.0	0.0	100.0	5,869
Klepierre	1.0	0.0	0.0	58.0	12.0	0.0	14.0	0.0	15.0	100.0	0.0	100.0	14,204
Land Securities	0.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	10,009
Liberty International	0.0	95.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	95.5	4.5	100.0	5,772
ProLogis Europe	9.0	26.0	6.0	29.0	8.0	2.0	7.0	0.0	13.0	100.0	0.0	100.0	3,332
PSP Swiss Property	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	100.0	0.0	100.0	4,557
Realia Business	0.0	0.0	0.0	44.0	0.0	0.0	56.0	0.0	0.0	100.0	0.0	100.0	3,119
SEGRO	4.6	75.5	0.0	2.9	0.0	0.0	0.0	0.0	17.0	100.0	0.0	100.0	3,234
Unibail-Rodamco	16.0	0.0	0.0	60.0	0.0	9.0	8.0	0.0	7.0	100.0	0.0	100.0	22,855
<b>Continental Europe (Investment Cos.)</b>	<b>12.3</b>	<b>0.5</b>	<b>3.6</b>	<b>54.3</b>	<b>3.9</b>	<b>4.6</b>	<b>7.1</b>	<b>7.4</b>	<b>6.3</b>	<b>100.0</b>	<b>0.0</b>	<b>100.0</b>	<b>94,771</b>
<b>United Kingdom (Investment Cos.)</b>	<b>0.4</b>	<b>92.2</b>	<b>0.0</b>	<b>5.3</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>1.3</b>	<b>99.1</b>	<b>0.9</b>	<b>100.0</b>	<b>41,856</b>
<b>Pan-Europe (Investment Cos.)</b>	<b>8.6</b>	<b>29.2</b>	<b>2.5</b>	<b>39.0</b>	<b>2.6</b>	<b>3.2</b>	<b>4.9</b>	<b>5.1</b>	<b>4.7</b>	<b>99.7</b>	<b>0.3</b>	<b>100.0</b>	<b>136,627</b>
<b>Core Europe (Other Business Models)</b>	<b>8.0</b>	<b>2.7</b>	<b>31.9</b>	<b>25.9</b>	<b>0.0</b>	<b>2.7</b>	<b>26.2</b>	<b>0.0</b>	<b>2.7</b>	<b>100.0</b>	<b>0.0</b>	<b>100.0</b>	<b>13,560</b>
<b>Pan-Europe (All)</b>	<b>8.5</b>	<b>28.3</b>	<b>3.5</b>	<b>38.5</b>	<b>2.6</b>	<b>3.2</b>	<b>5.6</b>	<b>4.9</b>	<b>4.7</b>	<b>99.7</b>	<b>0.3</b>	<b>100.0</b>	<b>1,533</b>

Source: Company data, Morgan Stanley Research

April 6, 2009

Property



**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of March 31, 2009)

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April 6, 2009

Property

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
<b>Overweight/Buy</b>	<b>686</b>	<b>31%</b>	<b>211</b>	<b>37%</b>	<b>31%</b>
<b>Equal-weight/Hold</b>	<b>993</b>	<b>44%</b>	<b>249</b>	<b>43%</b>	<b>25%</b>
<b>Not-Rated/Hold</b>	<b>33</b>	<b>1%</b>	<b>8</b>	<b>1%</b>	<b>24%</b>
<b>Underweight/Sell</b>	<b>521</b>	<b>23%</b>	<b>107</b>	<b>19%</b>	<b>21%</b>
<b>Total</b>	<b>2,233</b>		<b>575</b>		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

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Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

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**Industry Coverage:Property**

Company (Ticker)	Rating (as of)	Price (04/03/2009)
<b>Bart Gysens, CFA</b>		
British Land (BLND.L)	E (02/17/2009)	410p
Brixton (BXTN.L)	O (01/29/2009)	25p
Castellum (CAST.ST)	U (07/21/2008)	SKr47.3
Corio NV (COR.AS)	E (01/29/2009)	€33.83
DIC Asset (DAZG.DE)	O (01/29/2009)	€4.44
Derwent London (DLN.L)	E (11/06/2008)	743p
Fabege (FABG.ST)	U (04/16/2008)	SKr29
GAGFAH (GFJG.DE)	U (11/06/2008)	€3.74
Gecina (GFCP.PA)	U (01/29/2009)	€34.17
Great Portland Estates (GPOR.L)	U (07/08/2008)	256p
Hammerson (HMSO.L)	O (01/29/2009)	278p
IVG Immobilien (IVGG.DE)	U (04/24/2008)	€5
Icade (ICAD.PA)	E (01/29/2009)	€58.48
Immoeast (IMEA.VI)	++	€1.29
Klepierre (LOIM.PA)	U (01/29/2009)	€14.53
Land Securities (LAND.L)	O (01/29/2009)	483p
Liberty International (LII.L)	O (01/29/2009)	421p
ProLogis Europe (PEPR.AS)	O (11/06/2008)	€1.47
Realia Business (RLIA.MC)	U (06/16/2008)	€1.91
SEGRO (SGRO.L)	O (01/16/2008)	20p
Unibail-Rodamco (UNBP.PA)	E (01/29/2009)	€110
<b>Bianca Riemer</b>		
PSP Swiss Property (PSPN.S)	U (10/20/2008)	SFr50.75

Stock Ratings are subject to change. Please see latest research for each company.

**Exhibit III-D**

**Credit Suisse Report on  
Pommes à Ringo**

# Pommes à Ringo

## SECTOR REVIEW

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## FFO and AFFO updates

- **FFO and AFFO Updates** – The report below is our latest review of Funds and Adjusted Funds from Operations (or FFO and AFFO) calculations across our coverage universe. FFO and AFFO are commonly used valuation metrics in the United States. AFFO tends to be our favourite accounting metric, as it attempts to replicate the true cashflow per unit. Our Appendix below reviews the calculation of these two items.
- **Update (1) – the Japanese Lease-type Advantage** – Our analysis shows a continued shortfall of 24% between LPT dividends and reported cashflow. However, our research found one bright spot: trusts with Japanese exposure. A combination of (1) short lease terms, which in turn lead to minimal landlord investment, and (2) high levels of structuring-related income (capital hedges require no capital reserve) lead to a more modest (less than 15%) gap between reported and cash earnings.
- **Update (2) – Westfield and Development Interest Expense: Looks legit under US GAAP.** We have recently looked askance at the interest cost Westfield attributes to property held for future development. However, upon closer review of US REIT accounting practice, we have found that interest cost capitalization on land held for development *is* standard practice. An upward adjustment for this capitalized interest increases our 2006 and 2007 AFFO estimates by 4% and 5%, respectively – a key variable when comparing Westfield to its global mall peers.
- **Recurring cash earnings: DRT, Retail, and Japan** – On a valuation basis, we estimate the stocks with the highest recurring cash earnings yields are DB Reef Trust (tk: DRT) in large caps (a 2007 cash earnings yield of 5.5% versus a top 100 LPT average of 5.1%) and Macquarie DDR (tk: MDT) in small caps (cash yield of 7.8% versus 5.5% for the sector as a whole) – see Figure 10 below. In addition, the Japanese-based trusts (BJT and GJT) showed more relative multiple attractiveness on a post-capex basis.
- **Office – Likely Improvement:** The biggest gaps between dividends and cashflow have been office LPTs. However, incentives in many Australian and U.S. markets are narrowing, which in turn could improve cash earnings. Indeed, we think much of the earnings ‘growth’ in office LPTs will occur in cash (rather than reported) earnings, as lower fitout costs translate into higher cash earnings. We will review the potential for such an event in forthcoming research.

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## Table of contents

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Summary of Earnings Cross-Comparisons	3
FFO and AFFO: An Update	4
Results	4
1: Funds From Operations (FFO)	4
What's New: Westfield and Predevelopment Interest Capitalization: the Yanks	
Expense it	5
How Big a Number?	5
2: "Quasi" AGAAP	6
3: AFFO	7
What's New? The Japanese Office Advantage	7
AFFO and the Cost of a Dividend	8
AFFO Today versus Full Cycle – Office Should Get Better	9
Long-Term AFFO and Valuation	10
Humility – AFFO and Debt/Income Hedge mark to Market	13
What's New on Mark to Markets	13
Debt Mark to Market-Why Should We Care?	14
Appendix A: Overview of LPT Earnings Metrics	15
So what's this FFO thing?	15
Why FFO?	15
So, why not just use AGAAP?	16
Main Differences: AGAAP, IFRS, and FFO	16
AGAAP, IFRS, and AFFO – Why the Adjustments Aren't Always the Same	18
Appendix A: Accounting Summary	20
Appendix B: AGAAP, IFRS, FFO, and AFFO: Every Adjustment We Could Think Of	21
A: Rent Straightlining	21
B: Below Market Leases	21
C: Recurring Capitalized Expenditures	22
D: Lease Acquisition Costs	22
E: Above Market Debt/Loan Premium Amortization	23
Overall Results	23

# Summary of Earnings Cross-Comparisons

**Figure 1: Summary of earnings metric, trailing reporting period <sup>(1)</sup>, Credit Suisse LPT coverage universe (cents per unit)**

Metric Definition Company	Ticker	Subsector	Earnings Metric, Latest Reporting Period			
			Distributable Earnings As reported	(E) CS AGAAP (2) Old Earnings Regime	(E) CS FFO US REIT Earnings	(E) CS AFFO Cashflow
Babcock & Brown Japan	BJT	Diversified	5.8	5.6	5.6	5.5
Centro Properties Group	CNP	Retail	19.9	18.1	18.2	16.8
Centro Retail Group	CER	Retail	6.3	6.3	6.4	5.4
Commonwealth Property	CPA	Office	4.4	4.4	4.8	3.4
DB RREEF	DRT	Diversified	5.6	5.6	6.0	5.1
Galileo Shopping America Trust	GSA	Retail	5.1	5.1	5.5	4.4
GPT Group	GPT	Diversified	27.5	27.5	27.6	21.0
ING Office Fund	IOF	Office	5.5	5.5	5.7	3.8
Macquarie Countrywide Trust	MCW	Retail	7.7	7.6	7.9	6.8
Macquarie DDR Trust	MDT	Retail	5.1	4.9	5.2	4.2
Macquarie Office Trust	MOF	Office	6.3	5.6	6.0	3.7
Macquarie Prologis Trust	MPR	Industrial	6.0	5.9	6.1	5.1
Reckson New York	RNY	Office	6.4	6.3	7.2	3.3
Rubicon America Trust	RAT	Office	11.5	8.3	8.4	7.2
Tishman Speyer	TSO	Office	8.6	8.8	8.8	1.9
Westfield	WDC	Retail	103.7	99.6	100.6	92.4

(1) Full year 2006 for calendar reports. Half year 07 for companies with fiscal year reports. Performance fees treated as extraordinary events for external managers. (2) Like for like AGAAP (does not reflect company inconsistencies). Please see report below.

Source: Company data, Credit Suisse estimates

**Figure 2: Trailing reporting period earnings multiples, Credit Suisse coverage universe**

Metric Definition Company	Ticker	Subsector	Trailing Period Earnings Multiple (1)			
			Distributable Earnings As reported	(E) CS AGAAP (2) Old Earnings Regime	(E) CS FFO US REIT Earnings	(E) CS AFFO Cashflow
Galileo Shopping America Trust	GSA	Retail	11.6x	11.6x	10.8x	13.3x
Macquarie DDR Trust	MDT	Retail	11.8x	12.2x	11.4x	14.0x
Rubicon America Trust	RAT	Office	9.2x	12.7x	12.5x	14.6x
Macquarie Countrywide Trust	MCW	Retail	13.7x	13.8x	13.3x	15.5x
Centro Retail Group	CER	Retail	13.4x	13.4x	13.2x	15.6x
Babcock & Brown Japan	BJT	Diversified	16.8x	17.4x	17.4x	17.7x
DB RREEF	DRT	Diversified	15.7x	15.7x	14.6x	17.2x
ING Office Fund	IOF	Office	14.2x	14.2x	13.7x	20.5x
Commonwealth Property	CPA	Office	15.8x	15.8x	14.5x	20.5x
Macquarie Office Trust	MOF	Office	12.3x	13.9x	13.1x	20.9x
Westfield	WDC	Retail	20.4x	21.2x	21.0x	22.9x
GPT Group	GPT	Diversified	18.6x	18.6x	18.5x	24.4x
Macquarie Prologis Trust	MPR	Industrial	21.4x	21.8x	20.9x	25.0x
Centro Properties Group	CNP	Retail	22.7x	24.9x	24.8x	26.9x
Reckson New York	RNY	Office	17.9x	18.2x	16.1x	35.0x
Tishman Speyer	TSO	Office	15.0x	14.7x	14.7x	67.4x
<b>LPT Sector Average</b>			<b>16.4x</b>	<b>16.9x</b>	<b>16.3x</b>	<b>23.4x</b>

(1) Full year 2006 for calendar reports. Half year 07 for companies with fiscal year reports. Performance fees treated as extraordinary events for external managers.

Source: Company data, Credit Suisse estimates

# FFO and AFFO: An Update

Due to a recent breakdown in earnings cross-comparability, Credit Suisse has committed to undertaking a regular 'Apples to Apples' review of LPT earnings on a like-for-like basis. The following is a brief description of the earnings metrics that we use to cross-compare LPTs relative to each other:

1. **Funds From Operations (FFO)** – Funds from operations is an estimate of recurring accounting earnings, generally equal to reported earnings less unrealized fair market value changes and extraordinary gains on sale.
2. **“Quasi” AGAAP** – “Quasi” AGAAP is equal to FFO without the benefit of non-cash rent from straightlining lease steps and including the amortization of leasing commission expense. These adjustments tend to make “Quasi” AGAAP modestly more conservative than FFO. Please note that our “Quasi” AGAAP uses consistent accounting practices, which was not the case for LPTs across the old AGAAP regime (please see our Appendix for more detail).
3. **Adjusted Funds From Operations (AFFO)** – Adjusted Funds from Operations (AFFO) attempts to approximate recurring cashflow per unit. AFFO reports rents on a cash basis, expenses all costs as incurred rather than as amortized, and treats all recurring capital expenditures as expenses.

Our Appendix at the end of the report provides detail on each calculation.

We believe these metrics will also increase cross-comparability to global REITs (FFO and AFFO are commonly used earnings metrics in the United States) and non-real estate companies (our AFFO calculation is an attempt to estimate recurring cashflow per unit). What follows is our latest update of this analysis.

## Results

### 1: Funds From Operations (FFO)

Figure 3 below shows our estimated conversion of the company-reported distributable earnings of our coverage universe to FFO (A detailed breakdown on each calculation is available on request). Our analysis suggests that most LPTs would have slightly higher earnings if reported earnings were restated as FFO, primarily due to most Australian earnings metrics excluding straightline rent and including leasing commission amortization as a cost. Those companies with a downward adjustment from FFO to earnings were generally for company-specific reasons, including:

- (1) the exclusion of overheads and withholding tax (in Westfield tk: WDC);
- (2) share option expense (in Centro, tk: CNP);
- (3) incentive fee compensation that would be treated as an inter-company transfer under U.S. FFO (in Centro, tk: CNP);
- (4) gains on sale (in Macquarie Countrywide, tk: MCW, and Macquarie Office, tk: MOF). Some companies include gains on sale of operating assets in their distributable earnings calculation. FFO treats such gains as extraordinary and excludes them from the calculation; and
- (5) loan fee amortization treatment (in Rubicon America, tk: RAT, and Babcock & Brown Japan, tk: BJT). Some companies add back loan fee amortization in their distributable earnings calculation, which is an expense under FFO.

Please note that some trusts with a negative adjustment from FFO to distributable earnings did not pay out all of their earnings in the first place. For example, Macquarie

Office (tk: MOF) only paid out 5.6 cents of their reported distributable earnings of 6.3 cents, or about 93% of our FFO calculation of 6.0 cents.

**Figure 3: Trailing reporting period FFO as a percentage of distributable earnings, Credit Suisse coverage universe <sup>(1)</sup>**

Company	Ticker	Reported		FFO as % of EPU
		Distributable EPU	Credit Suisse FFO	
Reckson New York	RNY	6.4	7.2	112%
Commonwealth Property	CPA	4.4	4.8	109%
DB RREEF	DRT	5.6	6.0	108%
Galileo Shopping America Trust	GSA	5.1	5.5	107%
ING Office Fund	IOF	5.5	5.7	104%
Macquarie DDR Trust	MDT	5.1	5.2	103%
Macquarie Countrywide Trust	MCW	7.7	7.9	103%
Tishman Speyer	TSO	8.6	8.8	102%
Macquarie Prologis Trust	MPR	6.0	6.1	102%
Centro Retail Group	CER	6.3	6.4	101%
GPT Group	GPT	27.5	27.6	100%
Babcock & Brown Japan	BJT	5.8	5.6	97%
Westfield	WDC	103.7	100.6	97%
Macquarie Office Trust	MOF	6.3	6.0	94%
Centro Properties Group	CNP	19.9	18.2	92%
Rubicon America Trust	RAT	11.5	8.4	74%
<b>Sector average</b>		<b>14.1</b>	<b>13.8</b>	<b>100</b>

(1) Full year 2006 for calendar reports. Half year 07 for companies with fiscal year reports. Performance fees treated as extraordinary events for external managers.

Source: Company data, Credit Suisse estimates

### What's New: Westfield and Predevelopment Interest Capitalization – the Yanks Expense it

A material change to our FFO and resulting AFFO calculations has been the treatment of capitalised interest for Westfield (tk: WDC). Westfield currently uses operating segment earnings as its headline reported number. This number assigns interest cost on predevelopment properties to development segment earnings. This attribution leads to de facto interest capitalisation by excluding interest cost from operating segment earnings that otherwise would have been expensed under AGAAP or IFRS. We generally assume that IFRS does a good job assigning what development interest carry can be capitalised, and have previously kept predevelopment interest expense in our FFO and AFFO calculations (a more conservative number).

However, we recently underwent a fundamental review of the predevelopment projects where Westfield was assigning interest cost, and compared their capitalisation policies to that of US REITs. We found that Westfield's \$1.4 billion predevelopment book (classified as "Properties Held for Future Redevelopment" on its balance sheet) is dominated by raw land. We also found that US REITs typically do capitalize the interest carry on similar projects. As a result, we believe that allocation of predevelopment interest cost outside of operating earnings (in other words, capitalising predevelopment interest carry) is the appropriate treatment for FFO and AFFO.

### How Big a Number?

In 2006, the interest cost attributable to predevelopment was \$62m, or roughly 4% of reported operating segment earnings. However, predevelopment interest cost attribution will likely rise based upon the size of the current predevelopment book. Figure 4 shows the growth of the predevelopment book since 31 December 2005. Westfield's run-rate predevelopment interest carry is now almost twice what it was a year ago, predominantly



due to additional investments in Stratford, which will be developed into a shopping centre near London's Olympic site. We believe this elevated amount of predevelopment carry will continue until Westfield announces an official start to Stratford, by far its largest land site (by our estimate, 35% of the predevelopment pipeline). When Stratford is underway, we believe capitalised interest will be allowed under IFRS.

**Figure 4: Westfield properties held for redevelopment, 31 December 2005-present**

31/12/2005	30/06/2006	31/12/2006
810	1,390	1,421

Source: Company data, Credit Suisse estimates

Assuming a 6% interest carry, the 31 December 2006 predevelopment book would imply an annual carry of \$85m, or 5% of operating segment earnings. However, of equal importance is how predevelopment interest capitalisation impacts Westfield's earnings growth rate. Earnings growth without predevelopment carry would be anaemic and not representative of Westfield's underlying corporate performance. Put another way, if the market continued to judge Westfield on old AGAAP earnings growth, it would be waiting with baited breath for the day Stratford was officially counted as a development rather than a predevelopment. We do not consider this an appropriate to judge a company.

## 2: "Quasi" AGAAP

For those attempting to do AGAAP reconciliation, Figure 5 below compares FFO excluding straightline and including leasing commissions to currently reported earnings. This is a "quasi AGAAP" metric, as it does not take into account many of the company-by-company inconsistencies of various calculations (please see our Appendix below for more detail).

**Figure 5: Trailing reporting period FFO excluding straightline, but including lease commission amortization as a percentage of distributable earnings (quasi AGAAP Proxy), Credit Suisse coverage universe<sup>(1)</sup>**

Company	Ticker	Reported	Quasi	AGAAP as
		Distributable EPU		
Tishman Speyer	TSO	8.6	8.8	102%
Centro Retail Group	CER	6.3	6.3	100%
Commonwealth Property	CPA	4.4	4.4	100%
DB RREEF	DRT	5.6	5.6	100%
Galileo Shopping America Trust	GSA	5.1	5.1	100%
GPT Group	GPT	27.5	27.5	100%
ING Office Fund	IOF	5.5	5.5	100%
Macquarie Countrywide Trust	MCW	7.7	7.6	100%
Reckson New York	RNY	6.4	6.3	99%
Macquarie Prologis Trust	MPR	6.0	5.9	98%
Babcock & Brown Japan	BJT	5.8	5.8	97%
Macquarie DDR Trust	MDT	5.1	4.9	96%
Westfield	WDC	103.7	99.6	96%
Centro Properties Group	CNP	19.9	18.1	91%
Macquarie Office Trust	MOF	6.3	5.6	89%
Rubicon America Trust	RAT	11.5	8.3	72%
<b>Sector average</b>		<b>14.1</b>	<b>13.5</b>	<b>97%</b>

(1) Full year 2006 for calendar reports. Half year 07 for companies with fiscal year reports. Performance fees treated as extraordinary events for external managers.

Source: Company data, Credit Suisse estimates

### 3: AFFO

Figure 6 below compares our estimate of FY06 AFFO to distributions (a detailed breakdown of our calculation is available upon request). The analysis offers the following observations:

1. *Dividends aren't covered* – After accounting for recurring capital expenditures, leasing costs, and straightline rents, we estimate that in the past reporting period, recurring cashflow supported only 76% of trust dividends.
2. *Retail adjustments versus Office* – We generally find capital costs in the retail sector tend to run lower than office.
3. *There's no reserve on fees* – Centro Properties' (tk: CNP) Distribution/AFFO adjustment is particularly small despite its share option related adjustment (see above) not only because it is a retail LPT, but because 27% of its 1H07 EBIT was from fees-which have no capital expenditure/straightline adjustment against it.

**Figure 6: Estimated trailing period cash earnings (AFFO) as a percentage of distributions<sup>(1)</sup>, LPT sample set**

Company	Ticker	Subsector	AFFO per unit	Distribution per Unit	AFFO as % of Distribution
Babcock & Brown Japan	BJT	Diversified	5.5	5.8	96%
Macquarie Prologis Trust	MPR	Industrial	5.1	5.4	94%
DB RREEF	DRT	Diversified	5.1	5.6	92%
Galileo Shopping America Trust	GSA	Retail	4.4	5.1	87%
Centro Properties Group	CNP	Retail	16.8	19.3	87%
Westfield	WDC	Retail	92.4	106.5	87%
Macquarie Countrywide Trust	MCW	Retail	6.8	7.8	87%
Centro Retail Group	CER	Retail	5.4	6.3	86%
Macquarie DDR Trust	MDT	Retail	4.2	5.0	85%
GPT Group	GPT	Diversified	21.0	27.5	76%
ING Office Fund	IOF	Office	3.8	5.5	70%
Commonwealth Property	CPA	Office	3.4	5.1	67%
Macquarie Office Trust	MOF	Office	3.7	5.6	67%
Rubicon America Trust	RAT	Office	7.2	11.7	62%
Reckson New York	RNY	Office	3.3	6.4	51%
Tishman Speyer	TSO	Office	1.9	8.5	23%
<b>Sector average</b>			<b>11.4</b>	<b>13.9</b>	<b>76%</b>

(1) Full year 2006 for calendar reports. Half year 07 for companies with fiscal year reports. Performance fees treated as extraordinary events for external managers.

Source: Company data, Credit Suisse estimates

#### What's New? The Japanese Office Advantage

The trust with the smallest differential between reported and cash earnings was Babcock Japan (tk: BJT). BJT has 100% and 43% of its assets in Japan and office respectively. BJT benefits from Japanese office lease structure characteristics that we believe make landlord capital investment lower than office in other countries. We note the following lease factors tend to keep the discrepancy between reported and cash earnings small within Japanese office trusts:

1. **Fitout** – Most Australian and US office leases contain a fitout allowance where the landlord pays for tenant office fixtures. In contrast, the standard lease structure dominates the Japanese office market with a two-year duration. Due to the short lease term, Japanese landlords generally are not expected to pay a fitout allowance.
2. **Rent Frees** – Rent-free periods are common in most US and Australian office markets, particularly on new leases. As we will note in our appendix below, these

rent-free periods tend to be amortized over the course of a lease, leading an overstatement of accounting revenue versus cashflow in recently purchased buildings. Japanese standard leases tend not to have rent-free periods, eliminating this potential discrepancy between reported and cash rents.

3. **Leasing Commissions** – Under IFRS, leasing commissions are also capitalized and amortized, which can lead to a discrepancy between reported and cash earnings for portfolios with new assets. This gap can particularly occur in LPTs with US assets, where leasing commission schedules tend to be most onerous (the US custom is to pay commissions as a percentage of an entire lease's rent, rather than a percentage of the first year, as is the case in Australia). In Japan, there tends to be minimal difference between cash and reported leasing commission cost for the following reasons:
  - a. *Term* – Due to their two-year lease term, there is little room for discrepancy related to amortization period.
  - b. *Quantum of Cost* – Leasing commissions on office leases are typically limited to only one or two months rent.
  - c. *Renewal* – Leasing commissions are typically paid only on a new lease. As such, if tenants regularly renew every two years (high retention is common in Japan), leasing cost as a percent of operating income can be nominal.

Figure 7 below provides a summary of the level of lease investment necessary in Japanese office relative to the United States and Australia.

**Figure 7: Comparison of lease investment, Japanese versus US and Australian office**

	US	Australia	Japan
Leasing Commissions	Percentage of entire lease term	Percentage of first year's lease	Two months of new lease, none on renewal
Leasing Commission Amortization	Material	Material	Modest-if any
Fitout	Common	Common	Uncommon
Rent Free Period	Common	Common	Uncommon

Source: Company data, Credit Suisse estimates

For our analysis, Babcock Japan was the only trust with a full reporting period. However, we believe LPTs with Japanese assets with recent IPOs will have similar characteristics. For example, Galileo Japan (tk: GJT) guided to a 2008 capital reserve requirement of ¥130 million (A\$1.4m), or only 6% of reported distribution.

## AFFO and the Cost of a Dividend

At first glance, AFFO seems to be an academic topic: why should investors care about an earnings metric if the market continues to use other yardsticks (such as dividend yield) to judge valuation and performance?

Figure 8 below, assuming that company dividend deficits are funded by the company's weighted average cost of capital, on average, trusts in the last reporting period faced an annualized 1.4% dividend drag as a percentage of earnings from the difference between their dividend payouts and reported cashflow. Given our coverage universe 07-08 DPU growth rate is only 4%, a small drag in earnings from cashflow shortfall can have a material impact on the overall growth rate.

**Figure 8: (E) Trailing Period earnings drag from dividend deficit**

Company	Ticker	Dividend Deficit/ Sh (Cashflow-Dividend) (A)	Imp Cap Rate (Wgtd Cost of Capital) (B)	Lost DPU from Dividend Drag (AxB)	Lost Earnings as a % of 06 DPU
Babcock & Brown Japan	BJT	-0.2	3.6%	-0.01	-0.1%
DB RREEF	DRT	-0.5	5.9%	-0.03	-0.5%
Centro Properties Group	CNP	-2.5	4.3%	-0.11	-0.6%
Westfield	WDC	-14.1	4.7%	-0.66	-0.6%
Macquarie Countrywide Trust	MCW	-1.0	6.1%	-0.06	-0.8%
Centro Retail Group	CER	-0.9	5.9%	-0.05	-0.8%
Galileo Shopping America Trust	GSA	-0.6	6.6%	-0.04	-0.8%
Macquarie DDR Trust	MDT	-0.8	7.0%	-0.05	-1.0%
GPT Group	GPT	-6.5	4.7%	-0.31	-1.1%
ING Office Fund	IOF	-1.7	6.0%	-0.10	-1.8%
Macquarie Office Trust	MOF	-1.9	5.6%	-0.11	-1.9%
Commonwealth Property	CPA	-1.7	5.6%	-0.10	-1.9%
Rubicon America Trust	RAT	-4.4	6.9%	-0.30	-2.6%
Reckson New York	RNY	-3.1	5.8%	-0.18	-2.8%
Tishman Speyer	TSO	-6.6	4.6%	-0.30	-3.6%
<b>Sector Average</b>					<b>-1.4%</b>

(1) Full year for fiscal year reports. Half year for companies with calendar year reports. Source: Company data, Credit Suisse estimates

Source: Company data, Credit Suisse estimates

## AFFO Today versus Full Cycle – Office Should Get Better

The biggest gaps between dividends and cashflow have been office LPTs. However, some of this discrepancy is related to events that exaggerate capex cost relative to long-term levels. For example, Tishman Speyer (tk: TSO) completed 445,000 square feet of leasing in the last six month period (as at 31 December, TSO's overall portfolio was 8.0 million square feet, with 4.0 million square feet TSO's pro rata ownership), leading to 107,000 square feet of net absorption. 29% of this leasing was related to the new GATX Corporation lease in Chicago, arguably the highest incentive market in TSO's portfolio. Ironically, strong leasing leading to higher occupancy often leads to an initial *decline* in cashflows due to leasing costs, but leads to higher cashflow long term. In addition, Macquarie Office (tk: MOF) has undergone an above-trend amount of foyer renovations in recent months.

Figure 9 below shows our estimate of 2007 AFFO as a percentage of distributions based on the Credit Suisse estimate of long-term recurring capex and accounting adjustments. On a long term basis, we think that the FFO/AFFO adjustment for many of the trusts discussed above (such as Macquarie Office and Tishman) will improve relative to levels experienced in the most recent reporting period. As a result, the dividend drag from cashflow shortfall will also be mitigated.

We also wish to make the following observations regarding long-term AFFO:

Our answer is that cashflow (what AFFO is trying to approximate) impacts all earnings metrics, especially dividends. This is because dividend shortfalls cost trusts future earnings, as they must be funded by dilutive debt and equity. As shown in In a sector where many trusts are sold as higher yielding, lower growth names, minor earnings drags can all but eliminate earnings growth.

In a sector where many trusts are sold as higher yielding, lower growth names, minor earnings drags can all but eliminate earnings growth.

1. *Long-term may not be tomorrow* – The AFFO estimates shown below are based upon long-term recurring capital expenditures, the difference between our estimate and what the company will realize in a given year can be quite large. For example, as noted above, TSO's capital expenditures may continue to remain high as it continues to manage lease rollover in Chicago (57% of the 295,355 square foot USG lease, which rolls in June 2007, remains to be leased).
2. *Gearing works against you* – Companies with above-average gearing (such as Reckson New York (tk: RNY) and Rubicon America (tk: RAT)) tend to have large adjustments as a percentage of earnings, as a small increase in an expense line item has a large impact on earnings. As we show in our implied cap rate/EBIT multiple section below, the impact of capital reserves will be modestly more muted on an ungeared basis.
3. *Assumptions under review*. Finally, incentives in many Australian and U.S. markets are narrowing, which in turn could improve cash earnings levels. Indeed, we think much of the earnings "growth" in office LPTs will occur in AFFO, as lower fitout costs translate into higher cash earnings. As a result, our reserves in 2008 and beyond may be smaller than our long-term assumptions below. We will review the potential for further reserve narrowing in forthcoming research.

That being said, we implore investors to consider the impact of cashflow/dividend deficits to Net Asset Value (NAV) when office LPTs go ex-dividend. With many trusts, operating cashflow is close enough to dividends that an NAV adjustment at the ex-dividend date tends to be a rounding error. However, for office trusts (particularly those with half year dividend payouts), the NAV can be materially reduced subsequent to a dividend date (i.e.-period cashflow is materially lower than dividend payout).

**Figure 9: (E) 2007 AFFO as a percentage of distributions based on average cycle concessions and recurring non-cash adjustments**

Company	Ticker	(E) 07 Dividend	(E) 07 AFFO	07 Div as % of AFFO
Macquarie DDR	MDT	10.0	9.3	93%
Centro Properties	CNP	39.6	36.7	93%
Centro Retail	CER	12.6	11.4	90%
Babcock & Brown Japan	BJT	11.5	10.4	90%
GPT Group	GPT	29.2	26.0	89%
Westfield	WDC	106.5	94.6	89%
Galileo Japan Trust	GJT	7.7	6.7	87%
Macquarie Countrywide	MCW	15.6	13.5	87%
DB RREEF	DRT	11.2	9.7	87%
Galileo	GSA	10.2	8.6	84%
ING Office	IOF	10.4	8.4	81%
Macquarie Office	MOF	11.2	8.3	74%
Rubicon America	RAT	11.8	8.3	70%
Commonwealth Property	CPA	10.2	7.0	69%
Reckson New York	RNY	8.6	5.3	62%
Tishman Speyer	TSO	17.0	9.8	58%
<b>Sector Average</b>				<b>81%</b>

Source: Company data, Credit Suisse estimates

## Long-Term AFFO and Valuation

Figure 2 at the beginning of this report lists the multiples of our trusts under coverage using trailing earnings metrics. However, we are quite leery to use our trailing 'snapshot' AFFOs as a basis for valuation given the year-on-year fluctuation that can occur with capital expenditures. We are more comfortable to use our long-term AFFOs (net of

normalized capital expenditures) as a basis for valuation. On a post capex basis, our highest top 100 yield comes from DRT, with our largest overall yield from MDT

Figure 10 below shows the AFFO yield versus dividend yield for our coverage universe.

On a valuation basis, we estimate the stocks with the highest recurring cash earnings are DB RREEF Trust (tk: DRT) in large caps (a cash earnings yield of 5.5% versus a top 100 LPT average of 5.1%), and Macquarie DDR (tk: MDT) in small caps (cash yield of 7.8% versus 5.7% for our coverage universe as a whole).

**Figure 10: 2007 AFFO yield versus dividend yield, Credit Suisse coverage universe**

Company	Ticker	Dividend Yield	AFFO Yield	Diff
Centro Properties	CNP	4.4%	4.1%	-0.3%
Westfield	WDC	5.0%	4.5%	-0.6%
Macquarie DDR	MDT	8.4%	7.8%	-0.6%
Babcock & Brown Japan	BJT	5.9%	5.3%	-0.6%
GPT Group	GPT	5.7%	5.1%	-0.6%
Centro Retail	CER	7.5%	6.7%	-0.7%
DB RREEF	DRT	6.3%	5.5%	-0.8%
Macquarie Countrywide	MCW	7.4%	6.4%	-1.0%
Galileo Japan Trust	GJT	7.6%	6.6%	-1.0%
ING Office	IOF	6.6%	5.4%	-1.3%
Galileo	GSA	8.6%	7.3%	-1.3%
Macquarie Office	MOF	7.2%	5.3%	-1.9%
Commonwealth Property	CPA	7.3%	5.1%	-2.3%
Tishman Speyer	TSO	6.6%	3.8%	-2.8%
Reckson New York	RNY	7.5%	4.6%	-2.9%
Rubicon America	RAT	11.2%	7.8%	-3.3%
<b>Sector Average</b>		<b>7.1%</b>	<b>5.7%</b>	<b>-1.4%</b>

On a post capex basis, our highest top 100 yield comes from DRT, with our largest overall yield from MDT

Source: Company data, Credit Suisse estimates

On an unlevered basis, we can also take capital expenditures into account when making our implied cap rate calculations. Figure 11 below compares our implied cap rate (generally, the inverse of an EBIT multiple) on an NOI versus cash basis. Again, we believe the largest adjustment from nominal to cash NOI will generally come from office trusts, such as Commonwealth Property (tk: CPA) and Reckson New York (tk: RNY), although the percentage impact is much smaller on an unlevered than levered basis. Meanwhile, the smallest adjustments are made in retail and Japan-focused trusts.

**Figure 11: Credit Suisse implied cap rates, NOI vs. cash basis**

Company	Asset Class	Main Country	Ticker	Implied Cap		
				NOI	Cash	Diff
Reckson New York	Office	US	RNY	7.2%	5.8%	-1.4%
Commonwealth Property	Office	Aus	CPA	7.0%	5.7%	-1.3%
Tishman Speyer	Office	US	TSO	5.6%	4.5%	-1.1%
Macquarie Office	Office	Aus/US	MOF	6.7%	5.7%	-1.0%
ING Office	Office	Aus/US/Eur	IOF	7.0%	6.0%	-1.0%
Rubicon America	Office	US	RAT	7.7%	6.9%	-0.8%
DB RREEF	Diversified	Aus	DRT	6.7%	5.9%	-0.8%
Galileo	Retail	US	GSA	7.2%	6.6%	-0.6%
GPT Group	Diversified	Aus	GPT	5.3%	4.8%	-0.5%
Centro Retail	Retail	Aus	CER	6.3%	5.9%	-0.4%
Westfield	Retail	US/Aus/UK	WDC	5.1%	4.7%	-0.4%
Macquarie DDR	Retail	US	MDT	7.3%	7.0%	-0.3%
Macquarie Countrywide	Retail	US/Aus	MCW	6.4%	6.1%	-0.3%
Babcock & Brown Japan	Diversified	Japan	BJT	4.0%	3.7%	-0.3%
Centro Properties	Retail	Aus	CNP	4.5%	4.3%	-0.2%
<b>Sector Average</b>				<b>6.3%</b>	<b>5.6%</b>	<b>-0.7%</b>

Source: Company data, Credit Suisse estimates

## Humility – AFFO and Debt/Income Hedge Mark to Market

Please note that the AFFO adjustments we have shown above fell short of one significant adjustment necessary between our calculation and true reported AFFO: Debt/income hedge mark to market. Above-market debt arises from assumed debt in real estate acquisitions and mergers. If the rate on the debt is above market interest rates, according to IFRS and US GAAP, the book value of the debt must be increased to its current present value. The premium between book value and the principal due at maturity is amortized over the term of the loan. This loan premium amortization creates a non-cash reduction to interest expense, understating debt costs, and overstating earnings relative to cashflow.

US AFFO typically takes into account the amortization of the mark to market of assumed debt. Figure 12 below provides an example. We estimate that \$50m of face value debt was assumed in a recent acquisition. In addition, we assume the three-year debt is at an in-place rate of 7%, while market rates for debt with a similar maturity are at 4%. As a result of this calculation, the present value of the debt is \$54m. The company will have to carry the debt at the \$54m value, creating a book premium of \$4.2m over the face value of the loan. With a lease term of five years, this will create a non-cash reduction in interest expense of \$1.4m per year.

**Figure 12: Example of mark to market of above market debt**

Assumed Debt (000)	\$50,000
In-Place Rate	7.00%
Market Rate	4.00%
Wgtd Average Maturity (Yrs)	3
NPV Debt	\$54,163
<u>Loan Premium</u>	<u>\$4,163</u>
<b>Estimated Loan Premium Amortization Deduction per Year</b>	<b>-\$1,388</b>

Source: Company data, Credit Suisse estimates

In the United States, disclosure of the difference between cash and reported interest expense (as well as non-revenue producing capex) is near systematic-allowing for a reversal of the amortization benefit from FFO to AFFO calculations. Please note page 15 of General Growth's (tk: GGP) 2Q06 earnings supplement for an example of disclosure.

Similar mark to markets are made upon the assumption of income hedges. However, little US disclosure exists on the size of currency hedge mark to markets. That being said, we believe that this is a result of lack of experience rather than policy (the US has a much exposure to offshore markets than Australian LPTs). As a result, we believe that US AFFO would also adjust for the cash/accounting differences in income hedges in a method similar to debt premium amortization disclosure.

In Australia, some disclosure of this adjustment is beginning to find its way into disclosures. For example, Westfield (tk: WDC) now reports its operating earnings with both debt costs and hedge rates reported on a cash basis. In addition, both Macquarie Office (tk: MOF) and ING Office (tk: IOF) have assumed debt as part of transactions, and open to sharing the quantum of this adjustment to the market. However, other companies do provide the reversal of the debt amortization mark to market. As a result, we were unable to provide a complete review of AFFO net of debt mark to market for the LPT sector, and were unwilling to penalize the AFFO calculations of those LPTs that were willing to disclose these adjustments.

### What's New on Mark to Markets

The above companies have seen a significant narrowing in the difference between their cash and reported impacts of both currency hedges and debt costs:



1. **Westfield and the Passage of Time** – With the passage of time, Westfield's debt and currency hedges will be reset, slowly eliminating merger mark to markets. This process has already started. In 2006, Westfield had an 11-cent difference between financial and cash U.S. income swaps. In 2007, this level will fall to 7 cents.
2. **IOF and the Homer Building** – A significant component of IOF's above market debt arose from its acquisition of the Homer building in April and November 2005. US\$112 million of property-specific debt was recently refinanced, reducing the need for mark to market changes.
3. **MOF and One Liberty Square** – The Macquarie Office (tk: MOF) sale of One Liberty Square in Boston extinguished approximately US\$27m of marked to market debt dating back to the Principal America Office (PAO) portfolio.

## Debt Mark to Market – Why Should We Care?

Similar to other non-cash adjustments, the non-cash amortization of debt mark to market leads to an overstatement of distributions relative to cashflow. As a result, companies that would otherwise seem to be funding their dividends through operating earnings are actually borrowing to fund their dividends-thereby exacerbating the earnings drag shown in Figure 12 above. Put another way, direct real estate investors with a cashflow and IRR focus tend to avoid real estate assets encumbered with above-market debt due to a lower initial return on equity. In contrast, public financial statements make such properties look as 'clean' financially as assets free and clear of debt.

## Appendix A: Overview of LPT Earnings Metrics

Figure 13 lists every definition each trust uses for its earnings for our coverage universe. Notably, we estimate that there are currently 10 different earnings metrics within our 16 stock universe.

**Figure 13: Company-reported earnings metric, Credit Suisse coverage universe**

Company	Ticker	Terminology for Earnings in 06
Babcock & Brown Japan	BJT	Cash Distribution
Centro Retail Group	CER	Operating Distributable Income
Centro Properties Group	CNP	Distributable Profit
DB RREEF	DRT	Distributable Earnings
Galileo Japan Trust	GJT	Cash Distribution
GPT Group	GPT	Realised Operating income
Galileo Shopping America	GSA	Distributable Earnings
ING Office Fund	IOF	Distributable Income
Macquarie Countrywide Trust	MCW	Distributable Earnings
Macquarie DDR Trust	MDT	Distributable Earnings
Macquarie Office Trust	MOF	Distributable Earnings
Rubicon America Trust	RAT	Net Operating Profit (adjusted)
Rubicon Europe Trust Group	REU	Net Operating Profit (adjusted)
Reckson New York Property Trust	RNY	Adjusted NPAT
Tishman Speyer Office Fund	TSO	Operating Earnings
Westfield Group	WDC	Operating Segment

Source: Company data, Credit Suisse estimates

To 'fix' the earnings cross-comparability problem, Credit Suisse has decided to translate earnings into a funds from operations (FFO), AGAAP and adjusted funds from operations (AFFO) basis.

### So what's this FFO thing?

Funds from Operations, or FFO, is the most commonly used metric for US REIT earnings. FFO is defined by NAREIT, or the National Association of Real Estate Investment Trusts, the main industry body for the US REIT sector. A copy of the NAREIT white paper can be found at the website below:

[www.nareit.com/policy/accounting/NationalPolicy\\_\(042601\).pdf](http://www.nareit.com/policy/accounting/NationalPolicy_(042601).pdf)

Please note that the Credit Suisse definition of FFO differs slightly from the NAREIT policy. Notably, many LPTs run large currency and interest rate hedge books, whose mark to market by definition would run through the US GAAP P&L and hence FFO. However, we believe the unrealized mark to market of derivatives gets investors further away, rather than closer to the true earnings power of a company. As a result, we exclude balance sheet re-measurements from our analysis. We also draw inspiration from Prologis (tk: PLD.US). In addition to standard FFO, Prologis provides its own supplementary FFO that excludes the impact of derivative re-measurement. The Prologis supplement gives a detailed breakdown on their alternative FFO definition. We provide a link to that supplement below:

<http://files.shareholder.com/downloads/PLD/59952756x0x48344/1A33C88F-F2C2-4C72-A815-FC540D720C70/2Q 2006 - FINAL.pdf>

#### Why FFO?

From all accounts, the marginal property securities investment dollar (or yen, or pound, or euro) is increasingly being invested on a global basis. As a result, we believe that cross-comparisons of 'apples to apples' earnings metrics will increasingly be used throughout

the world. A like-for-like calculation of FFO will allow investors to cross-compare US REITs and Australian LPTs – the two largest property trust markets in the world.

### So, why not just use AGAAP?

After closer review, we have found that AGAAP was not a particularly good standardizer of earnings. The following are samples of discrepancies that occurred on a company-by-company basis under the AGAAP regime:

1. *Straightline rents (please see our discussion for detail below)* – Even under AGAAP, Westfield did straightline rents. In 2005, the adjustment on the US portfolio was US\$14m (roughly one cent per unit).
2. *Valuer fees* – Under AGAAP, some trusts chose to capitalize valuer fees to property while others expensed the line item. In the US, since properties are not regularly valued, this does not tend to be an expense for REITs. However, for the sake of our FFO calculation, we will treat this cost as an expense.

Given a lack of consistency in AGAAP in the first place, we have chosen to use FFO as our ‘first line’ in property earnings.

## Main Differences: AGAAP, IFRS, and FFO

A shorthand definition of FFO would be as follows:

$$FFO = US\ GAAP - Gains\ on\ Sale\ of\ Operating\ Properties + Depreciation$$

With our one ‘tweak’ regarding derivative mark to market, the Credit Suisse simplified definition would be

$$FFO = US\ GAAP - Gains\ on\ Sale\ of\ Operating\ Properties + Depreciation - Unrealized\ Change\ in\ Derivative\ Values$$

At first glance, FFO and AGAAP seem to be approximations of each other. AGAAP had no depreciation charge on assets (Australian property, unlike US property, is regularly revalued) and many trusts backed out gains on sale from their AGAAP-based earnings calculations. However, a number of subtle differences create discrepancies between the two calculations – as well as between FFO and the plethora of the earnings definitions creeping into the market. Figure 14 below summarizes some of the main differences between FFO, AGAAP and IFRS Accounting (In addition, we provide sample calculations of many of these adjustments in our appendix titled “AGAAP, IFRS, FFO, and AFFO: Every Adjustment We Could Think Of” at the end of this report). The main differences are as follows:

1. *Straightline rents* – Straightline rents are the ‘flattening’ of lease-terms. For example, if a 10-year lease pays \$10 for the first five years and \$20 for the second half, US GAAP (and hence FFO) requires companies to report \$15 rent throughout the course of the lease. Companies with leases predominantly in the early period of long-term leases typically have a negative straightline adjustment. Under IFRS, rents are straightlined, but there are modest differences in the treatment of rent free periods (please see our section titled “AGAAP, IFRS and AFFO – Why the Adjustments Aren’t Always the Same” for more detail).
2. *Below-market leases* – Below-market leases is a US accounting anomaly that creates a spread between nominal and cash earnings. If an asset is acquired with in-place leases below market rates, the present value of the difference between existing and market rents is booked as a deferred liability (deferred revenue associated with acquired operating leases). The liability is amortized over the course of a lease-term, creating a non-cash benefit to rental revenues. We have seen no evidence of this adjustment in Australian accounting regimes. As a result, lease mark-to-market adjustments tend to overstate US GAAP and FFO versus

earnings produced under AGAAP or IFRS regimes. For an example on this calculation, please see Figure 18 later in this report.

3. *Leasing commissions* – In the US leasing commissions are capitalized to the property value, while in Australia (under both IFRS and AGAAP) they are capitalized but expensed through the P&L.

**Figure 14: Examples of differences between FFO, AGAAP, and IFRS**

Line Item	FFO	AGAAP	IFRS
Straightline	Included	Escalations on cash basis, rent free amortized	Escalations on cash basis, rent free amortized
Lease Mark to Market	Included	NA	NA
Leasing Commissions	Capitalized	Capitalized and Amortized	Capitalized and Amortized

Source: Company data, Credit Suisse estimates

In addition, there a number of company-specific line items related to distribution policies that have led to a difference between US FFO and distributable earnings. The following are three examples:

1. *Loan fee amortization* – Some trusts have taken on the policy of excluding loan fee amortization from their current earnings, a practice we believe is incorrect. Loan fees are a cost. They either should be expensed upfront when there is a cash cost (and run through distributable earnings) or expensed as the amortization of this cost is incurred. In essence, the amortization of loan costs over the life of a debt term is an example of accounting doing a good job – spreading a recurring cost over the life of a piece of debt.
2. *Share option expense* – US GAAP now requires option expensing – which in turn reduces FFO. Within our coverage universe, Centro's Employee Share Plan, or ESP program is not expensed as part of the company's distributable earnings.
3. *Gains on sale* – Some LPTs are beginning to include all gains on sale in their distributable earnings calculation. For FFO, this is not the case. Gains on operating properties (typically denoted by assets that are subject to a depreciation charge) are excluded from FFO. Instead, gains on sale included in FFO are specific to the following circumstances:
  - a. *Land sales* – Sales of raw land (which by definition is not subject to depreciation) are included in FFO.
  - b. *Outlot sales* – Outlot sales (common for US strip center REITs with on-grade parking) is another quasi-land sale that runs through FFO.
  - c. *Sales of properties earmarked as trading assets* – Many US REITs cordon off a component of their portfolio, which they classify as trading assets (an example would be the Ameriton subsidiary of Archstone Smith, tk: ASN.US). The gain on sale net of the asset value when the asset was classified as a trading asset is included in FFO.

Regardless of the country where we did our calculation, we have always had a bias for adjusted funds from operations or AFFO, over AGAAP, FFO, or whatever type of distributable earnings the market is trying to pitch. AFFO's goal is to approximate the actual cashflow a trust generates that can be claimed by equity holders. As a result, AFFO tries to strip out all non-cash items from FFO. The following are a summary of five of the growing list of adjustments that must be made between Funds from operations and cashflow. Again, we provide sample calculations of many of these adjustments in our appendix titled "AGAAP, IFRS, FFO, and AFFO: Every Adjustment We Could Possibly think of" at the end of this report.

*Recurring capitalized expenses* are recurring costs that are capitalized rather than expensed. Examples of such capitalized costs include roof and HVAC replacement, paving, exterior painting and carpeting. These costs are treated as expenses under AFFO.

*Lease acquisition costs* are capitalized leasing commissions and tenant improvements typically paid on new leases and renewals. These costs are also treated as expenses under AFFO.

*Debt mark to market* arises from assumed debt in real estate acquisitions and mergers. If the rate on the debt is above market interest rates, according to GAAP, the book value of the debt must be increased to its current present value. The premium between book value and the principal due at maturity is amortized over the term of the loan. This loan premium amortization creates a non-cash reduction to interest expense, understating debt costs, and overstating earnings relative to cashflow. AFFO calculations typically reverse the non-cash benefit of this amortization.

*Non-cash rent straightlining and lease mark to market* adjustments (see definitions above) are also reversed out of AFFO from FFO.

Figure 15 below summarizes the above major adjustments from FFO to AFFO:

**Figure 15: Summary of Major Adjustments from FFO to AFFO**

Item	Description	Impact versus Cash Earnings
Recurring capital expenditures	Recurring costs that are capitalized rather than expensed	Operating expenses are understated
Lease acquisition costs	Tenant allowances and leasing commission costs	Operating expenses are understated
Rent straightlining	Higher revenues from future rent bumps recognized in the current period	Revenues are overstated
Debt Mark to Market	Debt book premium amortized over the course of the loan	Interest expense is understated
Lease Mark to Market	Below market rent liability amortized over lease-term	Revenues are overstated

Source: Company data, Credit Suisse estimates

## AGAAP, IFRS, and AFFO – Why the Adjustments Aren't Always the Same

At first glance, it would seem that some of the adjustments to AFFO are available through the use of financial statements. For instance, AGAAP never straightlined lease bumps, IFRS reports the amortization of fitout costs, and both AGAAP and IFRS reported the amortization of leasing commissions. However, the following factors require a considerable amount of 'tweaking' before they resemble a true cash earnings metric:

1. *Straightline rents and rent-free periods* – AGAAP typically did not straightline rent bumps, but did straightline rent frees. US adjustments from FFO to AFFO typically adjust for both factors. Our AFFO estimates below allow for an uptick to those trusts we believe would have additional straightline rents due to rent frees.
2. *Leasing commissions – cash versus amortized* – AGAAP and IFRS both amortize leasing commissions through the P&L. However, AFFO adjustments typically include the full cash cost.

Many LPTs have a plethora of recently acquired assets, which in turn generally leads to an understatement of cash leasing commissions versus the amortized expense. For example, an LPT buys building A with 100 square feet whose leases have an average term of 10 years, and each lease has \$1 of leasing commission cost to renew. In the first year of the lease, the cash leasing commission will be \$1, but the amortization will be only 10 cents (\$1/10-year lease term). In year two, there will be 20 cents of amortization (10 cents from the first period plus 10 cents from the second), 30 cents in year three, and so on. In

this example, amortized leasing commission expense will not equal cash expense until year 10.

Since very few LPT assets have been owned through a full leasing cycle, amortized leasing expense tends to understate the true cash cost. As a result, our cash leasing commissions, provided by companies, generally are higher than amortized leasing commissions.

3. *Tenant fitout contribution – cash versus amortized* – Tenant fitout contribution suffers from the same timing issues as leasing commissions, leading to a chronic understatement of true cost in the IFRS amortization. As a result, company provided cash tenant fitouts tend to be higher than cash fitout.

## Appendix A: Accounting Summary

**Figure 16: Items commonly included and excluded between IFRS, FFO, and AFFO**

Line Item	FFO	AFFO	AGAAP	IFRS
Straightline	Included	Excluded	Escalations on cash basis, rent free amortized	Escalations on cash basis, rent free amortized
Debt Mark to Market	Included	Excluded	Included	Included
Lease Mark to Market	Included	Excluded	NA	NA
Fitout	Capitalized	Expensed	Capitalized	Capitalized and Amortized
Capex	Capitalized	Expensed	Capitalized	Capitalized
Leasing Commissions	Capitalized	Expensed	Capitalized and Amortized	Capitalized and Amortized

Source: Company data, Credit Suisse estimates

## Appendix B: AGAAP, IFRS, FFO, and AFFO: Every Adjustment We Could Think Of

Below is a set of example calculations of the various factors that lead to differences between Australian and US accounting regimes. A summary of these adjustments is shown in Figure 21 at the end of this section.

### A: Rent Straightlining

Rent straightlining is the “flattening” of rent terms over the course of a long-term lease. We show an example of an adjustment from FFO to cash AFFO for recurring capex in Figure 17 below. In the example, we estimate that an office REIT comprised of 10 million leased square feet is comprised of 1 five-year lease beginning at a rent of \$15, increasing to \$16 at year three. This makes the weighted average rental rate equal to \$15.60 over the course of the lease.

On a cash basis, in year one, the REIT will receive \$150m in cash from the tenant (10 million times \$15). However, GAAP accounting will assume that the company is receiving \$156m in revenues from the lease (10 million times \$15.60). As a result, we would estimate that there would be a \$6m (\$150m minus \$156m) reduction from IFRS to AGAAP to reflect rent straightlining. FFO would include the benefit of the straightline rents.

Please note that the straightlining used in IFRS is modestly different from the straightlining used in AFFO. Notably, AGAAP does not straightline rent bumps – but it *does* straightline rent frees. As a result, in our example below the adjustment from FFO to AFFO (\$7m) is modestly larger than the adjustment from IFRS to AGAAP (\$6m).

**Figure 17: Example of Rent Straightlining**

Total Square Feet ('000)	10,000
Lease Term (Yrs)	5
Rent per foot, Years 1-2	\$15.00
Rent per foot, Years 3-5	\$16.00
Avg. Straightlining Rent per foot, Term of Lease	\$15.60
Cash Rent, Year 1 of Lease	\$150,000
GAAP Rent, Year 1 of Lease	-\$156,000
<b>Estimated Straightline Rent Deduction, Year 1 of Lease ('000)</b>	<b>-\$6,000</b>
<b>Additional Straightline Rent Associated with Rent Frees</b>	<b>-\$1,000</b>
<b>Gross Straightline Rent Deduction for AFFO Purposes</b>	<b>-\$7,000</b>

Source: Credit Suisse estimates

### B: Below Market Leases

Below Market Leases is another accounting anomaly that creates a spread between reported and cash earnings. If an asset is acquired with in-place leases below market rates, the present value of the difference between existing and market rents is booked as a deferred liability (deferred revenue associated with acquired operating leases). The liability is amortized over the course of a lease-term, creating a non-cash benefit to rental revenues-again overstating FFO versus cash AFFO earnings.

We show an example of an adjustment from FFO to cash AFFO for below market leases in Figure 18 below. In the example, we estimate that a 1 million square foot lease maturing next year receives cash rents of \$15 per square foot, but whose market rents are \$17 per foot. This will create a \$2 million liability that will be added back as non-cash rental revenue over the term of the lease.

*Please note that we have need seen any implementation of lease mark to market yet under any Australian accounting regime. As such, the calculation below is for illustrative*



purposes only, and to help investors consider additional adjustments to be made when comparing with US REITs.

**Figure 18: Example of below-market lease adjustment**

SF Purchased ('000)	1,000
In-Place Rent/Ft	\$15
Market Rent/Ft	\$17
Wgtd Average Maturity (Yrs)	1
<u>Deferred Revenue from Operating Leases</u>	<u>\$2,000</u>
<b>Estimated Below Market Lease Deduction per Year (000)</b>	<b>-\$2,000</b>

Source: Company data, Credit Suisse estimates

## C: Recurring Capitalized Expenditures

Recurring capitalized expenditures (recurring capex) are costs that are necessary to maintain the long-term life of a property that are capitalized rather than expensed. Recurring capital expenditures are typically estimated on a per square foot, or for apartments, a per unit basis. We show an example of an adjustment from FFO to cash AFFO for recurring capex in Figure 19 below. In the example, we estimate that an office REIT comprised of 10 million square feet requires capital expenditures of \$0.25 per square foot to sustain the value of its property. As a result, we would estimate that there would be a \$2.5 million (10 million times \$0.25) reduction from FFO to cash AFFO to reflect recurring capitalized expenditures. *Please note that only AFFO treats any of recurring capex cost as an expense.*

**Figure 19: Example of recurring capitalized expenditures adjustment**

<b>Total Square Feet ('000)</b>	<b>10,000</b>
Recurring Capex per Square Foot	-\$0.25
<b>Estimated Annual Capex Reserve Deduction ('000)</b>	<b>-\$2,500</b>

Source: Company data, Credit Suisse estimates

## D: Lease Acquisition Costs

Lease acquisition costs are capitalized leasing commissions and tenant improvements typically paid on new leases and renewals. Tenant acquisition costs are most common in the retail and office sectors. We show an example of an adjustment from FFO to cash AFFO for recurring capex in Figure 20 below. In the example, we estimate that an office REIT comprised of 10 million leased square feet has an average leasing cost per square foot per year leased (including both leasing commissions and fitout costs) is \$1.50. As a result, we would estimate that there would be a \$15 million (10 million times \$1.50) reduction from FFO to cash AFFO to reflect lease acquisition costs.

Please note that IFRS expenses the amortization of both leasing commissions and fitout costs, while AGAAP expenses the amortization of leasing commissions. However, as noted above, this cost tends to be below the cash cost for most trusts. In our example below, \$500,000 of leasing commissions are expensed under AGAAP and IFRS, while \$2m of fitout is amortized under IFRS.

**Figure 20: Example of lease acquisition costs**

<b>Total Square Feet ('000)</b>	<b>10,000</b>
<u>Average Leasing Costs per Square Foot per Year</u>	<u>-\$1.50</u>
Estimated Annual Capex Reserve Deduction ('000) (A)	-\$15,000
Amortized Leasing Commissions (Expensed Under AGAAP, IFRS) (B)	-\$500
<u>Amortized Fitout Cost (Expensed under IFRS) (C)</u>	<u>-\$2000</u>
<b>Estimated Annual Capex Reserve Deduction-Net-IFRS to AFFO ('000) (A-B-C)</b>	<b>-\$12,500</b>

Source: Company data, Credit Suisse estimates

## E: Above Market Debt/Loan Premium Amortization

Please see our example in Figure 20 above for a calculation.

### Overall Results

After reflecting all five factors, if our hypothetical LPT had \$75 million in IFRS earnings, other additional earnings metrics would be as follows:

- *AGAAP Earnings* would be \$71 million, of \$4 million lower than IFRS, due (1) a reduction of \$6 million due to straightline rent reversal and (2) an addback of \$2 million of amortized fitout cost.
- *Funds from Operations or FFO* would equal \$77.5 million, or \$6.5 million above AGAAP due to (1) a \$6 million addback of straightline rents and (2) a \$500,000 addback for leasing costs.
- *Adjusted Funds from Operations, or AFFO*—our best proxy for cash earnings, would equal \$49.6 million, or \$27.9 million below FFO due to (1) a straightline rent reduction of \$7 million, (2) a \$2 million reduction due to below market lease reversal (again, an adjustment we have yet to need to make in Australia), (3) \$2.5 million in recurring capital expenditures, (4) \$15 million in leasing costs, and (5) \$1.4 million due to the reversal of debt mark to market.

A summary of all adjustments is shown in Figure 21 below.

**Figure 21: Summary of example accounting adjustments**

Income Statement Line-Items	Reported IFRS	Adjustment Description	IFRS to AGAAP		AGAAP to FFO		FFO to AFFO	
			Adjustment	Earnings	Adjustment	Earnings	Adjustment	Earnings
Revenues	\$150,000	Straightline ( A)	-\$6,000	\$144,000	\$6,000	\$150,000	-\$7,000	\$143,000
		Below mkt lease (B)					-\$2,000	-\$2,000
Expenses	-\$40,000	Recurring Capex (C)		-\$40,000		-\$40,000	-\$2,500	-\$42,500
		Leasing Costs (D)	\$2,000	\$2,000	\$500	\$2,500	-\$15,000	-\$12,500
Net Operating Income	\$110,000		-\$4,000	\$106,000	\$6,500	\$112,500	-\$26,500	\$86,000
Interest Expense	-\$30,000	Loan Premium Amortization (E)	0	-\$30,000	0	-\$30,000	-\$1,389	-\$31,389
<u>G&amp;A</u>	<u>-\$5,000</u>			<u>-\$5,000</u>		<u>-\$5,000</u>		<u>-\$5,000</u>
Net Income	\$75,000		-\$4,000	\$71,000	\$6,500	\$77,500	-\$27,889	\$49,611
<u>Shares Outstanding</u>	<u>50,000</u>			<u>50,000</u>		<u>50,000</u>		<u>50,000</u>
Earnings per Share	\$1.50			1.42		1.55		0.99
Earnings as % of IFRS				95%		103%		66%

Source: Company data, Credit Suisse estimates

**Companies Mentioned** (Price as of 09 Apr 07)

Babcock & Brown Japan Property Trust (BJT.AX, A\$1.96, OUTPERFORM, TP A\$2.40, OVERWEIGHT)  
 Centro Properties Group (CNP.AX, A\$9.01, UNDERPERFORM, TP A\$7.60, UNDERWEIGHT)  
 Centro Retail Group (CER.AX, A\$1.69, NEUTRAL, TP A\$1.90, UNDERWEIGHT)  
 Commonwealth Property Office Fund (CPA.AX, A\$1.39, UNDERPERFORM, TP A\$1.37, OVERWEIGHT)  
 DB Reef Trust (DRT.AX, A\$1.77, OUTPERFORM, TP A\$2.00, OVERWEIGHT)  
 Galileo Japan Trust (GJT.AX, A\$1.01, OUTPERFORM [V], TP A\$1.18, OVERWEIGHT)  
 Galileo Shopping America Trust (GSA.AX, A\$1.18, NEUTRAL, TP A\$1.27, UNDERWEIGHT)  
 General Growth Properties (GGP, \$64.17, NEUTRAL, TP \$44.00, UNDERWEIGHT)  
 GPT Group (GPT.AX, A\$5.12, UNDERPERFORM, TP A\$4.80, OVERWEIGHT)  
 ING Office Fund (IOF.AX, A\$1.57, UNDERPERFORM, TP A\$1.52, UNDERWEIGHT)  
 Macquarie CountryWide Trust (MCW.AX, A\$2.10, OUTPERFORM, TP A\$2.35, UNDERWEIGHT)  
 Macquarie DDR Trust (MDT.AX, A\$1.19, OUTPERFORM, TP A\$1.40, UNDERWEIGHT)  
 Macquarie Office Trust (MOF.AX, A\$1.56, UNDERPERFORM, TP A\$1.51, UNDERWEIGHT)  
 Macquarie Prologolist Trust (MPR.AX, A\$1.28)  
 ProLogis Trust (PLD, \$65.67)  
 Reckson New York Property Trust (RNY.AX, A\$1.15, NEUTRAL, TP A\$1.25, UNDERWEIGHT)  
 Rubicon America Trust (RAT.AX, A\$1.06, NEUTRAL, TP A\$1.19, UNDERWEIGHT)  
 Tishman Speyer Office Fund (TSO.AX, A\$2.58, OUTPERFORM, TP A\$2.90, UNDERWEIGHT)  
 Westfield (WDC.AX, A\$21.14, NEUTRAL, TP A\$23.30, UNDERWEIGHT)

## Disclosure Appendix

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**Underperform\*\*:** The stock's total return is expected to underperform the industry average\* by 10-15% or more over the next 12 months.

*\*The industry average refers to the average total return of the analyst's industry coverage universe (except with respect to Asia/Pacific, Latin America and Emerging Markets, where stock ratings are relative to the relevant country index, and Credit Suisse Small and Mid-Cap Advisor stocks, where stock ratings are relative to the regional Credit Suisse Small and Mid-Cap Advisor investment universe.*

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**REESA Model Financial Statements  
August 2007 Model**

**Developed by the Global Real Estate Coalition:**

Asian Public Real Estate Association, APREA  
Association for Real Estate Securitization, ARES  
British Property Federation, BPF  
European Public Real Estate Association, EPRA  
National Association of Real Estate Investment Trusts, NAREIT  
Property Council of Australia, PCA  
Real Property Association of Canada, REALpac

**Contents:**

Statement of Comprehensive Income	Page 1
Statement of Financial Position	Page 2
Statement of Cash Flow	Page 3
Statement in Changes in Equity	Page 4

**Statement of Comprehensive Income  
August 2007 Model**

<b>Property Operations Income and Expense:</b>				
Gross rental revenue				\$
Interest on finance leases				
Service cost reimbursements from tenants				
Reimbursible service costs				
Property operating expenses				
Ground rent expense				
Share of net property income from unconsolidated affiliates, Note A				
<b>Net Property Income (NPI), Note B</b>				<u>\$</u>
<b>Other Operating Income and Expense (OOIE):</b>				
Gains/losses on sales of properties developed/acquired for sale, Note C				
Other operating revenue, including third party fees, Note D				
Other operating expenses, Note E				
G&A				
Dividend income				
Share of OOIE of unconsolidated affiliates, Note A				
<b>Total Other Operating Income and Expense</b>				<u>\$</u>
<b>Income From Operations before Finance Costs and Taxes</b>				<u>\$</u>
<b>Finance costs:</b>				
Interest expense, net				
Share of finance costs of unconsolidated affiliates				
Gains/losses on debt extinguishment				
<b>Total finance costs</b>				<u>\$</u>
<b>Income From Operations before Taxes, including deferred taxes</b>				<u>\$</u>
Taxes attributable to Net Operating Income				
Share of taxes of unconsolidated affiliates				
<b>Total Taxes Attributable to IFO</b>				<u>\$</u>
<b>Income from Operations (FFO/EPRA EPS)</b>				<u>\$</u>
<b>Other Income and Expense:</b>				
Gains/losses on sale of investment property				
Increase/decrease in unrealized value of investment property				
Increase/decrease in unrealized value of financial instruments including derivatives				
Depreciation of real estate not reported at fair value				
Share of other income and expenses of unconsolidated affiliates				
Other				
Income tax on other income/expense, including deferred taxes				
<b>Total Other Income and Expense</b>				<u>\$</u>
<b>Income from Continuing Operations</b>				<u>\$</u>
<b>Discontinued Operations, Note F:</b>				
Operating earnings/loss from discontinued operations				\$
Gains/losses on property sales from discontinued operations				
Taxes, current and deferred, attributable to discontinued operations				
<b>Income/loss From Discontinued Operations</b>				<u>\$</u>
<b>Net Income</b>				<u><u>\$</u></u>
<b>Other Comprehensive Income:</b>				
Gains and losses from currency translation of foreign operations				
Actuarial gains/losses on defined benefit plans				
Unrealized gains/losses on effective hedges				
<b>Total Other Comprehensive Income</b>				<u>\$</u>
<b>Comprehensive Income</b>				<u><u>\$</u></u>
<b>Earnings Per Share:</b>				
	<u>IFO</u>	<u>Cont. Ops.</u>	<u>Disc. Ops.</u>	<u>Net Income</u>
Basic	\$	\$	\$	\$
Diluted	\$	\$	\$	\$



**Statement of Financial Position**  
**August 2007 Model**

**ASSETS**

Current, note:

Cash and cash equivalents	\$
Accounts receivable	
Derivative contracts	
Other current assets	

Non-current, note:

Investment property	
Trading property	
Investment in unconsolidated affiliates (joint ventures)	
Finance lease receivables on investment property	
Property under development	
Investment property, held for sale	
Other non-current Assets	

<b>Total Assets</b>	\$
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**LIABILITIES**

Current, note:

Accounts payable and accrued expenses	\$
Current portion of long-term liabilities	
Distributions payable	

Non-current, note:

Long-term finance lease payable on investment property	
Long-term mortgages	
Long-term convertible debt	
Long-term construction loans	
Other long-term liabilities	
Income taxes payable	
Current	
Deferred	
Total income taxes payable	\$

<b>Total Liabilities</b>	\$
--------------------------	----

<b>NET ASSETS</b>	\$
-------------------	----

**SHAREHOLDERS' EQUITY**

Common stock	\$
Preferred stock	
Additional paid-in capital	
Retained earnings	
Reserves	
Accumulated Other Comprehensive Income	
Equity attributable to non-controlling interests (per Business Combination exposure draft)	_____

<b>Total Shareholders' Equity</b>	_____
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<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	\$
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Note: Current and non-current reporting on the face of the balance sheet would be optional.

**Statement of Cash Flow**  
**Direct Method Presented (Optional)**  
**August 2007 Model**

<b>CASH FLOW FROM OPERATIONS:</b>	
Gross Rental revenue received	\$
Interest received on finance leases	
Service cost reimbursements received	
Leasing costs paid where amortization is charged to revenue	
Expenditures for service costs	
Other property operations expenditures	
Ground rents paid	
<b>Net cash flow from direct property operations, optional</b>	<u>\$</u>
Proceeds from sales of trading property	
Other operating revenue received, including third party fees	
Other operating expenditures	
G&A expenditures	
Dividend income received, including distributions from unconsolidated affiliates	
Expenditures for interest	
Expenditures for taxes	
<b>Net cash from property operations, note</b>	<u>\$</u>
Other cash received/expended for continuing operations	
Net cash received/used by discontinued operations	
<b>NET CASH FLOW FROM OPERATIONS</b>	<u><u>\$</u></u>
<b>CASH FLOW FROM INVESTING:</b>	
Proceeds from sales of investment property	
Development of properties	
Improvements to operating properties	
Tenant leasing and improvements, where amortization/ depreciation is charged to amortization or depreciation expense	
Expenditures for acquisition of properties	
Other capital expenditures	
Investments in unconsolidated affiliates	
Proceeds from liquidation of investments in unconsolidated affiliates	
<b>NET CASH FLOW USED IN INVESTING ACTIVITIES</b>	<u>\$</u>
<b>CASH FLOW FROM FINANCING:</b>	
Proceeds from borrowings	\$
Cash used to repay financing	
Dividends/distributions paid	
<b>NET CASH FLOWS FROM FINANCING Activities</b>	<u>\$</u>
<b>INCREASE/(DECREASE) IN CASH DURING THE PERIOD</b>	<b>\$</b>
<b>CASH -- BEGINNING OF PERIOD</b>	
<b>CASH -- END OF PERIOD</b>	<u><u>\$</u></u>

Note: In jurisdictions that require reporting of distributable cash flow, such a measure should be reconciled to Net Cash Flow From Operations.

**Statement in Changes in Equity**  
**August 2007 Model**

	<u>Common Stock</u>	<u>Preferred Stock</u>	<u>Additional PIC</u>	<u>Retained Earnings</u>	<u>Accumulated OCI</u>	<u>Reserves</u>	<u>Minority Interest</u>	<u>Total Equity</u>
<b>Balance December 31, 2006</b>	_____	_____	_____	_____	_____	_____	_____	_____
Comprehensive income								
Issuance of preferred stock								
Additions to reserves								
Dividends								
<b>Balance December 31, 2007</b>	_____	_____	_____	_____	_____	_____	_____	_____
Comprehensive income								
Conversion of preferred stock								
Charges to reserves								
Dividends								
<b>Balance December 31, 2008</b>	=====	=====	=====	=====	=====	=====	=====	=====