

# *Joint Ventures as REIT Funds*

*Thursday, March 29  
10:00 - 11:00 a.m.*

**Moderator:**

Michael Pappagallo, EVP & CFO, Kimco Realty Corporation

**Panelists:**

Michael Brennan, President & CEO, First Industrial Realty Trust, Inc.  
Merrie Frankel, VP & Senior Credit Officer, Moody's Investors Service  
James Sullivan, Principal, Green Street Advisors Inc.

Contact	Phone
<i>New York</i>	
Philip Kibel CPA	1.212.553.1653
Craig Emrick CPA	
Griselda Bisonó	
John J. Kriz	
<i>Managing Director – Real Estate Finance</i>	

## REIT Joint Ventures and Funds: Weighing the Pluses and Minuses

### Summary Opinion

---

#### KEY TAKE-AWAYS

- Real estate investment trusts (REITs) are increasing their use of joint ventures and funds to finance real estate purchases and development pipelines, and diversify their revenues with additional advisory and management fees. All things being equal, Moody's views diversification as a positive credit characteristic.
- These joint ventures and funds may be more leveraged than a REIT's wholly owned assets, but off-balance sheet, achieving a reported (if not actual) balance sheet condition, and complicating an analysis of the true credit implications.
- A select group of REITs have been successfully using these structures for some time, which has provided them with revenue and funding diversification. However, as these structures are a rising trend among more REIT's, on a broad basis the related fees show a degree of historical variability, some of which may be due to the current high growth rate and early stage development for most firms. This variability is higher for acquisition, disposition and promote/success fees, but less so for property management and leasing fees.
- This Special Comment provides background on REITs' JV and fund structures, and outlines Moody's views of their credit implications. In addition, Moody's has historically taken a significant haircut on JV/fund income in our analysis. In this comment we expand on our quantitative and qualitative approach to these structures as first presented in "Rating Methodology for REITs and Other Commercial Property Firms," January 2006 available at [www.moody.com](http://www.moody.com).

## JOINT VENTURES AND FUNDS ARE HERE TO STAY...WITH POSITIVE AND NEGATIVE IMPLICATIONS

REITs have been increasing their use of joint ventures and funds to finance real estate purchases, diversify their revenues through advisory and management fees, and lever their businesses. We expect the rate of increase to accelerate, driven by managements' needs to drive earnings growth in a low cap rate/easy-mortgage-finance environment. We also believe the growth in these structures would continue with a reversal in cap rates, albeit at a slower rate. They are here to stay.

Moody's sees the negative aspects of the rise of JVs/funds creating a rating counterweight to REITs' positive track record and momentum in building greater diversity, depth and leadership. JVs and funds will likely be one of the driving business and creditworthiness factors for REITs for the rest of the decade. Some specific comments Moody's has about these structures are the following:

- A few REITs have been successfully using these structures for some time, building a skill base and market position, which has helped provide them with revenue and funding diversification. However, as these JV and fund structures are a rising trend among a larger number and range of REITs, on a broad basis the associated fees show a lack of track record and potentially high degree of variability. This variability is higher for acquisition, disposition and promote/success fees, but less so for the core property management and leasing fees. Also, if and when JV/fund fees zero out due to the winding up of the transaction, they can take time to replace – often longer than a lease expiration. In addition, unlike cash flows from rental properties, the JV/fund fee stream is not "collateralized" by an asset.
- REITs use JV and fund structures to enhance their nominal investment returns through fees and promote structures, and to achieve a reported (if not actual) balance sheet condition, such as leverage and relative use of secured debt.
- These JVs and funds can be highly leveraged with secured debt which is off-balance sheet, weakening REITs' financial and strategic flexibility, and making an analysis of the REIT's true financial profile more difficult. However, there are varieties of leverage approaches, so each REIT's situation needs to be examined individually.
- Security holders and REITs alike struggle with transparency; GAAP permits, and often requires, JVs to be treated as unconsolidated entities (*i.e.*, off-balance sheet). A complete, accurate credit picture can only be obtained by looking through the JV and fund structures to determine REITs' true debt exposures and financial interests in their JV and fund properties. REIT disclosures in this area could be improved, although here, too, there is variance in disclosure breadth and depth among firms.
- Issues of control are important – what control does the REIT retain over the management of the properties to ensure that its strategic objectives will be realized? Likewise, partners' exit or other strategies may not be consistent with the REIT's – and exit strategies can create contingent calls on a REIT's resources. These concerns are exacerbated for development ventures, where the REIT is often committed to purchase the completed property, and thus remains exposed to lease-up risks.
- Conflict-of-interest concerns, and attendant fiduciary liability, may arise over how opportunities are allocated among REIT-owned properties and JV/fund properties – for example, the way tenants are incentivized to a property in the REIT or in the JV.
- With the availability of debt financing, and cap-rates at low levels REITs are still incited to access "cheap" JV/fund equity *vs.* issuing their own common stock or other more expensive forms of capital.

## WHAT HAPPENS NEXT?

We believe the following trends are likely to occur over the short term in regards to REITs' use of JV and fund structures:

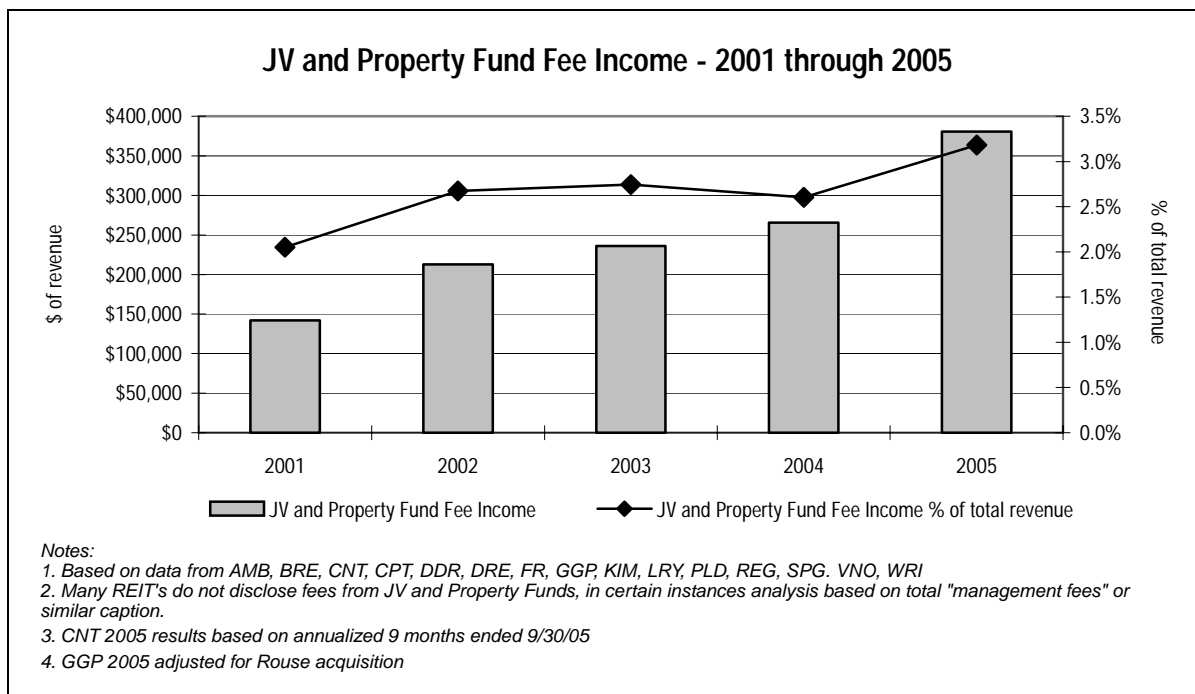
- The percentage stakes retained by REITs are likely to fall, in an effort to create further operating leverage. However, when REITs co-invest in the funds (as they usually do) there is an alignment of interests with the institutional partner, which tends to increase the longevity of the venture and related fees.
- Some REITs could become preponderantly real estate investment management firms, rather than direct investors.
- There will be a greater stratification between the REITs that are really adept at the JV/fund business and those that are not. Those that are not may find themselves stuck with some awkward deals.
- Because JV/fund arrangements limit a REIT's cash outlay, they are particularly attractive when the investment does not yield an immediate or attractive return. Some REITs employ JVs/funds to fund their development activities for this reason.

## MOODY'S APPROACH TO JV/FUNDS ANALYSIS

Reflecting the matters discussed above, Moody's has historically applied up to a 50% haircut to JV/fund income if we consider it to be "one-off" in nature (i.e., acquisition and disposition fees, development fees, promotes etc.), or applied a smaller haircut if it is related to management fees on what are deemed to be longer term ventures. (See additional discussion of Moody's analytical approach to JV/funds on page 8). Actions that would cause Moody's to provide greater weight to JV/fund cash flows are 1) growth in size and diversity of the JVs/funds, 2) laddering of deal maturities, 3) a consistently demonstrated ability to create new funds or refinance existing ones, 4) preference for management fees over promote and success fees, 5) consistent financial success of the JVs/funds, 6) structures with long lives, and 7) sound management infrastructures to operate a JV/funds business.

## JVs and Funds: Basics and Trends

JVs and funds are similar in that they are both multi-investor vehicles used to divide and share in the ownership or development of real estate. As displayed in the chart below for a sample of REITs, income related to these vehicles continues to grow in total amount as well as a percentage of revenue. Moody's expects this growth to continue. Recent activity includes Liberty Property Trust's formation of a £124 million UK joint venture with Doughty Hanson in December 2005, and ProLogis' announcement in February 2006 that it has formed a \$4 billion North American industrial property fund. Both REITs will retain a 20% interest in their respective structures.



## **JOINT VENTURE BASICS**

REIT JVs are typically two-party partnerships established to divide and share in the ownership or development of real estate. In one type of JV, the REIT partners with an entity such as an insurance company, private owner or pension fund that seeks to own a long-term interest in a property. The partner contributes capital, expertise and/or the property itself, and the REIT brings its capital and expertise, and typically manages the property. These JVs usually terminate after a predetermined period of years, often with one partner buying out the other's interest. Sometimes such JVs are entered into to dilute an individually large asset (uncommon), or by a private owner interested in partially liquidating its investment (also uncommon), or to tap into the expertise of a partner (uncommon for institutional or private owners, though some find it useful to benefit from, say, a large mall REIT's expertise and footprint; REITs expanding into new, perhaps international, markets can and do find partners helpful). In the past, the ownership split was often 50/50, though there is more interest from REITs in taking smaller stakes to achieve greater operating leverage. The REIT will typically manage the JV, and receive various fees for doing so.

JVs are also formed to facilitate development. These JVs involve a REIT partnering with a real estate developer and are of relatively short duration (though there may be serial deals), with the REIT not only managing the completed property, but also taking responsibility to buy the developer's interest when construction is complete. In effect, such transactions are off-balance sheet development financing for the REIT. For example, AMB Property Corporation had development and renovation projects with an estimated total investment of \$1.1 billion in progress at YE05. AMB's ownership of these projects ranged from 20% to 100%.

## **REAL ESTATE FUNDS**

Similar to JVs, real estate funds are typically multi-investor vehicles, which include some level of co-investment and sometimes merchant building by the REIT, which manages the fund and the fund's properties, and sources and sells investments. The partners usually contribute capital only and the REIT brings its expertise in development, asset management, leasing and property management, which generate fee income for the REIT. These funds usually terminate after a predetermined period of years, generally with the funds dissolved through sale of the assets among the partners and/or to third parties or replacement of partners. However, fund extensions and infinite life funds are growing in number. More so than JVs, funds can best be seen as a new and distinct line of business – third-party property investment for institutional investors – with all the attendant risks and opportunities.

### **Q: WHY DO REITS USE JV/FUND STRUCTURES?**

#### **A: ENHANCED NOMINAL RETURNS**

Why do REITs continue to use these structures? Both JVs and Funds allow REITs to reduce their real estate capital investment, yet enhance revenues through fee income, and operational scope by increasing the number of properties under management — effectively "leveraging" management income relative to contributed capital, and thus boosting equity returns. In theory and practice, JVs and funds diversify and augment REITs' income streams by supplementing capital appreciation and direct rental revenue with fees from activities such as property management and leasing. However, the JV business model retains a sizable real estate capital investment, and therefore has a hefty component of capital appreciation and lease revenue relative to management fees to achieve a total return. Even funds involve at least some (often ~20%) capital investment by the REIT, and therefore represent a purchase of a management contract with a material equity "kicker." The fee revenue is typically supplemented with various acquisition, sale and performance fees. The number of properties is also more than in JVs.

In today's low cap rate property environment, and with mortgage finance often viewed as being cheap, plentiful and on easy terms, often one way REITs can make performance from acquisitions pencil out at above their own costs of capital, and to grow, is to use JVs or funds, and more leverage.

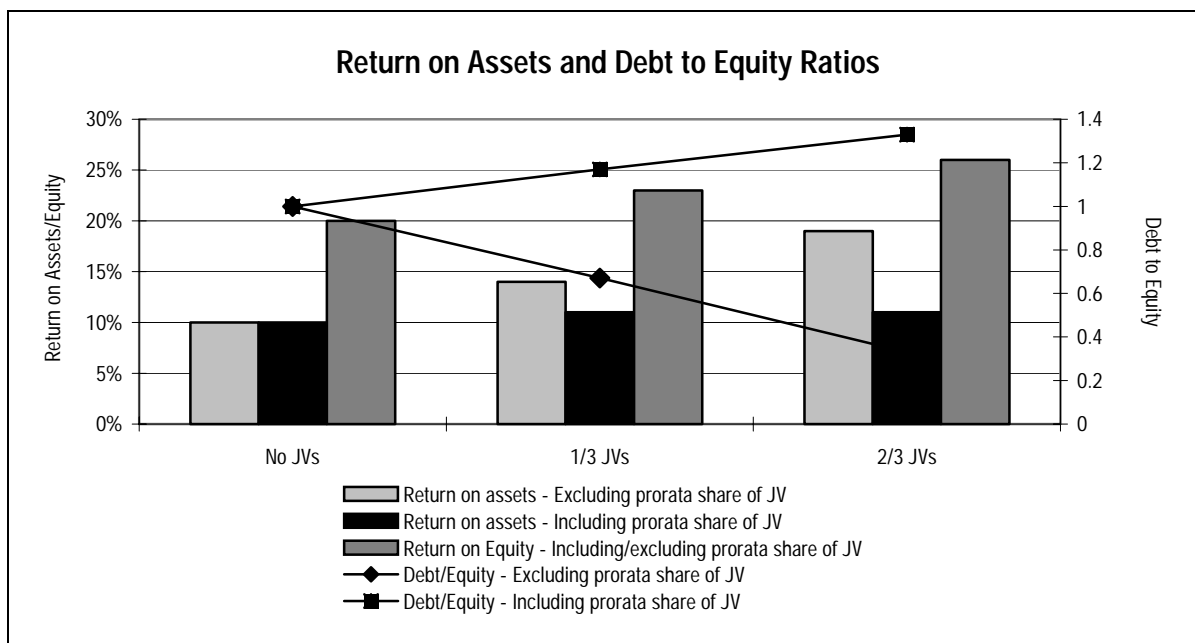
The enhanced nominal return that can be achieved through JV/Fund structures is demonstrated in the following example. Assume a REIT just starting out has \$15 million of cash to invest and a leverage tolerance of 50% for wholly owned properties, but its JVs can be levered with mortgages to 60% at the property level. The REIT can earn the following fees:

- For properties owned outright, it earns operating income through rents equal to 10% of property fair value (purchase price in this example). Therefore, if the REIT invests its original \$15 million and an additional borrowed \$15 million in property valued at \$30 million, annual operating income would be \$3 million.
- If the REIT invests via a JV and manages the JV's properties, the REIT would earn a management fee of 5% of the JV's operating income from rents (calculated at 10% of property value, as above for properties wholly owned and before the management fee). In addition, the REIT would earn its share of direct operating income (less the *pro rata* management fee). For example, if the REIT invests its \$15 million in a 25% interest in a property-owning JV, the total JV equity value would be \$60 million, which can be leveraged at 60% for total property investment of \$150 million. Here, the REIT would earn \$4.4 million, broken into the following components:
  - \$750,000 from its management fee (\$150 million x 10% operating income margin x 5% management fee)
  - \$3.6 million from its direct ownership (\$150 million x 10% operating income margin x (1 - .05) to reflect management fee x 25% ownership percentage).

**Highly aggressive scenario** — The following example illustrates how a REIT's reported return on assets, return on equity and leverage can be enhanced through the use of JV's. The assumptions used in this example (the same as those above) are that a REIT begins with \$15 million in cash and equity, has a leverage tolerance of 50% at the property level for wholly owned properties and a leverage tolerance of 60% at the property level for properties owned by a JV. The fees the REIT can earn from its property and JV investments are the same as those outlined above. Using these assumptions under three scenarios - no JV investments, one-third of investable cash in a 25% ownership in a JV, and two-thirds of investable cash in a 25% ownership in a JV - are reviewed below. As shown, JV structures can help REITs enhance reported returns, but when the REIT's *pro rata* share of the JV assets and debt is grossed-up on its GAAP balance sheet, one can see the leverage effects, too.

\$ in thousands	No JVs	1/3 JVs	2/3 JVs
Wholly Owned Properties	\$30,000	\$20,000	\$10,000
JV Value (Equity Method Accounting)	0	5,000	10,000
<b>Total GAAP Assets</b>	<b>30,000</b>	<b>25,000</b>	<b>20,000</b>
<b>Debt</b>	<b>15,000</b>	<b>10,000</b>	<b>5,000</b>
<b>Equity</b>	<b>15,000</b>	<b>15,000</b>	<b>15,000</b>
Total JV Assets	0	50,000	100,000
Total JV Mortgage Debt	0	30,000	60,000
<i>Pro rata share of JV Assets</i>	0	12,500	25,000
<i>Pro rata share of JV Debt</i>	0	7,500	15,000
Operating income related to 100%-owned properties	3,000	2,000	1,000
Operating income related to share of property in JVs	0	1,188	2,375
Fee income from JVs	0	250	500
<b>Total Operating Income</b>	<b>3,000</b>	<b>3,438</b>	<b>3,875</b>
<b>Key Ratios Excluding Pro Rata Share of JV</b>			
Return on assets	10.0%	13.8%	19.4%
Return on Equity	20.0%	22.9%	25.8%
Debt/Equity	1x	0.67x	0.33x
<b>Key Ratios Including Pro Rata Share of JV</b>			
Return on assets	10.0%	10.6%	11.1%
Return on Equity	20.0%	22.9%	25.8%
Debt/Equity	1x	1.17x	1.33x

As illustrated in the table below, the return on a REIT's capital invested through a JV or Fund, according to the scenarios outlined above, combined with fees the REIT typically earns for management and leasing, *inter alia*, result in higher GAAP asset returns and lower GAAP leverage than from direct property investment alone. However, when the REIT's *pro rata* share of the JV balance sheet is considered, the returns can decrease and leverage increase.



In general, due to the limited disclosures many REITs provide on an individual JV or fund basis, the exact effects of these structures on returns and leverage can be difficult to quantify or to adjust for in order to determine alternate, risk-adjusted returns and gearing.

### WHAT OTHER BENEFITS ARE THERE FROM JVs/FUNDS?

Although revenue growth and ROE enhancement have been important drivers behind the increase in JV/fund volume, JV/funds can provide additional benefits to REITs, including the following:

**Perceived to be Cheaper and Additional Sources of Capital** — Investments through JV/fund arrangements are an alternative source of capital for REITs. Not only do they tap into other, usually institutional, capital pools, but the *de facto* "letter stock" issued to partners is perceived to be cheaper capital. In addition, the JVs/funds can be levered with non-recourse debt secured by the JV/fund properties – perhaps at higher levels than the REIT itself.

**Relationship Benefits** — REITs can benefit from JV/funds through sharing the partner's expertise and business relationships. A construction partner, for example, might have local market or technical expertise, relationships with subcontractors, good materials sources or special familiarity with governmental approval processes. The REIT might also leverage a JV/fund experience with a partner into a longer term relationship, with preferred status on new transactions. Repeated transactions can increase the familiarity between REITs and institutional partners in regards to investment requirements and processes, reducing their transaction costs and increasing transaction volume. Relationships with partners can be of particular value in new markets, especially overseas. Simon Property/Chelsea in Japan, ProLogis in Europe and Asia, and AMB in Mexico are examples.

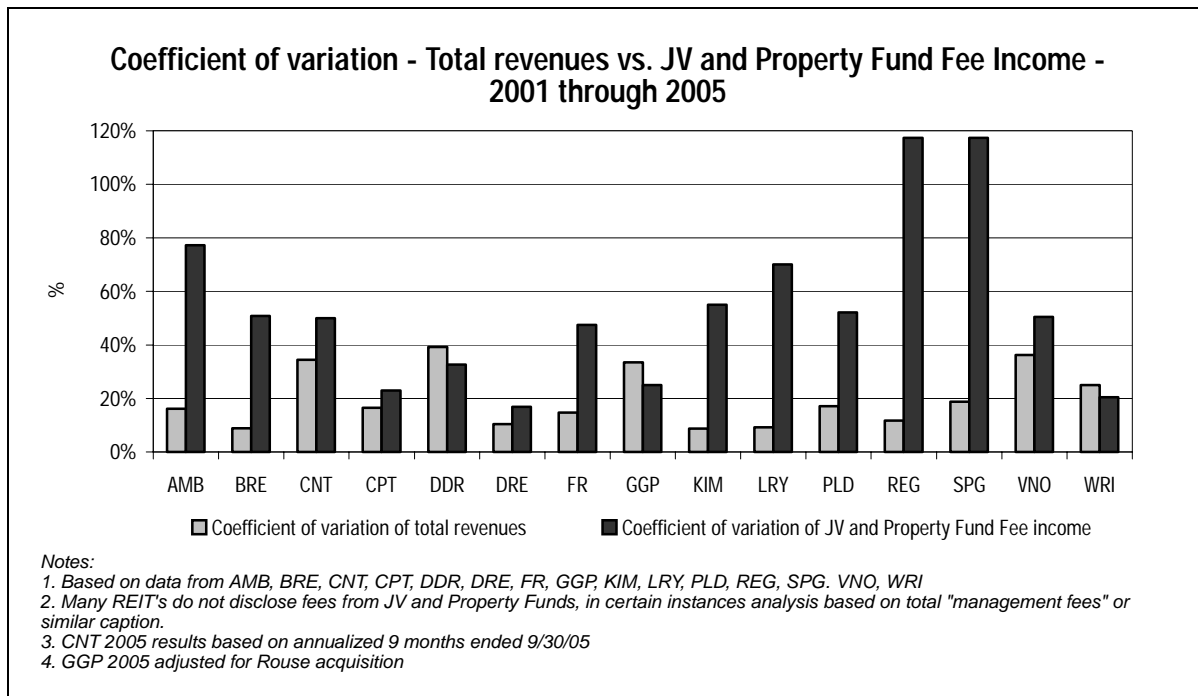
**Greater Size and Scope of Control** — Through JVs/funds, a given amount of REIT capital can control more assets, and thus help strengthen a REIT's leadership in a property sector or geographic area. This leadership can also benefit the REIT in its relationships with tenants and vendors.

## WHAT ARE THE COSTS OF JVs/FUNDS?

**Strategic and Financial Burdens** — JVs/funds constrain REITs' strategic flexibility. Although JV/fund arrangements typically provide for the REIT to retain control over the day-to-day operations of the properties, as a practical matter the REIT does have to answer to its partners in management of the properties. Furthermore, material decisions such as sale, financing, reconstruction and expansion typically require at least consultations with partners, if not formal approval, though such burdens tend to be less onerous with funds. Such circumstances can impair a REIT's control over assets, and strategic flexibility. Such costs are complex, are often opportunity costs, and tend to be back-ended.

**Liquidity** — In general, equity stakes in JVs/funds have limited liquidity – more so than for wholly owned properties. The use of *pro rata* accounting for analytic purposes, useful though it is, masks the fact that in the credit world, you need to deal with the unconsolidated company, and in this case a REIT's claim is on equity in a JV or fund, not a deed on a property.

**Increase in Earnings Volatility** — In theory, JV/fund business models could provide more diverse and stable income streams than the traditional REIT long-term, wholly owned property investment model. However, as displayed in the chart below for a sample of REITs (using REITs that disclose sufficient public data to perform the analysis), JV and fund income can display more volatility than REIT revenue as a whole, some of which may be due to the current high growth rate and early stage development for most firms. The chart displays the coefficient of variation for total revenues *versus* JV and fund fee income for 2001 through annualized 2005. The coefficient of variation, calculated by dividing the standard deviation of a data set by its mean, expresses how much dispersion exists relative to the mean, and permits direct comparison of different data sets. In essence, this represents how much volatility (risk) you are assuming in comparison to the expected return (mean) – simply put, the lower the coefficient of variation, the better the risk/return trade-off. Although some REITs show a coefficient of variation for JV/fund revenues that is similar to their total revenues, for the majority of our sample, the JV and fund income volatility represents a higher risk for the expected return in comparison to the REIT as a whole. This volatility may decrease as REITs become more familiar with JVs/funds, and grow their funds businesses with more transaction layering. It should be noted that there tends to be more stability in the core property management and leasing fees that a REIT earns. However, the management fee in a fund can be the highest priority flow — it comes ahead of debt service and the net cash flow distributed to the partners. Also, when REITs co-invest in the funds (as they usually do) there is an alignment of interests with the institutional partner, which tends to increase the longevity of the venture and related fees.





**The Matter of Nonrecourse JV/Fund Mortgages**— An additional credit issue is the degree to which the REIT limits its exposure on JV/fund non-recourse mortgages. Another potential back-ended cost, one should consider the pressures that might exist to induce a REIT to contribute towards satisfaction of even non-recourse mortgages. REITs are dependent on access to the capital markets, and walking away from even a non-recourse JV/fund-related debt could send a negative signal, especially if the property has become a strategic holding of the REIT. In most circumstances, Moody's accords limited benefit for the non-recourse feature.

**Exit Strategy**— Though it varies from case to case, JVs/funds can have structures in place to govern when assets are to be sold, and how. In some such cases, the REIT is *de facto*, if not *de jure*, obligated to take the asset on to its own balance sheet. This creates funding, liquidity and asset risk. Also, breaking up can be hard to do, even with a clear contract.

**Conflicts of Interest**— In regards especially to funds, there are potential conflict issues to consider between the REIT, which has its own assets and business, and those of its fellow investors. While good structures, such as rules on who gets first priority for an asset or tenant, or requiring all transactions in a specified sector to be fund-exclusive, it is difficult to achieve complete comfort here. This back-ended cost may not only be experienced in relationship disputes, but in legal liability, too, given, *e.g.*, fiduciary duties.

**Adverse Asset Selection**— The quality of assets "shared" through a JV/fund should also be considered. If the REIT's better properties are held through such structures, its bondholders end up with weaker assets supporting them. This could become the case should the REIT find itself in difficulty, and need to liquidate assets to generate cash.

**Use of Management Time**— JVs/funds can utilize substantial management time, and can become a distraction from a REIT's core business. This cost is real and can be high. There is also a need to build a separate operational structure.

**Weakened Transparency**— Investors' ability to track JV/fund performance, understand the fee, financing and other structures, and determine the REIT's earned income from JVs/funds can be limited. Best practice would be for a REIT to provide sufficient information to determine whether a JV/fund should be fully consolidated, *pro rata* consolidated or result in equity/cost accounting and, if a full or *pro rata* consolidation is deemed warranted, the performance of such. For example, Moody's would consider the following disclosures useful to complete these objectives:

1. Purpose/strategy of JV/fund (merchant building, property acquisition, etc.)
2. Level and scope of REIT's management activity, including how REIT's fees, including performance fees, are determined, and what the fees are
3. Ownership percentages
4. Key financial information: gross property assets, total debt, third-party debt, other intercompany balances, total liabilities or equity
5. Identity of partners

JV/fund assets and debt are almost always reported off-balance sheet, allowing REITs to achieve an improvement in reported (albeit normally not actual) financial condition. (See example on beginning page 5.) This reflects the fact that JVs/funds are often more highly levered than the REIT itself, and levered with mortgage debt. As a result, the following benefits appear to occur:

- Makes debt appear lower than it really is
- Higher ROA than actual
- Creates a perception of decreased sensitivity to property value declines

Moody's believes that the financial reporting of JV/funds as required by GAAP falls short of providing investors a full picture. Therefore, Moody's looks through each JV/fund structure to determine the REIT's true debt exposures and financial flexibility. This generally means considering either attributing the REIT's *pro rata* share of the JV/fund's assets and liabilities to the REIT, or fully consolidating the JV/fund into the REIT. Reporting a REIT's JV/fund "equity" as a partnership interest rather than as its constituent asset and funding parts masks the underlying leverage of the property, though it helps highlight the liquidity and subordinated cashflow characteristics of these structures.

**Funds Are an Untested Business**— Although some REITs have been successfully using these structures for some time, the Fund business is, at its heart, a new, distinct business line, and it is not yet clear that REITs will be successful in it long term. And do the costs – all of the costs – generate a competitive risk-adjusted return *vis-à-vis* wholly owned assets? We also note that the surge in fund activity has been occurring in a positive environment for institutional property investing. Establishing new funds can be a challenge.

**Lack of Collateral** – Revenues from rents on properties are more predictable and easier to replace, and there is the property itself "collateralizing" the cash flows that can also be sold in well established markets. Management fees, by contrast, tend to terminate at some point, are not as liquid as deeds on properties, and do not have the "collateral" characteristic. Unsecured debt of a REIT with cash flows from rents on properties are, in effect, quasi-collateralized by the properties, especially for REITs with standard bond covenants.

## WHAT'S THE EARNINGS MULTIPLE?

A large issue continues shaping up over what multiple investors should use to value JV/fund cash flows, especially fees. The multiple currently appears to be below REITs' traditional businesses. Should this multiple not rise on its own accord to what is deemed an appropriate level, some REITs might undertake actions to help achieve such a result – and it is unclear how, if at all, such actions would affect creditworthiness.

## MOODY'S TREATMENT OF REIT JVs AND FUNDS

### ***Quantitative and Qualitative Considerations for Balance Sheet Treatment***

Moody's recently discussed its analytical approach to these structures in "Rating Methodology for REITs and Other Commercial Property Firms," January 2006 available at [www.moodys.com](http://www.moodys.com). Moody's has expanded and deepened that general framework, as described below.

Although Moody's considers a significant number of qualitative factors in determining the analytical treatment for REITs' JVs/funds, our analysis begins by applying the following quantitative factors to an individual JV/fund to determine if it will be fully consolidated, *pro rata* consolidated, or treated as a cost/equity method investment in a REIT's financial statements. After this initial quantitative assessment, qualitative factors are considered to determine if a treatment different from the quantitative outcome is appropriate.

1. The following characteristics result in full consolidation:
  - i. an equity stake of greater than 50%, **and**
  - ii. involvement in managing the properties in the JV/fund
2. The following characteristics result in *pro rata* consolidation:
  - i. an equity stake greater than 50%, **and**
  - ii. no participation in managing properties in the JV/fund

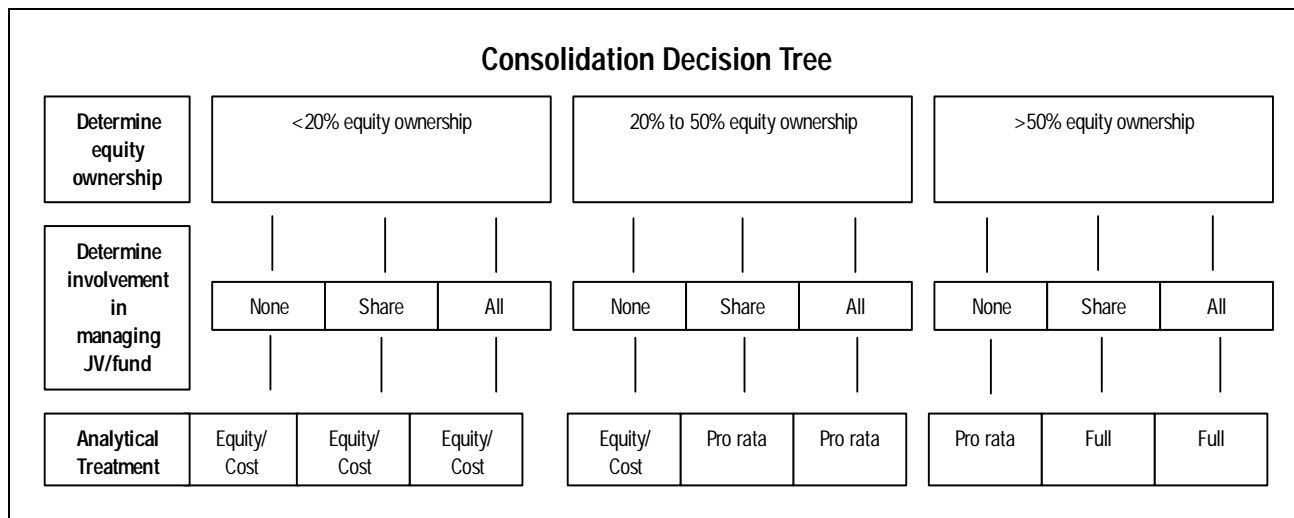
**Or**

- iii. an equity stake of 20% to 50%, **and**
  - iv. involvement in managing the properties in the JV/fund
3. The following characteristics result in equity, or cost method, accounting (primarily equity method except for instances of very low ownership):
  - i. an equity stake of 20% to 50%, **and**
  - ii. no participation in managing properties in the JV/fund

**Or**

- iii. an equity stake less than 20%

If the properties are deemed to be "mission-critical" for the REIT, we would tend to do a full consolidation, regardless of REIT ownership level.



The qualitative factors that Moody's considers to determine the analytical treatment of individual JVs/funds include:

- Nature and purpose of structure: Merchant building, JVs, Funds
  - Merchant building – Normally these are short-term arrangements in which the REIT is committed to buy the property when developed. These are often fully consolidated as Moody's considers these to be off-balance sheet development financing due to the REIT's residual risk to purchase property.
  - JV – Property acquisition/investment vehicles. Often *pro rata* consolidated as risk/rewards are shared between REIT and partner under many structures.
  - Funds – Normally institutional investment vehicles in which the REIT takes a small stake to demonstrate parallelism of interest, and is normally focused on management and other fees, such as promotes.
- Timing and process to liquidate (buy-out provisions)
- Any guarantees/funding agreements among investors in the JV/fund
- Rights of JV/fund partners (kick outs, participations) and any history of using these rights
- Types of management activities performed
- Amount (if any) of financing provided to JV/fund by owners
- Likelihood of REIT providing non-contractual support to the JV/fund
- REIT's "normal" timeframe for holding JV/fund investments
- Character of properties
- Size of JV/fund in comparison to overall REIT operations
- Strength of partners
- Management strategy, and how fees might affect REIT's decision-making

### ***Income Statement Treatment of Earnings***

As previously discussed, Moody's has concerns regarding the sustainability and volatility of JV/fund fee revenue. Therefore, in most situations when analyzing a REIT's income statement, Moody's will reduce JV/fund fees (be they asset and property management and leasing fees, promotes, success fees for exceeding agreed-upon rates of return, etc.) in each period to the REIT's four or five year historical average. This is a downside adjustment only – Moody's will not adjust these fees upward in periods with weak fee results.

However, this adjustment is normally not performed when a REIT exhibits fees that are a low percentage of total revenues and have a low standard deviation. In these situations, as fee income from JV/funds are not a significant portion of overall revenue and there is not significant variability in these revenues, Moody's would be unlikely to make adjustments to these amounts.

## ***A Case Study of Moody's Treatment***

Acme REIT has ownership in the following JVs and Funds:

- Fund-Alpha was formed four years ago and Acme REIT has a 19% ownership. In accordance with GAAP, Acme REIT's investment is accounted for on the cost basis. The Fund is primarily a property acquisition and investment vehicle, and Acme REIT performs all management activities for the fund's properties. Acme REIT's management fee income stream has shown high variability over the past four years as the fee structure is heavily weighted towards Acme REIT achieving a specific leased-up threshold. This threshold was exceeded in the last two years of the Fund's existence, but had not been achieved in the previous two years. Acme REIT's partners are numerous small institutional investors.
- JV-Bravo was formed seven years ago and Acme REIT has 50% ownership; in accordance with GAAP, Acme REIT's investment is accounted for under the equity method. The JV is primarily a property acquisition vehicle, and Acme REIT performs all management activities for the JV's properties. Acme REIT's management fee income has grown at a steady rate as the JV's properties continue to perform well. Acme REIT's partner is a well known European real estate development corporation that in the last two years has built its US-based development and management capabilities.
- JV-Charlie was formed last year between Acme REIT and a private venture capital firm to acquire a large portfolio, which is a strategic fit for Acme REIT. Acme has a 30% ownership and, in accordance with GAAP, Acme REIT's investment is accounted for under the equity method. The JV is primarily a property acquisition vehicle and Acme REIT performs all management activities for the JV's properties. The term of the JV is three years, with the REIT having the right of first refusal to buy the properties from the JV after the third year.

### Moody's Treatment

- Fund-Alpha: Using the factors above – a 19% ownership and performance of all management activities – our initial quantitative assessment would be to treat Fund-Alpha as a cost or equity method investment. However, the qualitative factors of small partners who would be unlikely to have the financial wherewithal to support the Fund in a time of crisis would result in pro rata consolidation treatment for this Fund. In addition, we would not adjust the current year management fees to the four year average as this would result in an upward adjustment.
- JV-B: Using the factors above – a 50% ownership and performance of all management activities – our initial quantitative assessment would be to fully consolidate JV-B. However, the qualitative factors of a strong JV partner that has the financial strength and management capability to replace Acme-REIT if needed, would result in *pro rata* consolidation treatment for this JV. In addition, despite the strong track record in management fee growth, we would adjust these fees down to the four/five year average in analyzing the current year.
- JV-C: Using the factors above – a 30% ownership and performance of all management activities – our initial quantitative assessment would result in *pro rata* consolidation treatment of this JV. However, the qualitative factors of the partner being a venture capital investor and the acquisition being a strategic fit for the REIT's portfolio would result in full consolidation of the JV into the REIT's financial statements.

## Appendix I

### A PRIMER ON JV ACCOUNTING

#### ***Current Accounting Guidance***

To determine the appropriate accounting for joint ventures, most REITs have looked to AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures* ("SOP 78-9"), presuming the ventures do not qualify as variable interest entities under FASB Interpretation No. 46 *Consolidation of Variable Interest Entities*. SOP 78-9 provides guidance on the following legal structures (this approach is being replaced as discussed below):

- Corporate joint ventures or general partnerships – Corporate joint ventures and general partnerships, where no single investor owns greater than half of the voting stock or otherwise controls the venture, are accounted for under the equity method by all owners. The equity method results in single line item recognition of the investors' proportionate share of the ventures' net book value and net income on its balance sheet and income statement, respectively. Situations where a single investor owns greater than 50% or otherwise controls an entity are considered to be corporate subsidiaries and would be consolidated by the controlling owner. *Pro rata* consolidation is not permitted.
- Limited Partnerships – General partners are considered to control, and therefore consolidate, limited partnerships, unless the limited partners have "important rights," for example the ability to replace the general partner or approve principal asset sales or purchases. In this case the limited partnership could be under control of a limited partner, in which case the limited partner would consolidate. Non-consolidating partners would use the equity or cost method of accounting.
- Undivided Interests – If real property is subject to joint control, investors should use the equity or cost method of accounting. If joint control is not present, and each investor is entitled to only its *pro rata* share of income, responsible for its *pro rata* share of expenses, and is severally liable only for indebtedness it incurs in connection with its interest in the property, the interest may be presented on a *pro rata* basis.

#### ***New Guidance for 2005 Financial Statements***

However, the guidance for limited partnerships in SOP 78-9 as discussed above is being replaced by Emerging Issues Task Force Issue 04-05, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* ("EITF 04-05"). EITF 04-05 requires:

1. A presumption that the general partner(s) controls a limited partnership and therefore must consolidate regardless of the general partner's level of ownership interest in the limited partnership.
2. This presumption can be overcome (and the general partner uses the equity method of accounting) if the limited partners have either:
  - a) "Substantive Kick-out Rights" — which is the substantive ability to dissolve the limited partnership or remove the general partners without cause. The rights are considered substantive if they:
    - 1) Can be exercised by a simple majority, and
    - 2) There are no substantive barriers to exercise (such as financial penalties, etc.)
  - b) "Substantive Participating Rights" — which are the rights to participate in significant business decisions that would be expected to be made in the ordinary course of the partnership's business.

The former "important rights" model is considered to be more "protective" in nature versus the more stringent "participating" nature of EITF 04-05, similar to the methodology presented in Emerging Issue Task Force Issue 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, as amended on June 29, 2005 ("EITF 96-16"). For example, the ability of a limited partner to block the sale of a factory by a partnership whose business is manufacturing would be considered protective and would qualify as an important right, but not as a substantive participating right. To be considered a substantive participating right the limited partner would need to have the right to block asset sales in the ordinary course of business — the sale of a factory would not usually occur in the normal course of business for a manufacturing entity.

*NB:* The FASB specifically considered REITs, and worded EITF 04-05 and amended EITF 96-16 so that a sale of assets representing a significant percent of the partnership's total assets (for example, REIT property sales) would not be precluded from being considered in the ordinary course of business, and therefore the ability to block these activities could be considered a substantive participating right *versus* a protective right.

EITF 04-05 is effective as of June 29, 2005 for new or modified joint ventures and for existing joint ventures for all reporting periods after December 15, 2005.

## Appendix II

---

### JV/FUND FINANCIAL STATEMENT DISCLOSURES

REITs' public financial statement disclosures regarding JV/Fund activities run the gamut from clear and comprehensive to thin and vague. Comprehensive and clear disclosure would provide sufficient information to allow for the determination if a JV/fund should be fully consolidated, *pro rata* consolidated, or result in equity/cost accounting, and if a full or *pro rata* consolidation is considered warranted, the ability to do so.

Disclosures that would help to achieve these objectives would include:

- Purpose/strategy of JV/fund (*e.g.*, merchant building, property acquisition, redevelopment)
- Current level and scope of REIT management activity, and character of fee streams
- Ownership percentages
- Key financial information: total assets, gross property assets, total debt, third-party debt, total liabilities, equity
- Identity of partners
- Wind-up provisions
- JV/fund encumbered assets and restrictions on sales
- Rights of partners
- Guarantees and funding agreements from REIT and partners
- Timing and process to liquidate (buy out provisions, etc.)

Certain REITs disclose either *pro forma* financial statements that consolidate each JV/fund on a *pro rata* basis, or a supplemental set of financial statements that aggregate the REIT's portion of the JV/fund's assets and liabilities in total. Although these disclosures are helpful, they do not allow an analysis that is a mix of full or *pro rata* consolidation based on the circumstances of each JV/fund. In addition, some REITs only provide certain information on their JV/fund activities at the time of the JV/fund's inception. Carrying this disclosure forward would improve transparency.

## Related Research

---

### **Special Comment:**

[Observations Of Governance In U.S. REITs: Some Weaknesses, Getting Better, September 2005 \(94031\)](#)

### **Rating Methodologies:**

[Rating Methodology for REITs and Other Commercial Property Firms, January 2006 \(96211\)](#)

[Key Ratios For Rating REITs And Other Property Firms, December 2004 \(91014\)](#)

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





To order reprints of this report (100 copies minimum), please call 1.212.553.1658.  
Report Number: 97276

**Authors**

Philip Kibel  
Craig Emrick

**Senior Associate**

Griselda Biso

**Production Associate**

Wing Chan

© Copyright 2006, Moody's Investors Service, Inc. and/or its licensors and affiliates including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. **NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.** Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at [www.moody.com](http://www.moody.com) under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Moody's Investors Service Pty Limited does not hold an Australian financial services licence under the Corporations Act. This credit rating opinion has been prepared without taking into account any of your objectives, financial situation or needs. You should, before acting on the opinion, consider the appropriateness of the opinion having regard to your own objectives, financial situation and needs.

Contact	Phone
<b><i>New York</i></b>	
Philip Kibel, CPA	1.212.553.1653
Christopher Wimmer, CFA	
Merrie Frankel, Esq.	
Brian Harris, CPA	
Karen Nickerson, CPA	
Craig Emrick, CPA	
Lori Marks	
Maria Maslovsky	
Angela Burriesci	
Daniel Michles	
Griselda Bisono	
Elaina Kozyr	
Lin Zheng	
John J. Kriz <i>Managing Director Real Estate Finance</i>	

## US REIT and REOC Industry Study

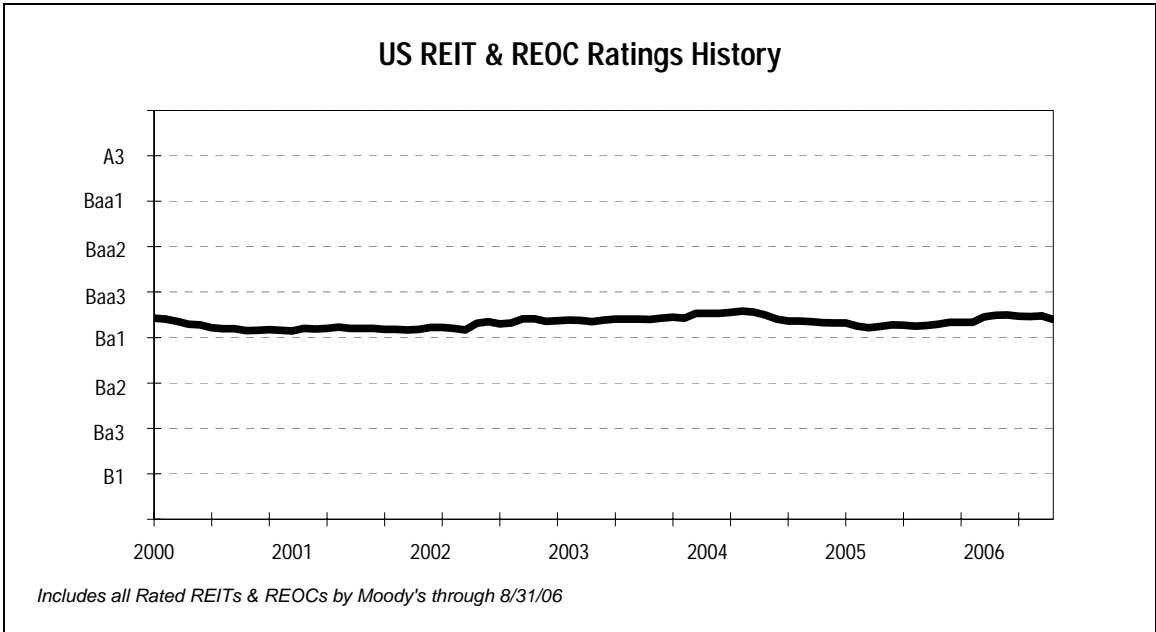
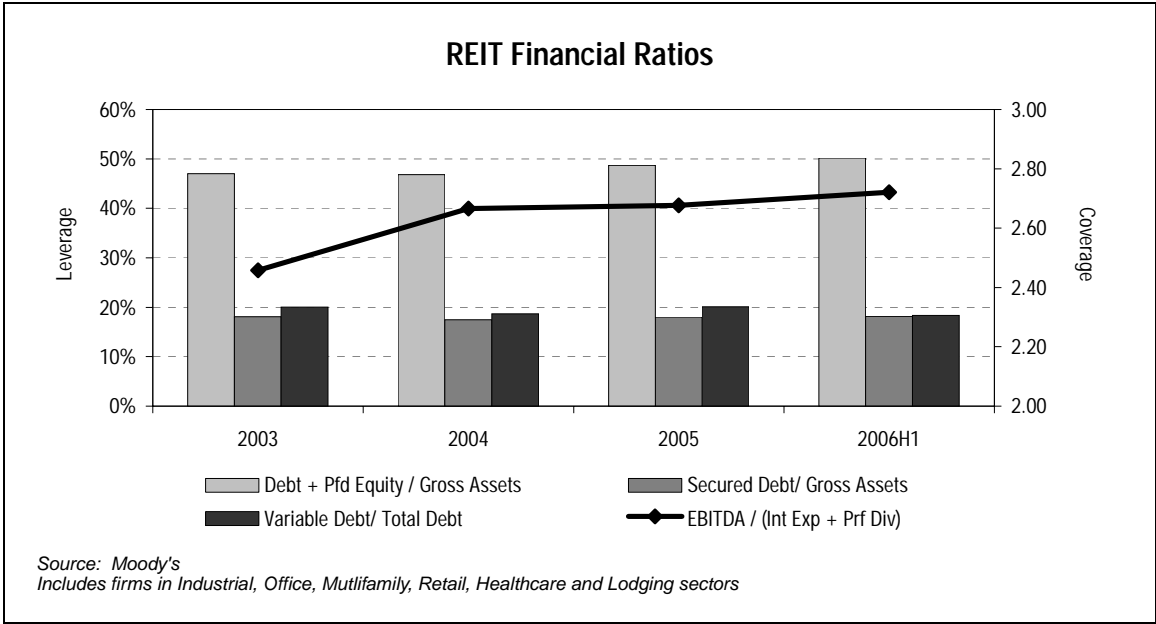
### *Stable Rating Outlook*

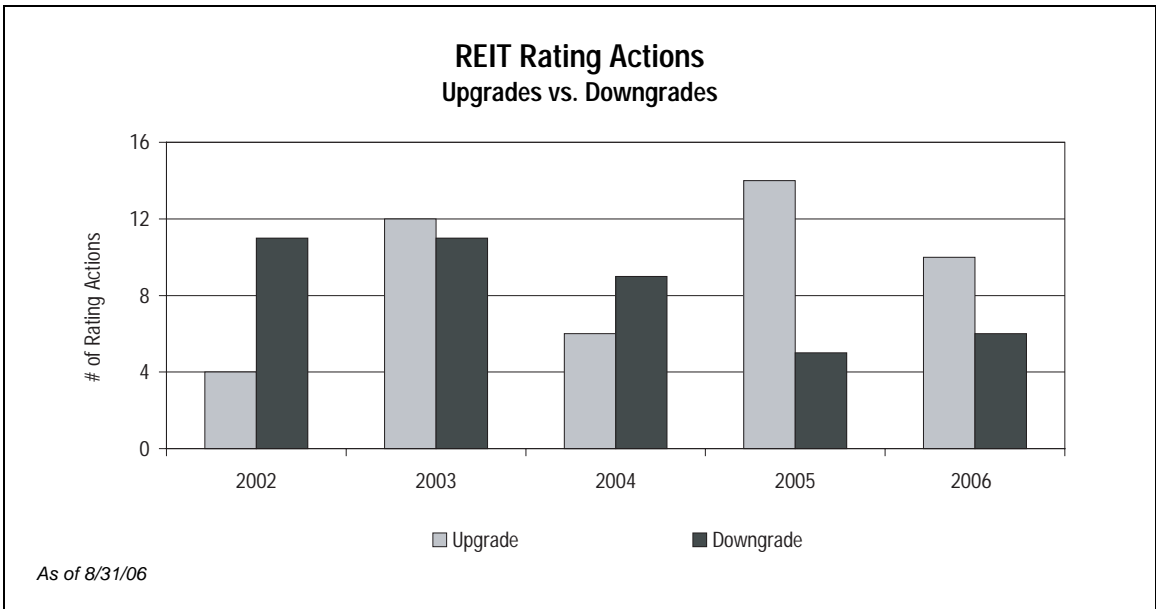
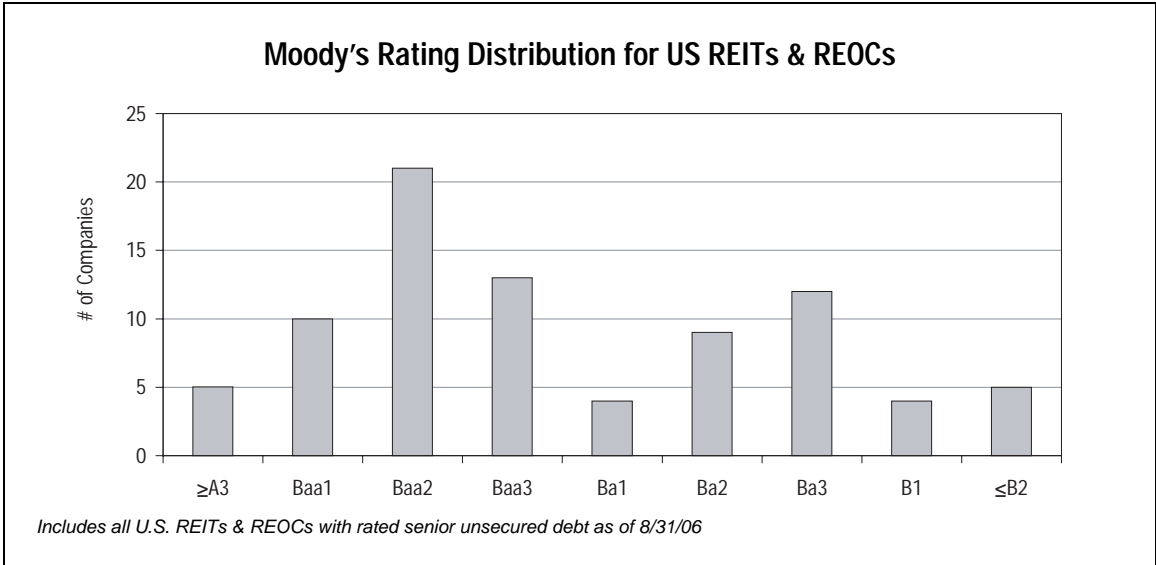
#### Summary Opinion

---

Moody's maintains a stable rating outlook for US REITs and REOCs. REITs have continued to prudently manage their balance sheets, with leverage and secured debt levels flat to up modestly in 2006, with increasing fixed charge coverage and operating margins. This is reflected by the mostly positive trend in Moody's rating actions that have occurred since the beginning of 2005, as well as the increased number of companies on the cusp of moving from the "Baa" category to the "A" category, and the percentage of companies with positive outlooks versus negative, 16% to 2%.

Despite mostly positive US REIT and REOC rating movement by Moody's, this has not been the case with M&A-related transactions, where increased leverage and secured debt often figure prominently. This activity may be waning as institutional investors' money is more fully put to work. Development has also been picking up in an effort to generate some earnings momentum in an environment where positive cash-on-cash acquisitions are difficult to source, though not (yet) to a level and of a character to create rating concern. Moody's remains cautious with respect to joint ventures and funds. These pursuits have enabled companies to enhance book earnings, build relationships and reduce concentrations, among other benefits. On the flip side, Moody's takes a cautious view here due to control issues, lower transparency, management diversion and cash flow uncertainty.





## Rating Assignments and Changes: 2005 and YTD2006

REIT/REOC	Rating Event	Date of Change	Previous Rating	Previous Outlook/ Review Status	New Rating	New Outlook/ Review Status
Public Storage	Upgrade	Aug-06	(P)Baa1	Review for Upgrade	(P)A3	Stable
Shurgard Storage Centers	Upgrade	Aug-06	Baa3	Review for Upgrade	A3	Stable
American Real Estate Partners, L.P.	Downgrade	Aug-06	Ba2	Stable	Ba3	Stable
Arden Realty L.P.	Upgrade	Jul-06	Baa3	Review for Upgrade	Aaa	Stable
CharterMac	First-time Rating	Jul-06	—	—	Ba3*	Stable
CarrAmerica Realty Corporation	Downgrade	Jul-06	Baa3	Review for Downgrade	Ba3	Stable
Developers Diversified	Upgrade	Jun-06	Baa3	Positive	Baa2	Stable
Longview Fibre Company	Downgrade	May-06	B1	Review for Downgrade	B2	Negative
CenterPoint Properties Trust	Downgrade	May-06	Baa2	Review for Downgrade	Baa3	Stable
PS Business Parks	Upgrade	May-06	Ba1**	Stable	Baa3**	Stable
MeriStar Hospitality Corporation	Downgrade	May-06	B2	Review for Downgrade	B3	Stable
Jones Lang LaSalle Incorporated	First Time Rating	Apr-06	—	—	Baa2*	Stable
Saxon Capital, Inc.	First Time Rating	Apr-06	—	—	B2	Stable
Felcor Lodging Trust	Upgrade	Apr-06	B1	Review for Upgrade	Ba3	Stable
Pan Pacific Retail Properties	Upgrade	Mar-06	Baa2	Review for Upgrade	Baa1	Stable
Prudential Real Estate Investors	Downgrade	Feb-06	Aa3	Review for Downgrade	A1	Stable
iStar Financial Inc.	Upgrade	Feb-06	Baa3	Review for Upgrade	Baa2	Stable
Clayton Holdings, Inc	First-time Rating	Jan-06	—	—	B1	Stable
Omega Healthcare Investors, Inc.	Upgrade	Jan-06	B1	Positive	Ba3	Stable
Longview Fibre Company	First-time Rating	Dec-05	—	—	Ba3	Stable
Capital Automotive REIT	Downgrade	Dec-05	Baa3	Review for Downgrade	Ba3	Stable
Ventas Inc.	Upgrade	Dec-05	Ba3	Positive	Ba2	Stable
Hospitality Properties Trust	Upgrade	Oct-05	Baa3	Stable	Baa2	Stable
La Quinta Properties	Upgrade	Oct-05	Ba3	Positive	Ba2	Stable
Host Hotels & Resorts, Inc.	Upgrade	Oct-05	Ba3	Positive	Ba2	Positive
Simon Property Group, LP	Upgrade	Sep-05	Baa2	Review for Upgrade	Baa1	Stable
Corrections Corporation of America	Upgrade	Sep-05	B1	Positive	Ba3	Stable
Brandywine Realty Trust	Upgrade	Aug-05	(P)Ba2**	Stable	(P)Ba1**	Stable
Gables Residential Trust	Downgrade	Jul-05	Ba1	Review for Downgrade	Ba2	Developing
Newkirk Master L.P.	First-time Rating	Jul-05	—	—	Ba2*	Stable
Tanger Factory Outlet Centers, Inc.	Upgrade	Jun-05	Ba1	Positive	Baa3	Stable
Camden Summit LP	Upgrade	Jun-05	Ba1	Review for Upgrade	Baa2	Stable
AMLI Residential Properties	Downgrade	Jun-05	Baa3	Negative	Ba1	Stable
Gables Residential Trust	Downgrade	Jun-05	Baa3	Stable	Ba1	Review for Downgrade
Host Hotels & Resorts, Inc.	Upgrade	May-05	B3**	Stable	B2**	Positive
Equity Inns, Inc	Upgrade	May-05	B3**	Stable	B2**	Stable
Kimco North Trust III	First-time Rating	Apr-05	—	—	Baa1	Stable
CB Richard Ellis Services, Inc.	Upgrade	Apr-05	B1	Stable	Ba3	Stable
TriNet Corporation Realty Trust	Upgrade	Apr-05	Ba1	Stable	Baa3	Stable
Maguire Properties, Inc	First-time Rating	Mar-05	—	—	(P)Ba2***	Stable
Trustreet Properties, Inc	First-time Rating	Mar-05	—	—	(P)B1	Stable
Shurgard Storage Centers	Downgrade	Feb-05	Baa2	Stable	Baa3	Negative

\* Bank Line  
\*\* Preferred Stock  
\*\*\* Senior Secured  
As of 8/31/06

## REIT and REOC Industry Profile

---

### STRENGTHS/OPPORTUNITIES

- Greater size, diversity and scope
- Moderate leverage, manageable debt maturities and sound liquidity
- Key financial measures stable
- Asset type (real property) supports liquidity in distress, and should boost bondholder recoveries
- REITs are culling their underperforming or non-core assets, and replacing them with higher quality assets, even at the expense of lower yields

### WEAKNESSES/CHALLENGES

- Little capacity for cash retention, especially after accounting for capital expenditures
- Potential trend of weakening covenants, perhaps followed by higher leverage and secured debt tolerances
- Leveraged joint ventures and fee-generation platforms such as funds can create complexity, new-business risks, volatile cash flows, and weakened liquidity and transparency
- Dependant on capital market access
- Ample capital flows to real estate make accretive acquisitions challenging
- Higher development pipelines and more focus on purchasing vacancies

### FACTORS THAT WILL LIKELY DRIVE US REIT/REOC RATINGS

- Achievement of strong sector leadership
- Portfolio diversification by tenant, industry and geography
- Increase in JVs and funds or other fee generating structures, which can reduce transparency and increase management complexity and earnings volatility
- Maintenance of moderate financial leverage and a large, diverse unencumbered asset pools, which may be affected by bond covenant shifts
- Adverse capital structure effects of M&A

## Some Key Questions

---

### WHAT DOES MOODY'S RATING METHODOLOGY GRID TELL US?

By using Moody's REIT Rating Methodology Grid<sup>1</sup>, which encompasses the key factors that drive our ratings, you can not only determine where a REIT or REOC would likely be rated, but also the characteristics most likely to drive an upgrade or downgrade. Moody's Real Estate Finance Team uses this grid as a starting point to evaluate the creditworthiness of a REIT or REOC. Additional analysis using rolling averages for grid inputs, as well as the historical trend of individual rating drivers, is performed to generate sharper insight into performance. Furthermore, *pro forma* information and alternate outcomes from different stress scenarios generate insight into the likely credit path of a firm.

The table below summarizes the key rating drivers and sub-factors that comprise Moody's Rating Grid. Moody's has applied this rating grid to all of its rated REITs. The results have been within one to two rating notches of the existing ratings except for some REITs in the lodging and healthcare sectors. For companies in these sectors, volatility of earnings tends to influence the rating more than a strong balance sheet. Healthcare REITs, for example, are acutely exposed to operator business volatility and government funding shifts, the two being linked, and often-high levels of tenant concentration and performance correlation. Lodging REITs experience often-sharp cash flow volatility due to daily movements in occupancy and room rates, with particular sensitivity to economic conditions.

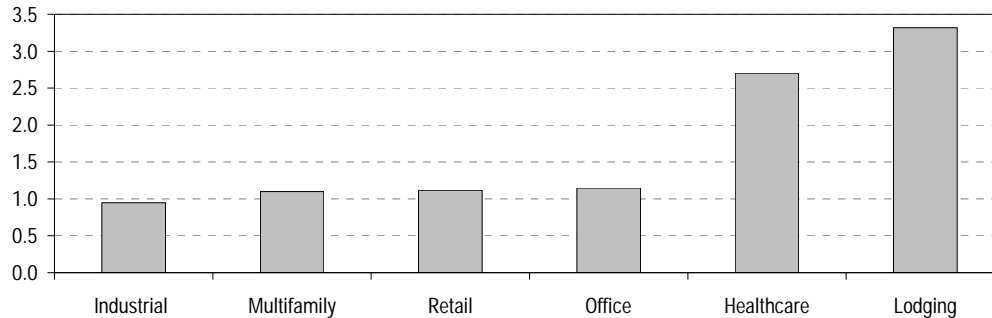
---

1. "Rating Methodology for REITs and Other Commercial Property Firms," January 2006.

## Moody's Methodology for REITs and Commercial Property Firms

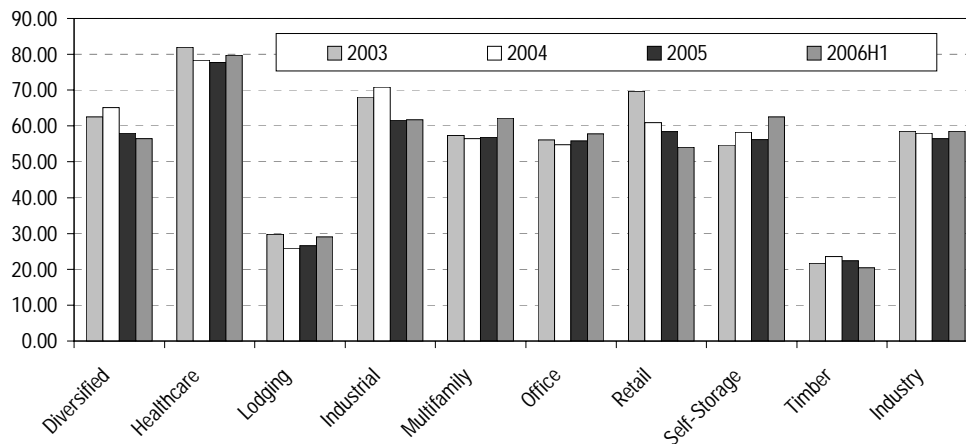
Rating Driver	Sub-Factors	Metric
Liquidity & Funding	Available bank line capacity Debt maturity profile Dividend payout ratio Size of unencumbered asset pool	Total Line - Outstanding Maximum Annual Maturity Dividend / FFO Unencumbered Assets / Gross Assets
Leverage & Capital Structure	Amount of effective leverage Debt relative to operating income Amount of secured leverage Ability to access capital	Debt + Preferred / Gross Assets Net Debt / EBITDA Secured Debt / Gross Assets Qualitative ("Excellent" to "Sporadic")
Market Position & Asset Quality	Degree of franchise and brand recognition Size and market penetration Level of diversity Size of development business Quality of assets	Qualitative ("Excellent" to "Low") Gross Assets Qualitative ("Excellent" to "Poor") Development / Gross Assets Qualitative ("Excellent" to "Low")
Cash Flow & Earnings	Operating margins Earning power Volatility of earnings Ability to service debt	EBITDA / Revenues Net Income / Average Assets Standard Deviation of ROAA EBITDA / Interest + Preferred Dividends
Internal & External Factors	Assessment of management Joint venture and fund activity	Qualitative ("Excellent" to "Modest") JV or Fund Revenues / Total Revenues

### Avg. Std. Deviation of REIT Return on Average Assets



Source: Moody's; based on data from 1998 to 2005

### Operating Margin (%)



Source: Moody's

## HOW DOES MOODY'S LOOK AT BOND COVENANTS IN RATING REITs?

Moody's REIT Rating Methodology has no explicit criterion for bond covenants — their evaluation is implicitly incorporated into other financial and qualitative factors, including our assessment of management. The existence and tightness of covenants suggests the level of management's risk appetite, and covenant changes likely signal new thinking surrounding capital strategy that could drive ratings.

### **"Standard" REIT Senior Unsecured Bond Covenants**

*Typically, violation of these negative covenants (without remediation within 30 to 90 days) can constitute a default and trigger acceleration of payment of principal and accrued interest. The denominator in the leverage calculations is often defined as the undepreciated book value of real estate assets or total assets:*

- **60% Total Leverage**
- **1.5X Cash Flow to Debt Service**
- **40% Secured Leverage**
- **150% Unencumbered Assets relative to Unencumbered Debt**

Covenant changes thus far have been limited to a handful of the largest REITs, and the changes focus on the definition of leverage. Some REITs have labeled the covenants anachronistic, given the sector's lack of widespread, serious stress, and further maturation. The rebuttal cites the covenants as a primary factor in the companies' lack of stress. Moody's expects the trend of covenant changes to continue as long as the property market remains robust. For each REIT that seeks to weaken the terms of its covenants, Moody's will examine its tendency to increase secured or unsecured leverage, to diminish coverage, and to maintain unencumbered assets. Weaker covenants are not necessarily in and of themselves rating drivers. Nonetheless, investors are reexamining the importance of covenants in other industries particularly where LBO activity has been heavy, perhaps with an eye to the mostly favorable results for REIT bondholders in such situations.

Significant changes — either substantial weakening or elimination — in a REIT covenant package are likely to result in a rating downgrade. This reflects not only the greater capacity of a REIT to, say, boost leverage or to structurally subordinate its unsecured creditors, but also the attitude of management to these matters. Of the four common covenants, ratings are most sensitive to the secured debt test. Increased utilization of secured debt in the capital structure beyond the 40% threshold can mean a *de facto*, if not *de jure*, recapitalization, leaving little support for unsecured bondholders. There is also the likely commensurate increase in aggregate leverage to consider.

Issuers and investors need to be aware of another important aspect of covenants, which entails preferred equity ratings. Moody's has assigned preferred ratings two notches below senior unsecured debt for non-REIT corporate issuers. REITs, on the other hand, have enjoyed tighter notching between preferred stock and senior bonds. Three elements drive this policy. The first two have to do with the high marketability of real estate assets and the lack of subordinated debt in the capital structure, which translate to higher likely levels of recovery in default. The third element reflects the protection availed by the standard REIT covenants. Absent covenants, or the presence of a deflated variety, Moody's is likely to increase the notching of an issuer's preferred rating relative to senior debt<sup>2</sup>.

General Growth Properties, a leading owner of US regional malls, and Capital Automotive REIT, which specializes in auto dealership properties, are examples of the relative rating effects altered covenants can produce. With respect to General Growth, it traditionally funded itself with secured debt and did not have any bond covenants until it acquired The Rouse Company, another mall owner and an unsecured bond issuer, in 2004. Given the presence of bond covenants at Rouse and lack thereof at General Growth, Rouse's senior unsecured rating is one notch higher than that of General Growth. The covenants at Rouse have prevented General Growth from substantially raising secured debt and total leverage at the Rouse level. Thus, on a stand-alone basis, Rouse's credit metrics are measurably stronger than its parent's on a consolidated basis. Capital Automotive was a Baa3 senior unsecured issuer prior to its LBO by institutional investors. The transaction entailed tendering for the firm's outstanding bonds with proceeds from a secured credit facility which was collateralized by virtually the entire portfolio of dealership properties. Once over half of the bonds had been tendered, the covenants were eliminated on the remaining bonds. Given this, and the absence of unencumbered assets, the senior unsecured bond rating was lowered to Ba3 — two notches below the senior secured rating and three notches below the pre-transaction senior unsecured rating.

2. "REIT Rating Methodology: Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale," August 2001.



## WHAT DO MERGERS AND PRIVATIZATIONS SPELL FOR US REITs?

As a result of low capital costs and an abundance of capital looking for a home in commercial real estate, the level of merger and acquisition activity involving REITs is hardly surprising. Fostering this activity is the still-active “deal-making” mentality of some REIT managements.

M&A has preponderantly resulted in negative actions due to the higher level of leverage and secured debt such deals typically have, and we do not expect that to change. As the chart below demonstrates, the negative-to-positive deal-related rating outcome ratio is 3:1 from January 2005 through August 2006. Whether the M&A trend itself is petering out, or is still full of vigor, is an open question. Though funding sources of such deals are ample, that can change — quickly. In addition, much of the impetus behind such deals is the filling of institutional investors’ higher allocations to property. As those allocations get filled, and as profit opportunities in “timing” sectors of the property business (such as office and lodging) wane, M&A may become less frequent. However, the properties that have gone into private hands, as opposed to inter-REIT mergers, will likely re-enter the REIT space before long — such private owners are often not long-term holders, and the public market is the easiest take-out for large asset pools. In the 1990s during the REIT IPO boom, it was suggested that REITs would take over most private property ownership. That was not true. The opposite is not true, either.

Summary of M&A-Related Rating Actions, 2005 — YTD2006						
Date of Action	Acquirer	Target	Type	Action	New Rating	Old Rating
Aug 06	Public Storage Trust	Shurgard Storage Centers	Public-to-Public	Upgrade	A3	Baa3
	Morgan Stanley	Glenborough Realty Trust	Public-to-Private	Review Down	—	(P)Ba1
	Morgan Stanley	Saxon Capital	Public-to-Private	Review Up	—	B2
	SL Green Realty	Reckson Associates	Public-to-Public	Review Down	—	Baa3
Jul 06	GE Real Estate	Arden Realty	Public-to-Private	Upgrade	Aaa	Baa3
	The Blackstone Group	CarrAmerica Realty	Public-to-Private	Downgrade	Ba3	Baa3
	Centro Properties / Watt	Heritage Property	Public-to-Private	Review Down	—	Baa3
	Kimco Realty	Pan Pacific Retail	Public-to-Public	Review Down	—	Baa1
May 06	Health Care Property Investors	CNL Retirement Properties	Private-to-Public	Review Down	—	Baa2*
	CalPERS / LaSalle	CenterPoint Properties	Public-to-Private	Downgrade	Baa3	Baa2
	The Blackstone Group	MeriStar Hospitality	Public-to-Private	Downgrade	B3	B2
Feb 06	The Blackstone Group	La Quinta Properties	Public-to-Private	Downgrade	B2	Ba2
	CDP Capital-Financing	CRIIMI MAE	Public-to-Private	Upgrade	Baa2	B3**
Dec 05	DRA Advisors	Capital Automotive REIT	Public-to-Private	Downgrade	Ba3	Baa3
Oct 05	Brandywine Realty Trust	Prentiss Properties Trust	Public-to-Public	Affirm	Baa3	Baa3*
Jul 05	ING Clarion	Gables Residential Trust	Public-to-Private	Downgrade	Ba3	Ba1
	Camden Property Trust	Summit Properties, Inc.	Public-to-Public	Upgrade	Baa2	Ba1
Apr 05	Centro Properties / Watt	Kramont Realty Trust	Public-to-Private	Confirm	B3	B3**
Mar 05	Trustreet Properties	US Restaurant Properties	Public-to-Public	Downgrade	B3	B1**
Jan 05	Colonial Properties Trust	Cornerstone Realty Income	Public-to-Public	Confirm	Baa3	Baa3*

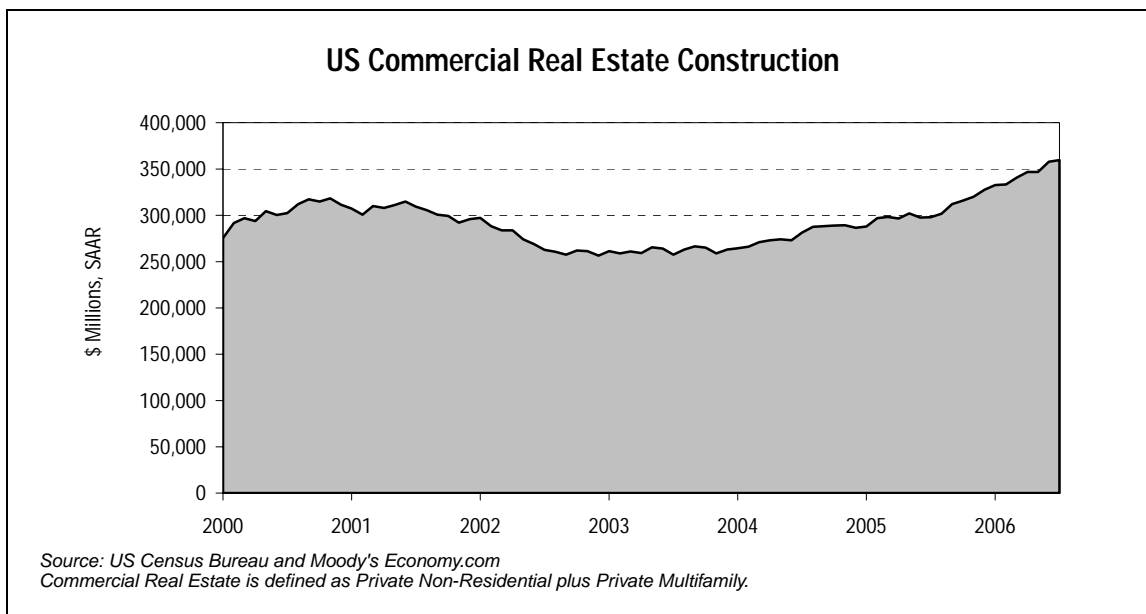
*Rating actions reflect latest or final with respect to target firm senior unsecured debt unless otherwise noted.  
\*Reflects acquiring entity's senior unsecured debt. \*\*Preferred equity rating.*

## WHEN DOES DEVELOPMENT BECOME A RATING CONCERN?

Moody's recognizes the need for REITs to grow and to drive earnings, including via development. The challenging acquisition environment has tipped the scales towards development as a growth vehicle. The following chart demonstrates this trend. In the early years of the decade, economic uncertainty combined with stressed real estate fundamentals characterized by high vacancies and low rents gave developers little reason to risk new construction, and total activity dipped to a low point below \$260 billion during 2003 on a seasonally adjusted annual basis. More recently, low interest rates and an improved US economy have helped development yields trump acquisition yields compressed by

an overcrowded arena of buyers. As the chart demonstrates, construction activity has accelerated beginning in 2004, and REITs' development pipelines have generally reflected this trend.

A REIT or REOC with an aggressive pipeline can get ahead of itself and increase the odds that it may not find tenants for its properties, limiting its ability to repay creditors or maintain its dividend. This consequence is exacerbated by firms which employ higher levels of leverage and particularly secured debt on their balance sheets, wherein loss of control or ownership can quickly become an issue should a meaningful portion of their assets serve as loan collateral. Even when borrowers are able to “walk away” from collateral, Moody’s will be concerned with the level of foregone cash flow.



As shown in Moody’s Rating Grid, development pipelines that represent more than 10% of gross assets are characteristic of a non-investment grade factor; however, there can be mitigants, such as low project risk, pre-leasing, staggered roll-out, redevelopment vs. greenfield development, lack of chunkiness and track record.

For example, the table illustrates how AvalonBay Communities, Liberty Property Trust and Duke Realty have added generously to their pipelines over the past 18 months. Whereas effective leverage for AvalonBay and Liberty has declined in this period, Duke’s has increased by 12.5%, or nearly 25% higher than year-end 2004. This is reflected in recent rating actions related to each of these REITs. AvalonBay’s Baa1 senior unsecured rating was assigned a positive outlook in early August 2006 and Liberty (Baa2) was also put on positive in September 2006. In both cases Moody’s commented on their growth combined with a conservative stance on leverage. Conversely, Duke’s Baa1 rating was recently affirmed. Relative to gross assets, the increase in development for Duke does not appear to be dramatic when compared to AvalonBay and Liberty. However, combined with the increase in effective leverage (versus decreases in the case of the other two REITs here), we believe the increased risks were multiplied and are creating a drag on the rating. For now, other factors such as the REIT’s development track record and leadership in its markets mitigate these concerns.

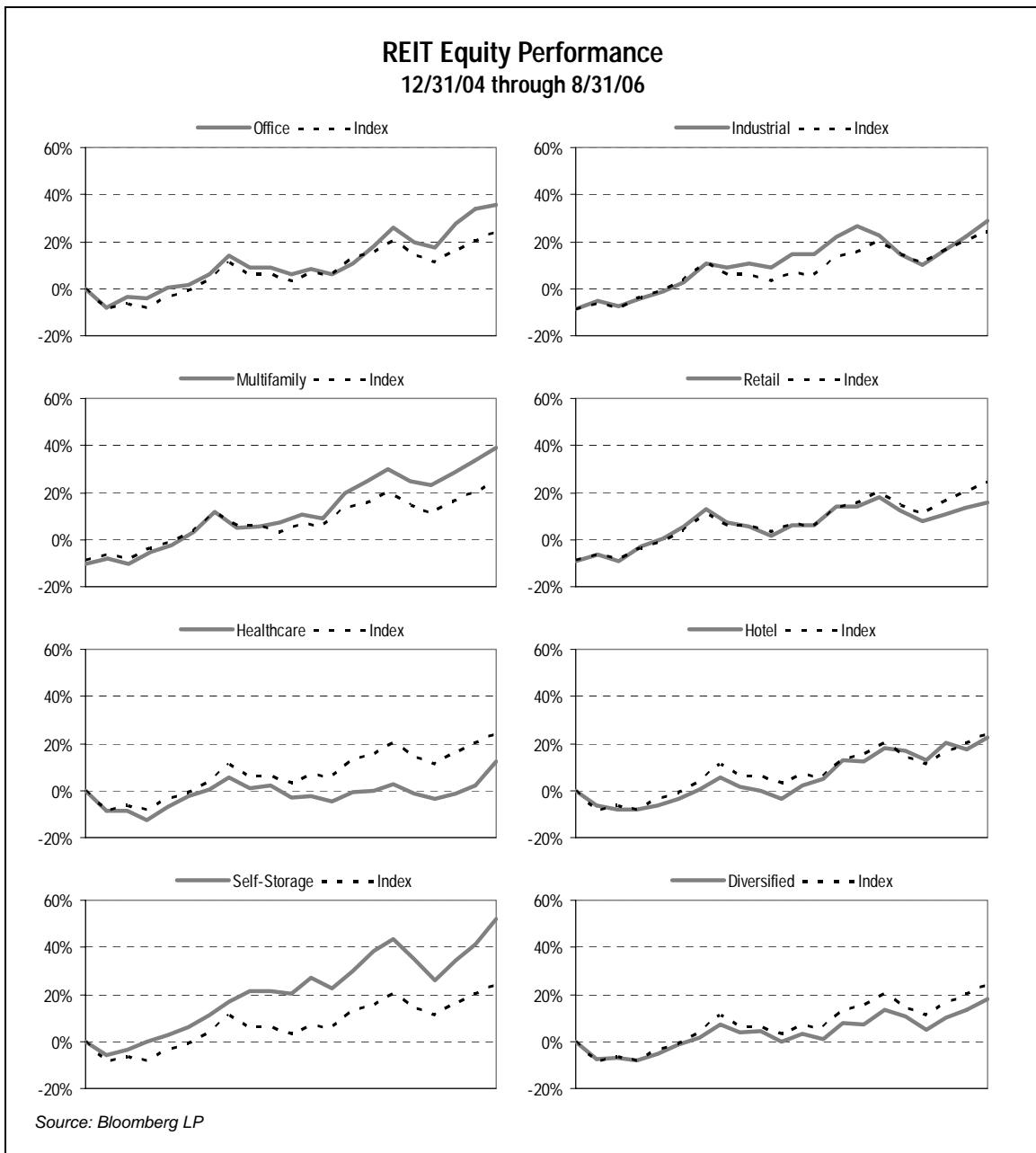
	----- 12/31/04 -----			----- 6/30/06 -----		
	Development Pipeline	% of Gross Assets	Effective Leverage	Development Pipeline	% of Gross Assets	Effective Leverage
AvalonBay Communities	\$546.7	9.3%	42.3%	\$1,412.0	22.4%	37.9%
Liberty Properties	143.9	3.0	46.8	924.9	17.4	40.9
Duke Realty	194.9	2.9	47.5	772.9	9.8	60.0

Source: Company reports, Moody's.

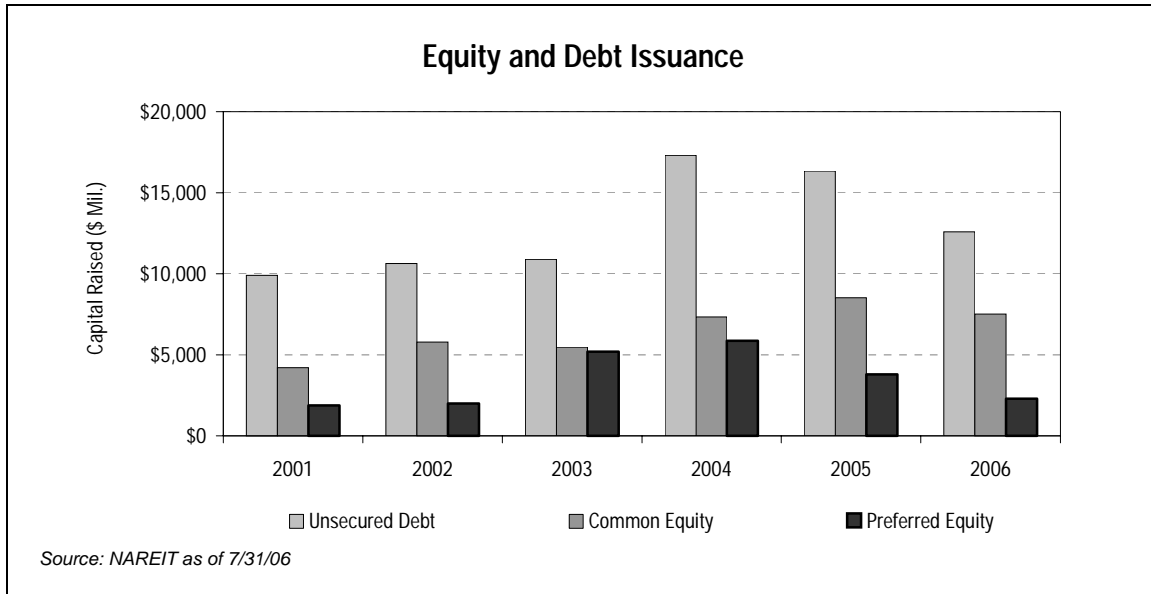
## HOW WILL A CHANGE IN THE CAPITAL MARKETS AFFECT REITs?

The upbeat capital and real estate markets have been a plus for most all REITs and REOCs, allowing them to boost returns by selling even mediocre assets at low cap rates, strengthening their balance sheets, and accessing all forms of funding easily and cheaply. The early 2000 recession was not a significant challenge for most REIT sectors, save lodging. Although revenues were crimped by wavering fundamentals, low and falling interest rates, low cap rates, a robust seller’s

environment, high equity values and ready access to funding (including a large influx of foreign capital) were key supports. If one or more of these factors had been removed, the fortunes of at least some REITs would have likely reversed.



It is often overlooked that REITs depend on regular capital market access. We have not seen access diminish recently, but we do expect changes will take place, as some REITs have looked at shortening the maturity structure of their debt and we have also seen substantial increase in convertible debt issuance. With respect to the former, Moody's views its use as a credit negative. For an industry with almost no cash retention capacity, funding a substantial part of its business with short-term debt reflects a high risk appetite.

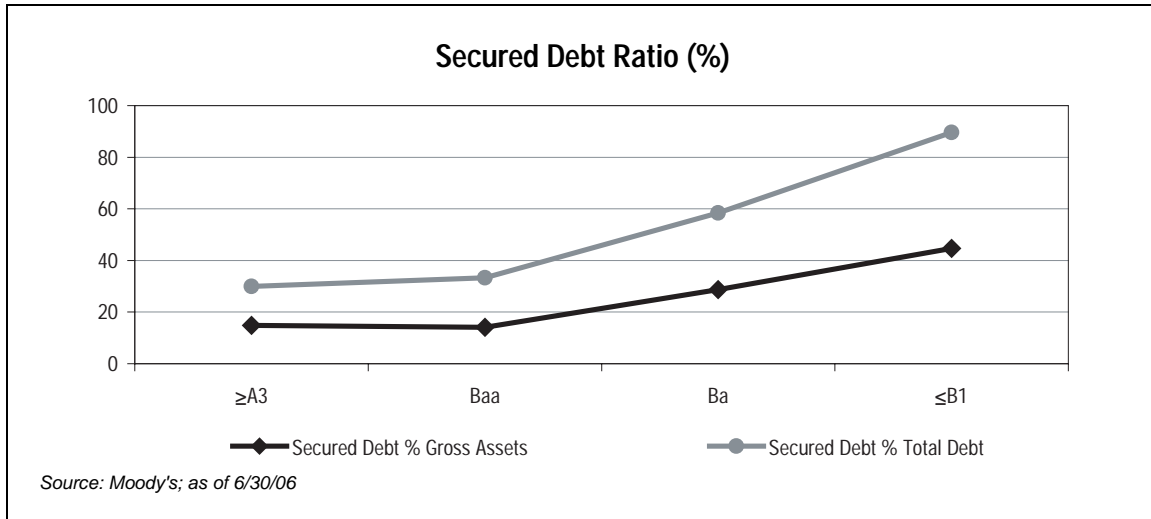


Convertible debt, a current fad, is considered debt, given the structures used. Recent issues provide the REITs with another source of inexpensive fixed-rate long-term financing. Yet the issuance of these instruments indicates that management believes it should be able to issue these instruments without much future dilution to its equity base or FFO per share (they are not incented otherwise to issue these securities), which begs the question whether the REITs' growth in stock prices, based on management's expectations, have hit a plateau.

### HOW MUCH SECURED DEBT IS TOO MUCH?

We focus on several ratios to evaluate the effects of secured debt on REITs' rated unsecured debt, financial flexibility and effective subordination. Moody's primary metric considers secured debt relative to gross assets, and levels below 20% are a "Baa" rating characteristic; less than 10% or lower is an "A" characteristic. Other ratios include the ratio of unencumbered assets to unsecured debt; interest coverages for unsecured debt generated by unencumbered assets; the mix and quality of the unencumbered asset pool; and the loan-to-value ratio of the secured assets. When rating unsecured debt, Moody's is cognizant of the ratio of unencumbered assets to total debt and, in particular, total unsecured debt. The larger the ratio, the more financial flexibility a REIT generally has (although high levels of mortgaged assets can render the unencumbered leverage ratio less relevant, so it is important to examine overall leverage as well). Another key factor in Moody's evaluation of the debt mix and refinancing risks is the REIT's or REOC's debt maturity schedule. The bunching of debt maturities presents financing risks: the more debt maturities are spread over time, the more flexibility the REIT or REOC will have — one of the pluses of mortgages, with their amortization schedules.

Examples of REITs that have levels of secured debt which constrain their rating (in these instances, below investment grade) include General Growth Properties and Apartment & Investment Management Company (AIMCO). Secured debt relative to gross assets at June 30, 2006 was 50% and 47%, respectively, with little in terms of unencumbered assets in either case. Conversely, Vornado Realty Trust, 52%, Boston Properties, 31%, and Archstone-Smith Trust, 20%, represent three issuers where relatively high levels of secured debt have been mitigated by other, positive factors which support investment-grade ratings, chief of which are a sizable unencumbered asset base marked by superior asset quality.



### WHICH ACCOUNTING ISSUES WILL HAVE THE GREATEST EFFECT ON REITS?

The Financial Accounting Standards Board (FASB) recently completed several projects related to fair value, and it is possible fair value accounting treatment for investment properties under US GAAP will be introduced in 2008. International Financial Reporting Standards (IFRS) already require investment properties to be recorded at fair value on the balance sheet with changes in unrealized gains and losses in the income statement, or disclosure of fair value in the footnotes if preparers choose to continue to use historical cost in their financial statements (with no income statement impact for unrealized gains and losses). In the “Roadmap” for convergence between US GAAP and IFRS, released jointly by the respective standard setters in February 2006, investment property accounting was placed in the “short-term” convergence category. The FASB will evaluate the accounting for investment property as part of Phase II of its Fair Value Option project; an exposure draft for this project is expected in the fourth quarter of 2006 or the first quarter of 2007. It is unclear at this time if the US standard will mirror the international standard or contain differences.

There are diverse opinions on the positives and negatives of fair value accounting for investment property. Those in favor say depreciation has little meaning for investment property, and it reduces the relevance of both the income statement and the balance sheet. Fair value treatment is more representative of the economics of many REITs’ business models. Those on the negative side fear a reduction in comparability, especially if fair value treatment is optional, and reliability, as a fair value number is more subjective than historical cost; fair value is also volatile.

Moody’s believes there is validity in both sides of this argument. We agree that neither depreciated, nor undepreciated, cost is usually representative of the fair value of real estate assets, especially for those REITs with low asset turnover. However, fair value treatment can create distortions, the level of which depends on how often a company revalues its assets and the dependability of the revaluations. Moody’s analysis incorporates both measurement bases. As it is widely available, undepreciated cost underlies many of our metrics, but in most instances fair value information is also incorporated. For example, leverage ratios are calculated using assets on both an undepreciated cost as well as a fair value basis, and the stability of asset values is reviewed as we consider stable asset values an enhancement of a REITs ability to sell or refinance properties in times of cash flow need. For those non-US REITs revaluing their real estate assets with a resulting income statement impact, Moody’s eliminates any unrealized gains. This treatment is similar to that for realized gains and losses in the calculation of FFO.

A corollary issue is how a fair value accounting regime could change how the “total assets” component of REIT bond covenants is defined. The most common definition is currently undepreciated cost. A change to fair value accounting could make definitions with fair value aspects more common and accelerate the diversification of REIT covenant definitions that is already underway. Although we do not believe pure fair value will become the new “standard” definition of total assets in covenants over the short term, over the long term, with more acceptance of fair value accounting, it possibly will.<sup>3</sup>

We do not expect a move to fair value accounting to impact outstanding bonds unless management proactively changes covenant definitions. Most definitions of total assets are clearly defined as undepreciated cost and this would not change in a move to fair value accounting. In addition, many indenture agreements contain language that permits “old” accounting to be used to calculate covenant compliance if “new” accounting would result in non-compliance.

3. “Fair Value Accounting for Investment Properties Is on the Horizon: How Will It Affect REIT Bond Covenants?” June 2006.

## Watch for These Credit Topics

---

### JOINT VENTURES & INVESTMENT FUNDS

REITs have been increasing their use of joint ventures and funds to finance real estate purchases, diversify their revenues through advisory and management fees, and lever their businesses — both operationally and financially. We expect the rate of increase to accelerate, driven by managements' needs to achieve earnings growth in a low cap rate/easy-mortgage-finance environment. We also believe the growth in these structures would continue with a reversal in cap rates, albeit at a slower rate. In short, these vehicles are here to stay<sup>4</sup>.

A few REITs have been successfully using these structures for some time which has helped provide them with revenue and funding diversification. However, these structures are a rising trend among a larger number and range of REITs. On a broad basis, the associated fees demonstrate little track record and a potentially high degree of variability. This variability is higher for acquisition, disposition and promote/success fees, but less so for the core property management and leasing fees.

Moody's sees the negative aspects of the rise of JVs/funds creating a rating counterweight to REITs' positive track record and momentum in building greater diversity, depth and leadership. JVs and funds will likely be one of the material business and creditworthiness factors for REITs for the rest of the decade. Some specific comments Moody's has about these structures:

- Unlike cash flows from rental properties, the JV/fund fee stream does not provide outright claim on and control of an asset.
- Senior management time and attention can be diluted by managing the relationship with JV partners or fund investors.
- The vehicles may be supplementing core nominal investment returns through potentially non-core fees and uncertain promote revenues.
- The structure could be a means to achieve a reported (if not actual) balance sheet condition, such as leverage and relative use of secured debt.
- The partnerships may result in higher hidden leverage with secured debt which is off-balance sheet, weakening REITs' financial and strategic flexibility.
- There are varying degrees of transparency and disclosure.
- There are conflict-of-interest concerns, with attendant fiduciary liability, which may arise over how opportunities and costs are allocated among REIT-owned properties and JV/fund properties.

Certain trends are likely to occur over the short term in regards to REITs' use of JV and fund structures. We see REITs lowering their stakes in these ventures in order to create additional operating leverage for the JV without increasing the REITs' financial leverage. For example, instead of earning \$10 million in management fees over a \$50 million dollar (or 50%) investment in a \$100 million dollar venture, the REITs will choose to invest \$20 million (or only 20%) to earn the same \$10 million in fees from the same \$100 million venture. However, alignment of interests with institutional partners will tend to increase the longevity of the venture and related fees. In addition, some REITs could become preponderantly real estate investment management firms, rather than direct investors. Moody's also sees a greater stratification between the REITs that are really adept at the JV/fund business and those that are not, with the latter perhaps finding themselves stuck with some awkward deals. Finally, because JV/fund arrangements limit cash outlays, they are particularly attractive when an otherwise profitable investment does not yield an immediate or attractive return. Some REITs employ JVs/funds to fund their development activities for this reason.

### BANK LINES & INTEREST RATE VOLATILITY

Revolving bank credit facilities are important components of REITs' funding. Almost all REITs actively use such revolvers, a reflection of REITs' fundamental, limited ability to retain cash because of their dividend distribution requirements, ongoing need for readily available investment funds, and small cash balances typically held on their balance sheets. These factors impel REITs to rely on bank lines of credit as their primary source of short-term liquidity. These revolvers provide REITs with maneuverability to quickly close on acquisitions, to fund development and other capital expenditures (capex), and to serve as bridge financing for maturing mortgages and bonds. However, without appropriate management and structure of the revolver, or a clear role for the facility in the REIT's capital structure, bank revolvers can create risks. Mismanagement or weak structuring of a bank facility can reduce a REIT's financial flexibility, which could create rating implications.

---

4. "REIT Joint Ventures and Funds: Weighing the Pluses and Minuses," April 2006.

If the bank credit facility balance outstanding is significantly over 50% for a sustained period of time, Moody's would likely see this as aggressive. Increasing percentages drawn imply increasingly aggressive funding postures. Total line availability above 50% on a regular basis is characteristic of companies rated "Baa" or higher. A persistently elevated outstanding balance may also indicate that the REIT is using its line of credit, which is by definition a short- to medium-term facility, as permanent financing, which Moody's would see as aggressive. High draw levels also weaken the REIT's liquidity resources. Other issues that would affect this analysis include large impending debt maturities, capital expenditures and acquisitions, cash retention, asset sales and likely issuances of term debt or equity.

Lines of credit are the primary source of variable rate debt for most REITs, though some REITs swap fixed-rate debt into floating-rate debt, and have variable-rate mortgages or construction loans. Variable rate debt can be risky for a REIT because of the potential for a rise in interest rates, counterbalanced by the typical fixed level of rent cash flows; the result can become a profit squeeze. Moody's has observed that there has not been a consistent, significant difference between investment grade REITs' and speculative grade REITs' variable-rate debt exposures. That said, Moody's would see as a negative rating factor a high level of variable rate debt — levels above 20% tend to equate to a below-Baa characteristic. In its analysis, Moody's adjusts down high levels of variable-rate debt to more normalized levels, with the difference being assigned a long-term cost of funds. This helps to highlight how much coverages are being supported by variable-rate debt, and assists in comparing REITs' performance. Moody's also stresses interest rates in its *pro forma* analyses. Many REITs hedge their lines of credit (such as via caps) to manage interest rate volatility and this can result in a higher tolerance for variable-rate debt.

We also recognize that a higher tolerance exists for sectors in which leases reset relatively more frequently. The lodging and multifamily sectors, with respective average lease durations of one day and less than one year, are more suited to carrying variable rate debt than the retail or office sectors, which typically have multi-year leases.

## "A" RATED REITs

While Moody's has a handful of REITs and REOCs rated "A", and more rated Baa1, a larger A-rated population would mean material progress on diversity and sector leadership, assisted by better balance sheet metrics, and a track record of consistent and sound performance in more challenging capital and property markets. These factors have been critical in the movement towards a larger group of A-rated REITs in 2006. The following are recent positive actions relating to senior unsecured on the Baa-A divide. These factors — especially diversity and leadership — will also be the key drivers for ratings into the upper end of the "Baa" category. These movements, over time, should result in a wider dispersion of ratings as some REITs pull away from the pack.

REIT	Old Rating/Outlook	New Rating/Outlook
Equity Residential	Baa1/Stable	Baa1/Positive
AvalonBay	Baa1/Stable	Baa1/Positive
Simon Property	Baa1/Positive	Baa1/Under review up
Public Storage	Baa1/Under review up	A3/Stable

## THE INTERNATIONAL ANGLE

International investing means different things to different investors, including: (1) property investments outside the USA by US REITs, (2) non-US property investors buying in the USA, (3) tapping overseas capital by US REITs, and (4) the establishment of more public property companies overseas, usually via a REIT vehicle.

### **Overseas Investment by US REITs**

More overseas investment by US REITs is occurring, and Moody's expects still more to come. Why? To drive growth in what is seen as a more constrained domestic market, and especially to leverage specialized skill bases and tenant relationships. However, most of the activity above nominal levels is concentrated in a few REITs, such as ProLogis, AMB, Simon, Kimco and Archstone — and even here the international numbers are not significant (yet).

Moody's sees overseas investments as a plus — a means of diversifying assets and cash flows, of strengthening the domestic franchise, and of extending that franchise globally. These efforts will take time to accomplish, however. Also, rapid growth, particularly in new markets, is often a precursor to problems, and there are a number of external, non-operating risks to consider, including foreign exchange, tax and regulatory risks. In addition, many such overseas investments utilize joint venture partners, with all of the usual complexity and leverage issues. That said, Moody's does recognize the prudence of enlisting local expertise, which helps REITs navigate unfamiliar territory. Furthermore, there is a particular tendency to employ significant leverage on non-US assets as a means of hedging FX risk and addressing tax issues. For the moment, for most all REITs, international investing is a minor analytical issue, and we expect it to remain so for the intermediate term.

### **Foreign Buyers in the USA**

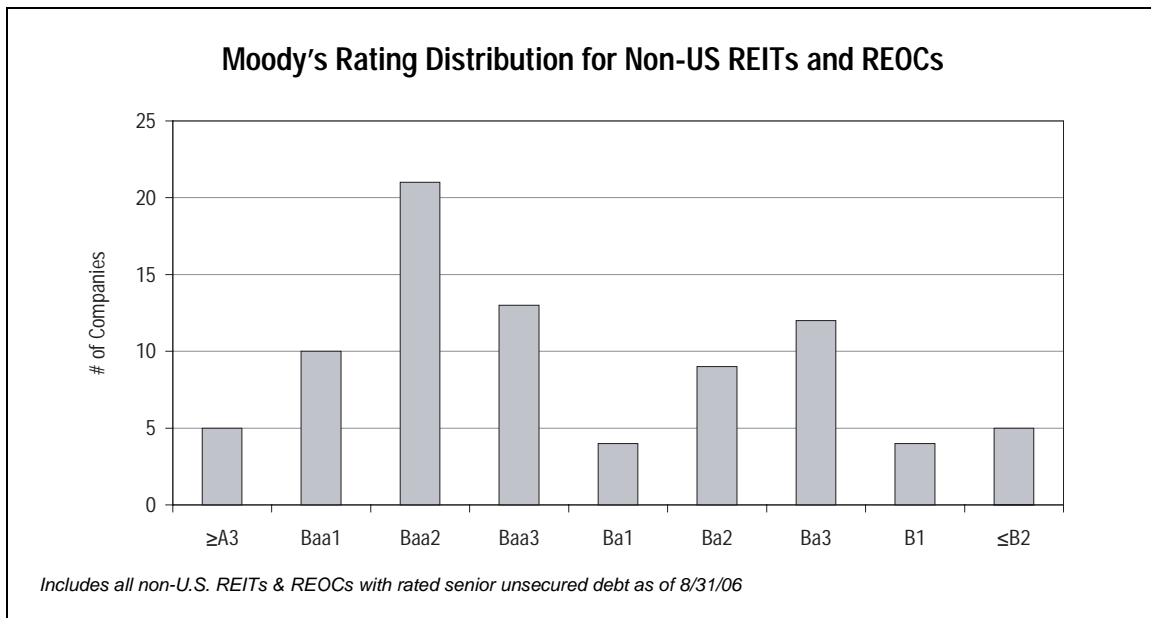
Foreign investors continue to be active buyers of US commercial property — including the purchase of REITs. Recent deals include Kramont and Heritage. Moody's view is that this trend is attenuating as cap rates have dropped (partly due to these investors, making acquisitions less appealing) and as allocations get put to work. It's unclear how sticky this recent wave of foreign money will be, so there may be a partial return of assets to the US public space in due course, providing renewed growth opportunities for REITs over the intermediate term. The ratings effects of these purchases of US REITs have been similar to those of other M&A events, with rating downgrades or withdrawals predominating.

### **Tapping Overseas Capital by US REITs**

We are still in the early stages of what should be a positive long-term process for US REITs, as they build investor followings overseas to draw upon a wider range of capital sources — including common stock and unsecured bonds. We have also seen REITs utilize non-US investors via joint ventures and funds (such as ProLogis, a successful leader), as well as US REITs entering into joint venture-type structures, such as certain Australian property trusts, to access foreign capital. How long some of these more recent structures will last — including JV-like Australian property trusts — is an open question, and such restructurings could create challenges for REITs, but it does not appear at this stage that such challenges would be particularly disruptive. More important is how a waning of enthusiasm by foreign investors could affect REITs' capital access and costs — always a credit worry in a non-cash-retention business.

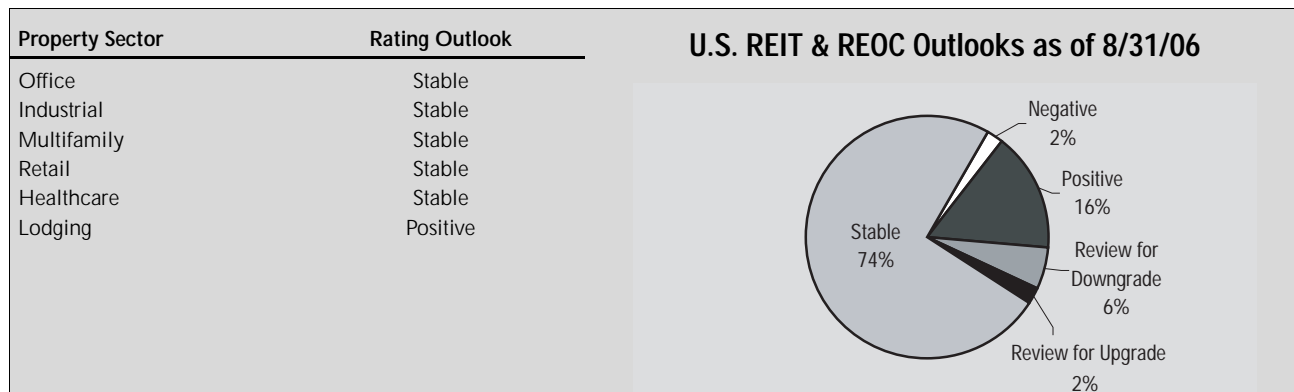
### **The Growth of REITs in Other Nations**

This trend continues, with the United Kingdom most recently joining the fold, and Germany a likely candidate. While the growth of REITs in new markets will steal some of the spotlight from US REITs, overall the globalization of REIT-like structures is a positive event for REIT credit. As REITs and public real estate firms grow in size, number and geographic reach, they reinforce the success and robustness of the public company concept, and the capital access that follows, and strengthen the long-term outlook for the industry.





## Moody's Rating Outlooks for Specific REIT Property Sectors



### OFFICE SECTOR

Moody's rating outlook for the US Office REITs is stable<sup>5</sup>. Office REITs have been active participants in M&A activity during 2006, comprising almost 50% of the total transaction volume. This activity, driven by the goal to invest early in the recovering office sector, and some large institutional investors' desire to reach their allocation targets sooner rather than later, has resulted in both positive and negative rating actions, determined primarily by prospective capital structures.

With the exception of other potential strategic transactions, Moody's does not anticipate any material shifts in the office REITs' ratings over the coming 18 months. This outlook reflects: 1) stabilizing office market fundamentals, and 2) limited delivery of supply scheduled in 2006 and 2007. The US national vacancy rate continues its decline year-over-year from 14.4% in 2Q05 to 13.1% in 2Q06<sup>6</sup>, but local fundamentals vary widely by market. Moody's notes that the rate of employment growth is expected to slow over the next few years<sup>7</sup>, which should attenuate the pace of improvement in many local office markets. Positively, high construction costs should continue to constrain new supply and to steady overall market fundamentals in the near term. Moody's expects that office cap rates will slowly begin to increase with rising interest rates, adding pressure on leveraged buyers and thus opening buying opportunities for REITs.

Office Sector Strengths	Office Sector Challenges
<ul style="list-style-type: none"> <li>• Access to capital is plentiful and diverse (for now)</li> <li>• Current strength in balance sheets</li> <li>• Improving market fundamentals: declining vacancy rates, pricing power shifting to landlords, supply growth limited for most markets</li> <li>• Some REITs are becoming more diverse</li> </ul>	<ul style="list-style-type: none"> <li>• Capital-intensive asset class with vulnerability to economic cycles</li> <li>• Competitive acquisition environment fostering more complex legal structures</li> <li>• AFFO payout ratios remain high</li> </ul>

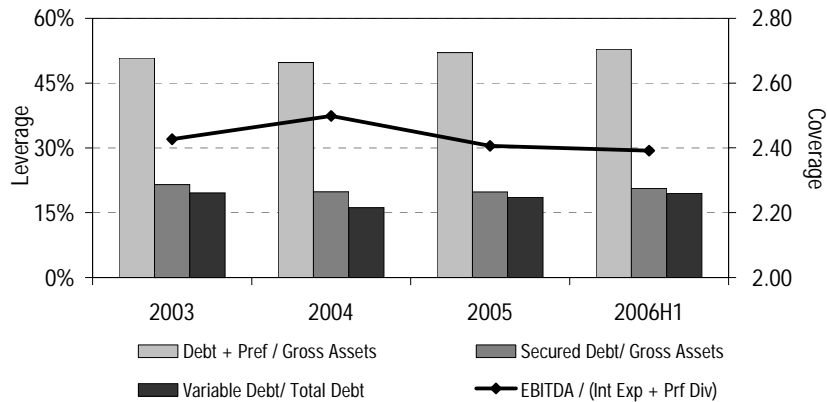
Moody's does not foresee any ratings upgrades for office REITs in the near term. Although many office REITs have achieved greater size and diversity, office REITs have yet to solidify their franchises — which are difficult to solidify in the first place. Franchise value will be a key driver in upward ratings, as most office REITs have achieved their target capital structures. Downward ratings will be largely balance sheet-driven.

5. "U.S. Office REITs Sector Commentary," September 2006.

6. Torto Wheaton Research — TWR FLASH Office Vacancy Index, July 12, 2006.

7. Moody's Economy.com Industry Outlook.

### Office REIT Financial Ratios



Source: Moody's  
Sector Includes: BXP, BDN, CEI, DRE, EOP, GLB, HIW, HRP, CLI, MPG, PSB and RA as of 6/30/06; data for ARI as of 2005YE, for CRE as of 3/31/06

Office REIT	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Arden Realty Inc.		—	—	Stable
Arden Realty Limited Partnership	Aaa	—	—	
Boston Properties, Inc.	—	—	(P)Baa3	Stable
Boston Properties Limited Partnership	Baa2	—	—	
Brandywine Realty Trust	—	—	(P)Ba1	Stable
Brandywine Operating, L.P.	Baa3	(P)Ba1	—	
CarrAmerica Realty Corporation	Ba3	—	—	Stable
CarrAmerica Realty LP	Ba3	—	—	
Crescent Real Estate Equities	—	—	B3	Stable
Crescent Real Estate Equities L.P.	B1	—	—	
Duke Realty Corporation	Baa1	—	Baa2	Stable
Duke Pass-Through Asset Trust	Baa1	—	—	
Duke Realty L.P.	Baa1	—	—	
Equity Office Properties Trust	—	—	(P)Baa3	Stable
EOP Operating, L.P.	Baa2	—	—	
Glenborough Realty Trust Inc.	—	—	Ba3	Review for Downgrade
Glenborough Properties, L.P.	(P)Ba1	(P)Ba2	—	
Highwoods Properties, Inc.	Ba1	—	Ba2	Stable
Highwoods Exercisable Put Opt.	—	—	—	
Highwoods Realty, L.P.	Ba1	—	—	
HRPT Properties Trust	Baa2	Baa3	(P)Baa3	Stable
Mack-Cali Realty Corporation	—	—	Baa3	Stable
Mack-Cali Realty, L.P.	Baa2	(P)Baa3	—	
Maguire Properties, Inc	—	—	—	Stable
Maguire Properties, L.P.	Ba2*	—	—	
Maguire Properties Holdings I, LLC	Ba2*	—	—	
PS Business Parks, Inc.	—	—	Baa3	Stable
Reckson Associates Realty Corp	—	—	(P)Ba1	Review for Downgrade
Reckson Operating Partnership	Baa3	—	—	

\*Bank Line  
As of 8/31/06

## INDUSTRIAL PROPERTY SECTOR

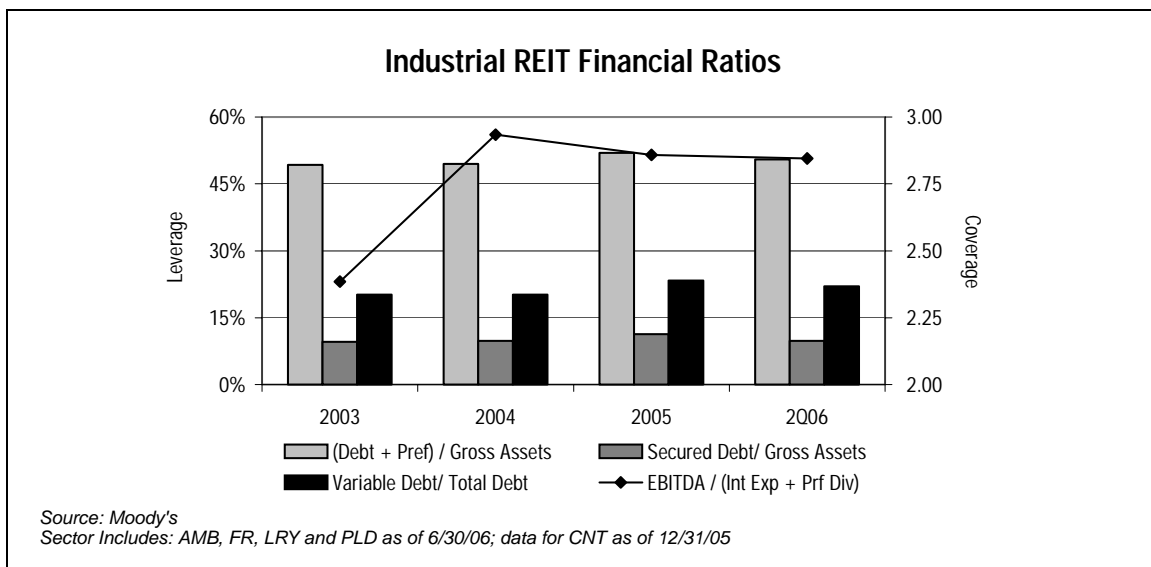
Moody's rating outlook for industrial REITs is stable, reflecting the sector's improving economic fundamentals and operating performance, combined with moderate leverage, ample unencumbered assets, few liquidity issues, aggressive tenant retention efforts and a sound global trade economy.

Moody's believes that the industrial property cycle is on an upswing. This optimism partly stems from the healthy Institute for Supply Management's Purchasing Managers Index (PMI) reading over the past year. The PMI decreased almost 300 basis points to 52.9% in September 2006 from 55.6% in December 2005 and below August's reading of 54.5%. A PMI reading of above 50% indicates that the manufacturing economy is expanding, while a reading below 50% suggests a contraction.<sup>8</sup> Manufacturing output is a key leading indicator of absorption in the industrial property markets, and the growth, albeit slower, still continues to positively affect industrial REITs, which continue to experience positive absorption of supply. This net absorption should lead to some measure of pricing power for market rents in the next 12 to 18 months. Global trade is also robust.

Industrial Sector Strengths	Industrial Sector Challenges
<ul style="list-style-type: none"> <li>• Low levels of secured debt</li> <li>• Tenant improvement costs are trending down</li> <li>• Tenant retention is solidifying</li> <li>• More positive absorption momentum</li> <li>• Rent roll downs are stabilizing</li> </ul>	<ul style="list-style-type: none"> <li>• Unabating reliance on fees and gains generated through joint ventures and real estate funds, international investments, and merchant building and fee development businesses</li> <li>• Speculative building is growing</li> <li>• Competitive cap rates are leading industrial REITs to purchase vacancy</li> <li>• Lease terms have been getting shorter</li> </ul>

Key credit consideration for industrial REITs include driving NOI from core same-store portfolios (these are still slightly negative to slightly positive) and the tendency to increase leverage as development pipelines and vacancy purchases grow. Moody's sees the growing reliance by industrial REITs on fees and gains generated through joint venture and real estate fund structures, merchant building, fee development businesses and international investments as an important rating matter. Funds and joint ventures tend to involve complex structures that diminish transparency and require a substantial commitment of managerial resources; the same is true of international investments, which also expose REITs to foreign exchange risks. Moreover, merchant building activities produce more volatile earning streams than those typically associated with pure rental income, diminishing industrial REITs' earnings quality. As industrial REITs' growth becomes more dependent on funds, joint ventures, international investments, merchant building and fee development businesses, the cushion that industrial REITs have in their ratings and outlooks is reduced.

The major threats to industrial REITs' stable ratings are a significant decline in their core portfolio quality, resulting in a material deterioration in earnings and cash flow contribution, and JV or fund structures coming off the rails. The industrial REIT sector is the highest rated sector in Moody's US REIT universe. A positive shift in the sector's rating outlook would be predicated upon a stronger focus on asset and earnings growth from core portfolios, coupled with continued growth in size, diversity and leadership. Having a more diverse JV/fund business, with a stronger track record and structures would mitigate risks over the long term.



8. Institute for Supply Management — Report on Business, October 2006.

Industrial REIT	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
AMB Property Corporation	—	—	Baa2	Stable
AMB Property, L.P.	Baa1	—	—	
CenterPoint Properties Trust	Baa3	—	Ba1	Stable
First Industrial Realty Trust	—	—	Baa3	Stable
First Industrial, L.P.	Baa2	—	—	
Liberty Property Trust	—	—	(P)Baa3	Positive
Liberty Property L.P.	Baa2	(P)Baa3	—	
ProLogis	Baa1	—	Baa2	Stable

*As of 8/31/06*

## MULTIFAMILY SECTOR

The rating outlook for this sector is stable, with a positive bias. Moody's currently maintains positive outlooks on four of ten rated apartment owner-operators. The multifamily sector is enjoying its most successful period since 2001. Fundamentals have reached levels near or better than their prior peak five years ago, which is translating to solid cash flows and debt service coverage. Portfolio occupancies are in most cases at 95% or above, giving landlords meaningful pricing power and virtually eliminating concessions. Moody's has also been encouraged by the improvement in operating margins and the maintenance of healthy balance sheets, which should provide better flexibility should markets become more challenging. Progress is also being made in growing and diversifying the REITs.

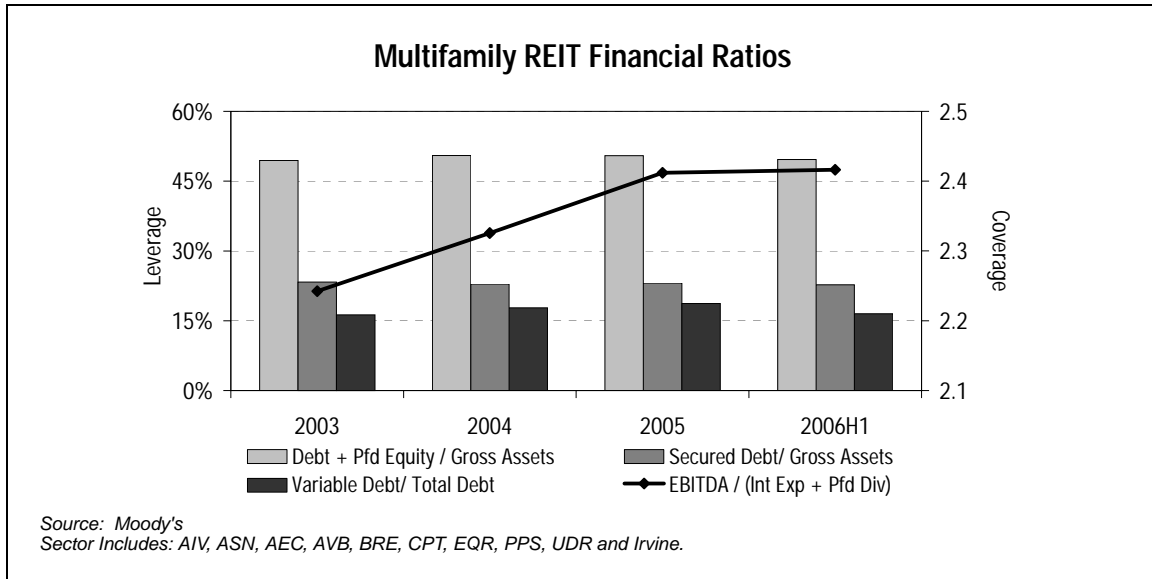
Much of this improvement can be attributed to higher job growth, a sound supply-demand relationship due to (until lately) little apartment development, reduction of the rental unit population by condominium conversions, and the slowdown in home-buying fostered in part by historical discrepancies in the cost of homeownership relative to leasing. What is more, the REITs' recent investments in various technology platforms related to leasing, revenue and procurement management should reduce NOI volatility and improve pricing skills.

Similar to other sectors, the apartment sector has responded to the challenging acquisition environment with augmented construction pipelines. We are also concerned about the emerging condo bust, with those units competing for renters' attention. The weakening single-family housing market should help the apartment business by encouraging would-be homeowners to wait for prices to fall further, but it can also have adverse economic effects, which would hurt the apartment space.

Multifamily REIT Development Pipelines					
	6/30/2006	12/31/2005	12/31/2004	6/30/2006 vs. 12/31/2005	6/30/2006 vs. 12/31/2004
Archstone	\$1,215.5	\$1,295.0	\$952.5	-6.1%	27.6%
AvalonBay	1,412.0	1,025.5	546.7	37.7%	158.3%
BRE Properties	316.4	355.1	276.9	-10.9%	14.3%
Camden	520.0	357.0	135.6	45.7%	283.5%
Equity Residential	964.7	464.4	326.7	107.7%	195.3%
Post Properties	178.7	99.0	95.0	80.5%	88.1%
United Dominion	352.8	145.2	125.6	142.9%	180.9%
<b>Total / Average</b>	<b>\$4,960.0</b>	<b>\$3,741.2</b>	<b>\$2,459.0</b>	<b>33.6%</b>	<b>101.7%</b>

*Source: Company reports, Moody's*

*Generally includes joint venture activity and excludes redevelopment, condo conversion or TRS-related activity. Amounts represent total expected pipeline cost, and often reflect the use of projections and estimates by the companies. Properties not stabilized or in lease-up are excluded. Companies with little or no new development pipelines, or which focus on redevelopment, have been excluded. Camden 12/31/04 figures have not been adjusted to include Summit Properties, which it acquired in 2005.*



Multifamily Sector Strengths	Multifamily Sector Challenges
<ul style="list-style-type: none"> <li>• Landlord pricing power rising</li> <li>• Homeownership is expensive, albeit falling</li> <li>• Asset recycling facilitated by compressed and undifferentiated cap rates</li> <li>• Fannie Mae and Freddie Mac funding access</li> <li>• Liquid asset class</li> </ul>	<ul style="list-style-type: none"> <li>• Supply levels threatened by new development and unabsorbed "for-sale" product,</li> <li>• Condo market weakness</li> <li>• Lowest fixed charge coverage</li> <li>• High secured and variable rate debt</li> </ul>

Multifamily REIT	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Apartment Investment & Management Co.	(P)Ba1	(P)Ba2	Ba3	Stable
Archstone-Smith Trust	Baa1	—	Baa2	Stable
Associated Estates Realty Corp	B2	—	B3	Positive
AvalonBay Communities, Inc.	Baa1	(P)Baa2	Baa2	Positive
Avalon Properties, Inc.	Baa1	—	—	
BRE Properties, Incorporated	Baa2	(P)Baa3	Baa3	Stable
Camden Property Trust	Baa2	(P)Baa3	(P)Baa3	Positive
Camden Summit Partnership, L.P.	Baa2	—	—	
Equity Residential Properties Trust	—	—	Baa2	Positive
ERP Operating L.P.	Baa1	—	—	
Lion Gables Residential Trust	—	—	—	Stable
Lion Gables Realty, L.P.	Ba2	—	—	
Irvine Apartment Communities, L.P.	Baa2	—	—	Stable
Post Properties, Inc.	—	—	Ba1	Stable
Post Apartment Homes, L.P.	Baa3	—	—	
United Dominion Realty Trust	Baa2	(P)Baa3	Baa3	Stable

As of 8/31/06

## RETAIL SECTOR

Moody's rating outlook for US Retail REITs ratings remains stable. Moody's does not anticipate any material shifts in retail property REITs' credit metrics in 2006, partly a reflection of continued consumer spending and retail REITs' often market-leading assets. We therefore do not expect any sector-wide upgrades or downgrades. Worry levels are highest for B and C regional malls, and for community centers with weak grocery and/or discount anchors, anchor sites that are too small, have too little line store space, or are not in in-fill locations.

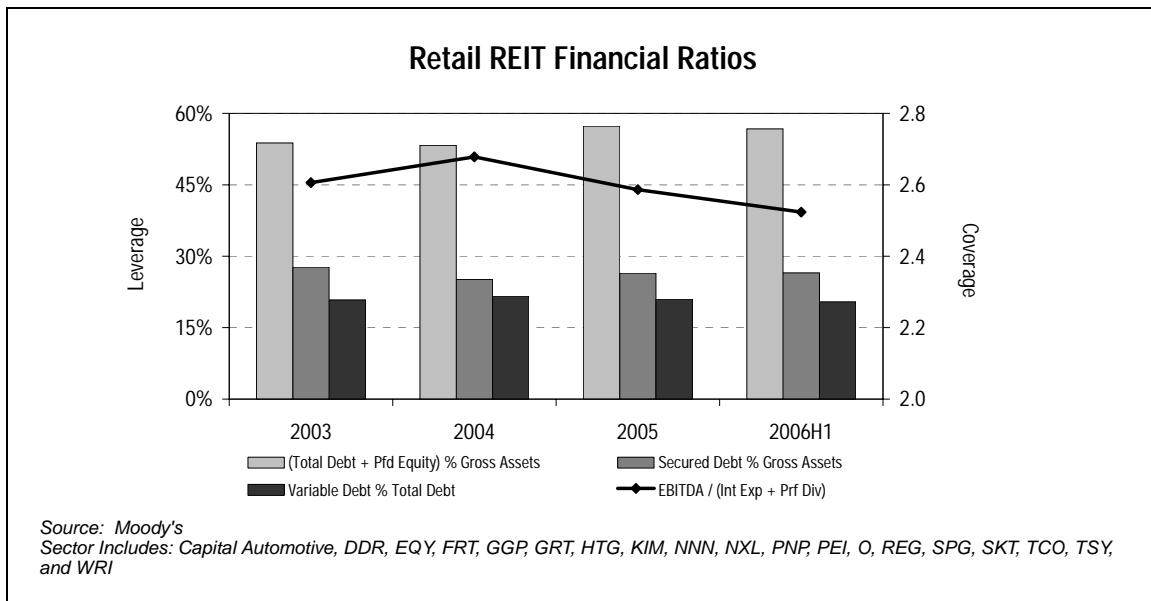
Retail Sector Strengths	Retail Sector Challenges
<ul style="list-style-type: none"> <li>• Sound balance sheets</li> <li>• Small levels of supply growth</li> <li>• Resilience of the consumer</li> <li>• Quality and well-located malls, shopping centers and outlets continue to thrive</li> <li>• Premium on asset management and development skills, which REITs have</li> </ul>	<ul style="list-style-type: none"> <li>• Consolidation of REITs and retailers</li> <li>• Upward trend in operating expenses and leverage</li> <li>• Investment activity is strong, with low cap rates, which creates competition from the private sector for portfolios</li> <li>• Pressure on home values and high energy prices may constrain consumers' purchasing power</li> </ul>

Retail is dependent upon consumer spending, which has continued to be robust. Whether consumers will continue to spend in the face of static wages and weakening home equity is questionable. Although the REITs lease space on relatively long term leases, prolonged pressure on consumer sales would crimp the ability of landlords to drive rents.

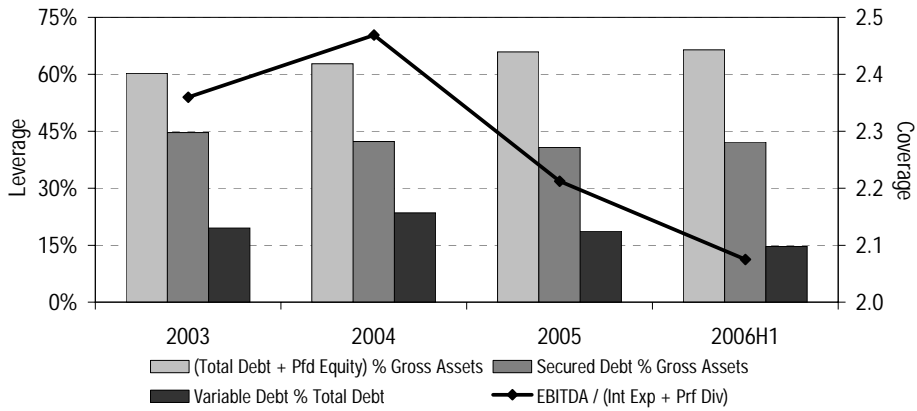
Major trends in the retail space include consolidation of REITs and retailers, retailer expansion, property redevelopment and international expansion. Recent M&A examples include Kimco/Pan Pacific and Centro Watts (an Australian REIT)/Heritage. Consolidation of property ownership can be positive for ratings if it creates a more geographically and tenant-diverse company, better performance and less debt, or a larger platform from which to negotiate with tenants and build a franchise. It can be a credit negative if it is debt-financed.

Consolidation among large retailers such as Federated/May and the Supervalu Inc./CVS Corporation acquisition of Albertson's (in which Kimco participated) fuels discussion about the future of department stores and large chains, their value as anchors, their influence over mall and community center owners, and store closings. Retailer consolidation can be a credit challenge for REITs by decreasing the supply of tenants, creating empty spaces, concentrating tenant credit exposures and adversely shifting negotiating power. This is a moderate, but growing, risk. Many REITs with tenant diversification view these changes as opportunities, and can work through the consolidations and bankruptcies by shifting tenants, or adding new tenants to vacant spaces.

A number of retailers with successful platforms are spinning off new concepts and companies to fill niches in the retail experience or market to specific age-groups. Examples include Abercrombie & Fitch (Ruehl, Concept V, Hollister), Anthropologie (Urban Outfitters, Free People), Chico's (Soma, White House/Black Market, Fitigues), and Clai-borne Concepts (Lucky/Lucky Kids, Liz, Sigrid Olsen, Juicy). Such expansions are positive credit events as they utilize space vacated by anchor consolidation and tenant downsizing, as well as create demand for space. International expansion — Simon, Taubman and Kimco, for example — is also happening. While we do not expect this to become a dominant theme anytime soon, such activities provide additional pillars for value creation.

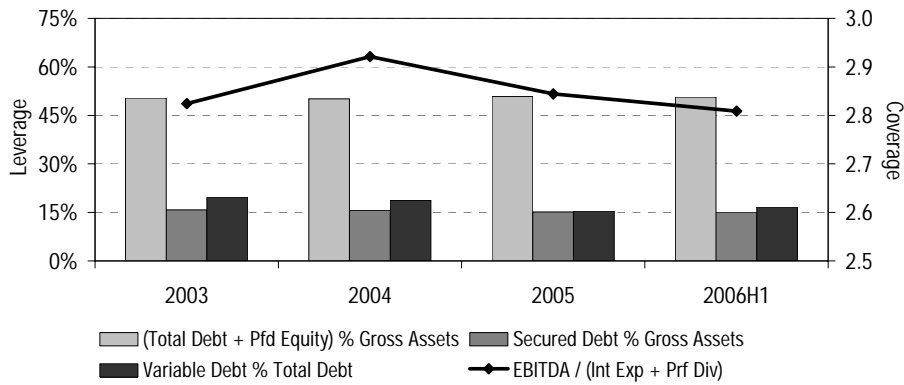


### Mall and Outlet REIT Financial Ratios



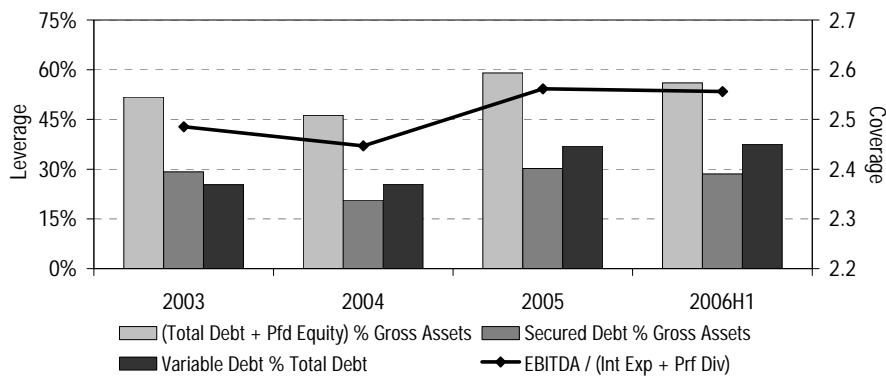
Source: Moody's  
Sector Includes: GGP, GRT, PEI, SPG, SKT, and TCO

### Shopping Center REIT Financial Ratios



Source: Moody's  
Sector Includes: DDR, EQY, FRT, HTG, KIM, NLX, PNP, REG and WRI

### Triple Net Lease REIT Financial Ratios



Source: Moody's  
Sector Includes: Capital Automotive, NNN, O and TSY

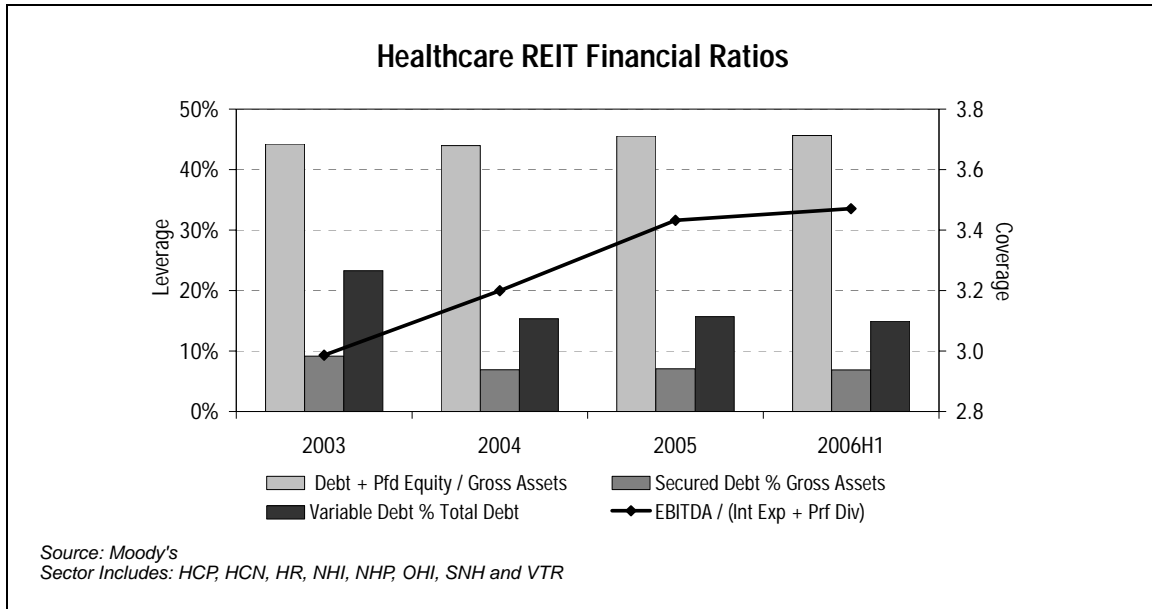
Retail	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Capital Automotive REIT	Ba3	—	B1	Stable
Capital Automotive L.P.	Ba1*			
Developers Diversified Realty	Baa2	—	Baa3	Stable
JDN Realty Corporation	Baa2	—	—	
Equity One	Baa3	—	(P)Ba1	Positive
Federal Realty Investment Trust	Baa2	Baa3	Baa3	Stable
General Growth Properties, Inc.	(P)Ba2	—	(P)B1	Stable
GGP Properties Limited Partnership	(P)Ba2	—	—	
Price Development Company, L.P.	Ba1	—	—	
Rouse Company (the)	Ba1	—	—	
Glimcher Realty Trust	(P)Ba2	(P)Ba3	B1	Stable
Heritage Property investment Trust, Inc.	—	—	—	Stable
Heritage Property Investment L.P	Baa3	—	—	
Bradley Operating Limited Partnership	Baa3	—	—	
Kimco Realty Corporation	Baa1	—	Baa2	Stable
Kimco North Trust III	Baa1	—	—	
Price REIT, Inc. (The)	Baa1	—	—	
Pan Pacific Retail Properties, Inc.	Baa1	(P)Baa2	(P)Baa2	Review for Downgrade
Western Properties Trust	Baa1	—	—	
National Retail Properties, Inc.	Baa3	(P)Ba1	Ba1	Stable
New Plan Excel Realty Trust	Baa2	(P)Baa3	Baa3	Stable
New Plan Realty Trust	Baa2	—	Baa3	
Excel Realty Trust, Inc	Baa2	—	Baa3	
Pennsylvania Real Estate Investment Trust	—	—	B1	Stable
Realty Income Corporation	Baa2	(P)Baa3	Baa3	Positive
Regency Centers Corporation	—	—	(P)Baa3	Stable
Regency Centers, L.P.	Baa2	—	—	
Simon Property Group, Inc.	—	—	Baa2	Positive
Chelsea Property Group, Inc.	Baa1	—	—	
CPG Partners, L.P.	Baa1	—	—	
Simon DeBartolo P.A.T. 1996-1	Baa1	—	—	
Simon Property Group, L.P.	Baa1	—	—	
Corporate Property Investors	Baa1	—	—	
Tanger Factory Outlet Centers	—	—	Ba1	Stable
Tanger Properties, L.P.	Baa3	(P)Ba1	—	
Taubman Centers, Inc.	—	—	B1	Stable
Truststreet Properties, Inc	B1	—	B3	Stable
Weingarten Realty Investors	A3	Baa1	Baa1	Negative

\*Bank Line  
As of 8/31/06

## HEALTHCARE SECTOR

Moody's has a stable rating outlook for healthcare REITs. Our sector outlook reflects strengthening fundamentals across the major healthcare property types, particularly the important skilled nursing facility (SNF) and assisted living facility (ALF) segments. The SNF sector's health is highly reliant on government reimbursement via the Medicare and Medicaid programs. The Centers for Medicare & Medicaid Services (CMS) recently announced that SNFs will receive a 3.1% market basket increase for 2007, so we expect continued steady performance from this sub-sector for the next 12-18 months. Given federal and state budget deficits, skilled nursing could experience reimbursement cuts for 2008, although we do not expect significant changes would occur in an election year. Furthermore, property-level coverages have been improving, and Moody's believes operators generally have sufficient cushion to absorb what would likely be modest cuts. The assisted living facility sector — another leading investment category for REITs — is also performing well. ALFs have largely recovered from the supply-demand imbalance that plagued the sector in the late 1990s and early 2000s. The decrease in new supply has helped ALF operators begin to realize revenue growth via both higher rental rates and occupancy.





Healthcare REIT Sector Strengths	Healthcare REIT Sector Challenges
<ul style="list-style-type: none"> <li>• Sound balance sheets characterized by modest leverage, good fixed charge coverage and sizable pools of unencumbered assets</li> <li>• Government reimbursement outlook for SNFs is stable through 2007</li> <li>• Low levels of new supply has helped assisted living sector</li> <li>• Tenant creditworthiness is improving</li> <li>• Positive demographic trends with aging baby boomer generation</li> <li>• More diversification by property type</li> </ul>	<ul style="list-style-type: none"> <li>• Property sub-types such as SNFs and hospitals are heavily reliant on government reimbursement; vulnerability to government actions is an endemic challenge</li> <li>• Tenant concentration is increasing due to operator consolidation</li> <li>• Increasingly competitive acquisition environment is reducing yields and prompting some firms to enter joint ventures or boost development</li> <li>• Specialized properties</li> </ul>

Healthcare REITs best positioned for positive rating actions will be those that demonstrate consistent, profitable growth, coupled with an ability to diversify by property type. Most healthcare REITs are concentrated in one or two property types — typically SNFs and ALFs. To the extent a REIT is able to gain size and leadership across at least three sub-sectors, it diversifies its value-creation capacity, its tenants (which are linked to asset types) and its reimbursement sources — all good for creditworthiness. This size and scope issue will be a key factor driving healthcare REITs' ratings over the long term.

Healthcare REIT	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Health Care Properties Investors	Baa2	—	Baa3	Review for Downgrade
Health Care REIT, Inc.	Baa3	(P)Ba1	Ba1	Positive
Healthcare Realty Trust, Inc.	Baa3	(P)Ba1	Ba1	Stable
National Health Investors Inc.	Ba3	B2	B2	Positive
Nationwide Health Properties	Baa3	—	Ba1	Stable
Omega Healthcare Investors	Ba3	—	B2	Stable
Senior Housing Properties Trust	Ba2	(P)Ba3	(P)B1	Stable
Ventas, Inc.	—	(P)B2	—	Positive
Ventas, Limited Partnership	Ba2	—	—	

As of 8/31/06

## LODGING SECTOR

Moody's rating outlook for the lodging REITs remains positive, reflecting a rebound in the industry fundamentals, which has led to improvements in credit metrics. Since the beginning of 2005, Moody's upgraded four lodging REITs, and maintains positive outlooks on two lodging REITs. During this period, Moody's took only one negative rating action, which was related to a levered acquisition.

During the first six months of 2006, expansion in the hospitality industry, which began in the second half of 2004, forged ahead, and lodging REITs benefited from it with strong operating results, in addition to pursuit and growth of a number of new markets and lines of business. In tandem with this strength in fundamentals, these REITs' credit profiles have been moving in the positive direction. The solid lodging fundamentals are evidenced by enduring growth in revenue per available room (RevPAR), driven by both average daily rates (ADR), and occupancy increases. The majority of RevPAR growth came from rises in ADR; this is especially favorable for driving operating income.

Lodging REITs' business growth and surging earnings have manifested themselves via improved credit metrics for the sector. Coverages have been on a steady rise since 2004, reflecting increased cash flows. Both total and secured leverage have remained stable on a book basis, and we would not anticipate historical figures to be immediately affected by the resurgence in the sector's earnings (other than through debt repayment). Positively, floating rate debt has decreased, which is especially favorable in a rising interest rate environment.

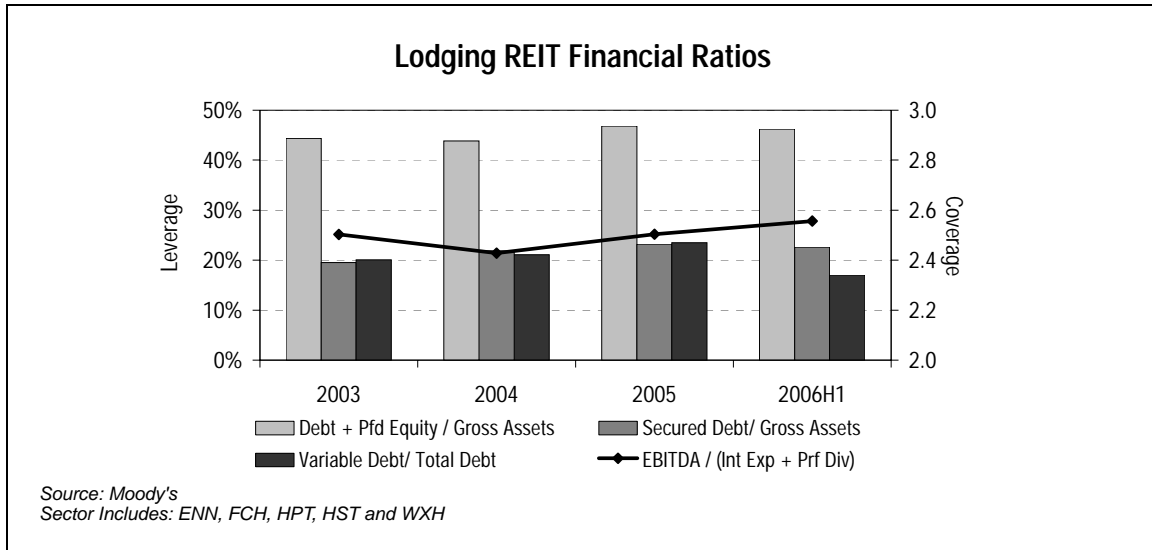
Moody's expects that strong hospitality fundamentals will persist into at least early 2007 (assuming no major exogenous stresses, such as a terrorist attack). The supply-demand equilibrium of the lodging industry has been tilted in REITs' favor for a number of quarters. This beneficial imbalance is supported by stable national economic growth (US GDP is forecasted to increase by a healthy 3.4% in 2006<sup>9</sup>) and by limited new construction. Although a recession or an economic slowdown, along with expense pressures, could pose a risk to the lodging environment, near-term curtailment in business travel, one of the key demand drivers, is unlikely in light of the 21% growth in corporate profits forecasted for 2006<sup>10</sup>. While consumers, another vital source of lodging demand, have felt the pinch of high gasoline prices, this seems to be moderating. Still, lodging REITs are experiencing some cost pressures — particularly in labor and insurance. However, in this cycle the threat of overbuilding does not loom as large as it has often had in the past due to high construction costs that curtail new development, as well as improved market transparency.

Moody's anticipates that lodging REITs will continue to reap the benefits of the upswing in the industry to strategically grow and improve the quality of their property portfolios without sacrificing balance sheet stability. Further rating upgrades will primarily reflect performance improvements, and in particular, balance sheet strengthening, as well as broadening of size, scope and diversity.

Lodging REIT Sector Strengths	Lodging REIT Sector Challenges
<ul style="list-style-type: none"> <li>• Strong demand from both business and leisure segments</li> <li>• Limited new construction</li> <li>• Stable leverage</li> <li>• Improved profitability and coverages</li> <li>• Decreased variable debt</li> </ul>	<ul style="list-style-type: none"> <li>• Pressure on consumer spending from high gas prices, debt, weak housing market</li> <li>• High gasoline prices affecting "drive-to" destinations</li> <li>• Increasing expenses (labor, insurance)</li> </ul>

9. Source: Moody's Economy.com, *Precis Macro*.

10. *Ibid.*



Lodging REIT	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Equity Inns, Inc.	B1	—	B2	Stable
Equity Inns Partnership, LP	Ba3	—	—	
FelCor Lodging Trust Inc.	—	—	B2	Stable
FelCor Lodging L.P.	Ba3	(P)B2	—	
Hospitality Properties Trust	Baa2	(P)Baa3	Ba1	Stable
Host Hotels & Resorts, Inc.	Ba2	—	B1	Positive
Host Marriott L.P.	Ba2	—	—	
Interstate Hotels & Resorts, Inc.	—	—	—	Positive
Interstate Operating Company L.P.	B2*	—	—	
MeriStar Hospitality Corporation	(P)Caa1	(P)Caa2	—	Stable
MeriStar Hospitality Operating Partnership L.P.	B3	(P)Caa2	—	
Winston Hotels, Inc.	—	—	B3	Positive

\* Bank Line  
As of 8/31/06

## Other Property Sectors

### SELF-STORAGE

The self-storage REITs maintained their dominance in this sector — expanding leadership through acquisitions of private portfolios, IPOs and, most recently, the acquisition of Shurgard Self Storage by Public Storage. REITs provide critical liquidity for this sector, and their success has made self-storage properties more mainstream investment assets. Self-storage facilities evidence certain operating-business characteristics. Like lodging, self-storage is a management-intensive business: high levels of customer interaction (especially commercial clients) and constant lease rollover require experienced and responsive on-site and back-office management. Though the self-storage industry continues to be dominated by small local and regional owners, consolidation continues. Brand awareness is growing, and companies that are able to build a recognizable and respected franchise, with regional leadership helping to drive efficiencies, will be able to capitalize on opportunities and outpace other owners.

Self-Storage REIT Sector Strengths	Self-Storage REIT Sector Challenges
<ul style="list-style-type: none"> <li>• Relatively stable cash flows over real estate cycles</li> <li>• Modest capital maintenance burden</li> <li>• Operational acumen and sophisticated cost management systems, client service and marketing plans</li> <li>• Established brand names</li> <li>• Stabilized facilities with low breakeven occupancies</li> <li>• Larger REITs with diversification and national presence</li> </ul>	<ul style="list-style-type: none"> <li>• More akin to an operating business than to real estate business</li> <li>• Locations can be difficult for alternative use, though sometimes have attractive higher-and-better-use characteristics</li> <li>• Low barriers to entry and long stabilization periods</li> <li>• Commodity-type characteristics can be vulnerable to new supply</li> </ul>

## CORRECTIONS

### ***Rating Drivers***

- High occupancy
- High barrier to entry market
- Demand for space expected to continue
- Lack of alternative use for space
- Short-term nature of contracts
- Reliance on government appropriations for payment of contracts
- Industry is sensitive to public opinion, liability and complex regulation
- Limited market share of the corrections space
- Material leverage

## TIMBER

### ***Rating Drivers***

- Pricing volatility can be mitigated by accelerating or reducing harvests, or land sales
- Overharvesting may lead to distribution gaps in timber age classes
- Heightened sale of land threatens decapitalization
- Three of the four timber REITs rated by Moody's possess virtually unencumbered asset bases
- Lower EBITDA margins than typical REITs, yet superior fixed charge coverage
- HBU (higher-and-better-use) properties command premiums to traditional timberlands
- Ancillary businesses add volatility
- Solid record of cash flow generation

Correctional Company	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Cornell Companies, Inc.	B3	—	—	Stable
Corrections Corporation of America	Ba3	—	(P)B2	Positive
GEO Group Inc.	B1	—	—	Stable
<i>As of 8/31/06</i>				

Property Service	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
CB Richard Ellis Services, Inc.	Ba3	B1	—	Stable
Clayton Holdings, Inc.	B1	—	—	Stable
Jones Lang LaSalle Incorporated	Baa2*	—	—	Stable
<i>As of 8/31/06</i>				

Timber	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Longview Fibre Company	Ba3*	B3	—	Negative
Plum Creek Timber Company, Inc	—	—	(P)Ba2	Stable
Plum Creek Timberlands, L.P.	Baa3	(P)Ba1	—	
Potlatch Corporation	Ba1	Ba1	—	Stable
Rayonier Inc.	Baa3	—	—	Stable
Rayonier Timberlands Operating Company, LP	Baa3	—	—	
* Senior Secured As of 8/31/06				

Diversified/Other	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
American Real Estate Partners, L.P.	Ba3	—	—	Stable
CharterMac	Ba3*	—	—	Stable
Colonial Properties Trust	—	—	Ba1	Stable
Colonial Realty L.P.	Baa3	(P)Ba1	—	
Forest City Enterprises, Inc.	Ba3	(P)B2	(P)B2	Stable
iStar Financial Inc.	Baa2	(P)Baa3	Ba1	Stable
LNR Property Corporation	B3	Caa1	(P)Caa2	Stable
Newkirk Realty Trust	Ba2**	—	—	Stable
Prime Property Fund, LLC	A3	—	—	Stable
Prudential Property Investment Separate Acct.	A1	—	—	Stable
Public Storage, Inc.	(P)A3	(P)Baa1	Baa1	Stable
Shurgard Storage Centers, Inc	A3	—	—	
Vornado Realty Trust	(P)Baa2	—	Baa3	Stable
Vornado Realty L.P.	Baa2	(P)Baa3	—	
Washington Real Est. Inv. Trust	Baa1	(P)Baa2	(P)Baa2	Stable
* Bank Line ** Secured Facility As of 8/31/06				

## MORTGAGE REIT SECTOR

As expected, the housing market continued to slow during 2006. The slowdown has accelerated during the second half of the year raising concerns regarding the likelihood of achieving a “soft landing.” The open question remains “how much will the housing market decline and how quickly.” According to Moody’s Economy.com, there is a significant probability of price declines in 100 of the nation’s 379 metropolitan areas. Furthermore, these areas represent almost 50% of the value of the US single-family housing stock.

Home builders have reported significantly slower new home sales, as well as increases in the number of homes deferred or cancelled, which has led to their declining profitability. Meanwhile, existing home sales declined to 6.6 million units in June 2006, which is 4.1% below the prior month’s and 11.2% lower year over year. Declines occurred in all US regions: Northeast, Midwest, South and West. June 2006 represents the third consecutive month in which home sales declined according to the National Association of Realtors (NAR).<sup>11</sup>

House price appreciation is slowing, which may further strain borrowers, especially subprime borrowers that purchased their homes during 2005 and 2006. Median home sales prices in June 2006 eked out a 0.9% increase over the prior year according to the NAR due to a 3.2% increase in sales price in the South. Home sale price declines are more pronounced in fast growth markets such as California and Florida. The Realtors’ Association in California and Florida reported sequential median price declines of 7% in the second quarter.

Prime lenders have had difficulty increasing profitability with the flat interest rate yield curve. This has led some mortgage REITs to develop additional mortgage acquisition channels in order to maintain volumes offsetting declining margins. Other strategies include moving down the credit spectrum into Alt-A product and purchasing ancillary businesses. These strategies have worked reasonably well so far. However the strategies expose the firms to additional risks that may compound issues should the market turn against them.

11. According to the California Association of Realtors, “C.A.R. reports sales decrease 30.1 percent in August, median price of home in California at \$576,360, up 1.6 percent from a year ago” on September 25, 2006 and the Florida Association of Realtors, “Florida’s Existing Home Market in August 2006: Sales Ease, Median Price Level” on September 5, 2006.

The interest rate environment is also affecting the subprime sector. Slowing origination volumes have pushed mortgage REITs, as well as others in the mortgage industry, to lower underwriting standards in order to maintain volumes. In Moody's view this is the age old reaction to slowing volumes and it has never ended on a good note. Deterioration in underwriting standards coupled with risk stacking that has occurred over the last few years is a significant concern. Over the past few years rising home values fueled by low interest rates and readily available capital has mitigated concerns regarding risk stacking. However, higher interest rates coupled with price appreciation that is flat to negative may create payment problems for adjustable rate borrowers, especially subprime borrowers. In the second quarter of 2006, the delinquency rate on first mortgages posted its first substantial increase since mid-2002, according to CreditForecast.com.

Moody's expects modest decline in home prices, as well as declines in origination volume to limit growth opportunities. The declines should be manageable as long as the economy remains healthy and unemployment does not increase significantly. However, REITs with significant product (e.g., option arm, interest-only, etc.) or geographic concentrations may not fare as well. As the housing economy moderates declines in mortgage related employment, a significant contributor to employment growth over the last several years, is a significant unknown.

Mortgage REIT	Senior Debt	Subordinate	Preferred Stock	Outlook/Review Status
Saxon Capital, Inc.	B2	—	—	Review for Upgrade
Thornburg Mortgage, Inc.	Ba2	—	B1	Stable
<i>As of 8/31/06</i>				

## Related Research

### **Rating Methodologies:**

[Rating Methodology for REITs and Other Commercial Property Firms, January 2006 \(96211\)](#)

[Key Ratios For Rating REITs And Other Property Firms, December 2004 \(91014\)](#)

### **Special Comments:**

[U.S. Office REITs Sector Commentary, September 2006 \(99289\)](#)

[Lodging REIT Sector Strong - Performance Continues, September 2006 \(98987\)](#)

[Healthcare REITs - Getting Better, August 2006 \(98885\)](#)

[Rating Triggers in Real Estate Finance Companies – 2006 Update, August 2006 \(98648\)](#)

[Fair Value Accounting for Investment Properties Is on the Horizon: How Will It Affect REIT Covenants?, June 2006 \(97738\)](#)

[REIT Joint Ventures and Funds: Weighing the Pluses and Minuses, April 2006 \(97276\)](#)

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







To order reprints of this report (100 copies minimum), please call 1.212.553.1658.  
Report Number: 100092

<u>Authors</u>	<u>Senior Associate</u>	<u>Production Associate</u>	<u>Production Specialist</u>
Christopher Wimmer, CFA Philip Kibel, CPA	Lin Zheng	Shubhra Bhatnagar	Yung Louie

© Copyright 2006, Moody's Investors Service, Inc. and/or its licensors and affiliates including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. **NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.** Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at [www.moody.com](http://www.moody.com) under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

This credit rating opinion has been prepared without taking into account any of your objectives, financial situation or needs. You should, before acting on the opinion, consider the appropriateness of the opinion having regard to your own objectives, financial situation and needs.

## ProLogis (PLD)

### Is ProLogis' Money Management Business Undervalued?

February 17, 2006 ■ Recent Price \$52.34 ■ DJIA 11,115 ■ RMZ 911

#### I. Overview

ProLogis (PLD) recently announced the creation of yet another huge co-investment fund. The \$4 billion vehicle will serve as a dedicated take-out source for its growing North American development pipeline and will expand the REIT's already sizable money management business by over 30% to \$15 billion. PLD currently trades at the largest NAV premium of any company in our coverage universe in large part because of its extraordinarily successful merchant-building operating model that is supported by the company's lucrative co-investment fund management business. Nevertheless, it is still fair to question whether the profitability and growth potential of the money management business is fully valued in PLD's share price, especially in the context of the valuations ascribed to publicly-traded equity and fixed-income money managers.

#### II. The New Fund

PLD raised \$1.5 billion in equity from third-party institutional investors. With leverage, the vehicle will have \$4 billion of total capacity. PLD intends to maintain a 20% interest in the fund, to be known as ProLogis North American Industrial Fund, which will serve as the primary take-out vehicle for PLD's U.S. and Canadian development and redevelopment deals. By providing a pre-capitalized buyer for

PLD's development, the fund mitigates an important source of risk in the merchant-building model. The fund has been seeded with \$750 million of properties from PLD, leaving over \$3 billion in additional capacity. At PLD's current development pace, the fund could support the merchant-building business for approximately three years.

Most of PLD's existing \$12 billion of co-investment funds are finite-life vehicles that have specific maturity dates ranging from 3-10 years. The new fund, by contrast, is an infinite-life vehicle. The infinite-life structure dissipates the risk that the lucrative fee stream that PLD enjoys expires upon maturity of the fund. As a result, **the earnings multiple investors ascribe to an infinite-life fund should be materially higher than for finite-life funds.** From the investors' standpoint, the key benefit of the infinite-life vehicle is enhanced liquidity. Over time, PLD hopes to become a market maker in the shares of the fund. However, the company has established safe-guards in order to avoid "a run on the bank" such as those that recently afflicted several large real estate funds in Germany. PLD is required to make a "reasonable" effort to provide liquidity to the fund's shareholders, but it can not be forced to liquidate assets if it deems the sales to be detrimental to the interest of the other investors in the fund.

Equity commitments were received from new and returning investors from all continents, placing a stamp of approval on PLD's track record and its abil-

#### Exhibit 1

**The average publicly traded money manager is valued at a price/earnings multiple of over 22. The finite-life nature of most existing PLD funds suggests a lower warranted multiple. However, the move toward infinite-life vehicles, plus the impressive growth potential of the REIT's money management business, argues for a much higher multiple.**

Name	Ticker	Forward P/E (1)
Alliance Capital	AC	18.1
Amvescap	AVZ	19.7
Blackrock Inc.	BLK	29.0
Cohen & Steers	CNS	25.2
Eaton Vance	EV	21.5
Franklin Resources	BEN	20.4
Janus Capital Group	JNS	28.3
Nuveen Investments	JNC	19.4
T. Rowe Price Group	TROW	21.0
		22.5

(1) Based on consensus analyst estimate and closing share price on 02/15/06.

Important disclosure on the last page.

## Exhibit 2

**PLD now trades at the largest NAV premium of any company in our coverage universe.**

Premium to NAV	
<u>PLD</u>	<u>REIT Average</u>
43%	7%

**The large premium is attributable to the extraordinarily successful international merchant-building business PLD has established, as well as the large, rapidly growing money management business the REIT has built. Other highly regarded developers that do not have a meaningful money management operation trade at NAV premiums of about 20-25%.**

Premium to NAV		
<u>Cousins</u>	<u>Boston Properties</u>	<u>Kilroy</u>
25%	26%	20%

**If we assume that PLD's merchant building business accounts for 20-30 percentage points of its NAV premium and that the balance of the premium is attributable to its money management business, then the implied multiple on the REIT's existing money management fee stream is in the 40-60X range. The multiple is high relative to those ascribed to publicly traded money managers, but PLD's growth prospects appear to be much better than most, supporting the higher level.**

Developer's Premium to NAV	Implied Money Manager Multiple
20%	60x
25%	52x
30%	43x

ity to attract a diverse group of capital providers. This significant equity commitment comes on top of more than \$1 billion raised in Japan in August '05. PLD's track record and well-established relationships with institutional investors, along with an unquenchable thirst for real estate among institutional players, suggests significant growth potential for PLD's money management model in the coming years.

### III. Fee Structure

PLD management suggested that property, asset management, leasing, and construction fees in the new fund could amount to 75-100 basis points on total asset value, which appears slightly higher than the current average across all of PLD's existing co-investment funds. We estimate that the incremental net profit margin on these fees should approximate 75% since the money management business is highly scalable. In addition, PLD may receive incentive fees (a.k.a. a promoted interest) for exceeding a 9% IRR threshold every three years. Performance will be measured through distributed cash flows and an independent third-party appraisal. This approach is consistent with the current value net income metric used by Green Street as a component of the

Franchise Value ranking for companies in our coverage universe. There is no "clawback" provision on the incentive fees. Clawbacks are sometimes used in private real estate funds in order for investors to recapture incentive fees that may have been paid in an up-market, but would not have been earned if the returns had been calculated over a longer time period.

### IV. Valuing the Money Management Business

PLD currently oversees \$12 billion in co-investment assets, of which it owns \$2.5 billion. With PLD's development pace now exceeding \$2 billion annually, assets under management could reach \$20 billion by the end of the decade. While the current development pace is arguably above the sustainable level, PLD's platform on three continents should help stabilize the development volume. In addition, the company's appetite for redevelopment-oriented acquisitions could further contribute to the money management platform over time.

Valuing money management businesses has become a key focus in any valuation exercise for PLD

and several other REITs. In our analysis we directly value the existing fee income and in-the-money promoted interests in a company's NAV estimate. Additional value is ascribed in the Franchise Value ranking for companies that are likely to grow their money management business in the future. The existing fee income is typically valued via a multiple on current net income. The promoted interests are valued via a discounted cash flow analysis.

**In order to capture the enhanced durability of PLD's fee stream as the result of its move towards infinite-life vehicles, we have increased the multiple used to value the existing fee income from 15X to 20X.** The change results in a total value of \$1 billion (\$4.00/sh) for the business segment, and translates to a \$1.00/sh (3%) increase in our NAV estimate to \$36.50/sh. PLD's money management operation is analogous to those of other equity and fixed-income asset managers, and publicly traded money manager valuations can be viewed as a good proxy for valuing PLD's on-going management fees. Large publicly-traded investment managers currently change hands at an average P/E multiple in excess of 22X. Unlike PLD, mutual fund managers do not typically invest capital in their funds, which increases the operating leverage in the business. However, their income stream can be more volatile due to the easy redemption features of most mutual funds and institutional investment allocations.

The in-the-money promoted interests are valued at \$300 million (\$1.25/sh) using an average discount rate of 10%. The value is highly sensitive to assumptions regarding the pace of future same-property NOI growth and residual cap rates. PLD is also awarded an above-average Franchise Value compared to its industrial peers to reflect the future value expected to be created through its expanding merchant-building and money management operations. An argument could be made for using a higher multiple (something like 40X or 50X) to value the money management business because of the enticing growth prospects. However, we choose to capture expected future value creation of all types (e.g. acquisitions, development, joint ventures, money management) through Franchise Value rankings. **To award PLD a high Franchise Value ranking and also use a growth-anticipating earnings multiple to value the money management business would be double counting.**

## V. Recommendation

PLD has raised over \$2.5 billion of equity for co-investment funds in Japan and North America over the past 6 months, swallowed a \$5 billion competitor through stock and debt issuance, put in place a \$2.6 billion multi-currency line of credit, and issued property debt at very low spreads to treasuries in Europe. PLD's enviable success in the capital markets is turning into a tangible competitive advantage. While

### A New Source of FFO?

*In early January, PLD purchased its 80% partner's share in three co-investment funds. The properties were subsequently used to seed the newly-formed North American fund. In the process, PLD realized three one-time gains that it will include in its 1Q06 FFO:*

- *A \$14 million (\$0.06/sh) deferred gain from marking to market the value of the properties contributed to the old funds at the time they were contributed;*
- *A \$22 million (\$0.09/sh) promoted interest (which is almost as high as the company's profits from holding the real estate);*
- *A \$31 million (\$0.13/sh) gain from property appreciation over the life of the old funds on PLD's 20% interest*

*The \$31 million gain marks the first time that PLD has included a gain on assets that had previously been depreciated. This practice is commonplace at industrial peers CenterPoint (CNT) and First Industrial (FR). However, including sales gains on depreciated properties is not sanctioned in NAREIT's FFO definition, and it was a surprising addition to PLD's '06 FFO roster.*

*The importance of sales gains in PLD's FFO (45% of total '05 FFO) makes the work of earnings-focused investors quite complicated. Multiple-based valuations need to be sensitive to the prominence of sales gains, particularly if PLD increasingly includes gains that most other REITs exclude from FFO.*

the risks to a merchant-building business model could become acutely visible in a rising cap rate environment, the near-term outlook for development and industrial fundamentals on a global basis is positive.

Our NAV-based Pricing Model concludes that PLD should trade at a 46% premium to NAV compared to the 7% premium at which the average REIT currently trades. When the premium is applied to our revised NAV estimate of \$36.50/sh, a warranted price of \$53.50/sh is indicated. At the current price, we maintain our BUY recommendation on the shares of PLD.

Jim Sullivan  
Cedrik Lachance

## Green Street's Disclosure Information

Conflicts of interests can seriously impinge the ability of analysts to do their job, and investors should demand unbiased research. In that spirit, Green Street adheres to the following policies regarding conflicts of interest:

- We do not engage in the underwriting of securities.
- Our employees are prohibited from owning the shares of any company in our coverage universe.
- Our trading desk does not commit capital.
- We do not perform M&A advisory work for companies in our coverage universe.
- Our employees do not serve as officers or directors of any company in our coverage universe.
- Companies that we cover do not, in any manner, compensate us for inclusion in our coverage universe.
- We do not accept consulting assignments, provide fairness opinions for, or otherwise accept any customized engagements from companies within our coverage universe.
- A number of companies we cover, including PLD, pay us an annual fee to receive our core research product. We do not solicit this business and, in aggregate, it represents less than 2% of our revenue.
- We serve as a sub-advisor to (but do not exercise control over) an entity that may own debt securities issued by companies in our coverage universe. Some of our employees have ownership interests in that entity.

While minimization of potential conflicts will remain a very important priority for us, we reserve the right to change any of these policies at any time. We encourage a careful comparison of these policies with those of other research providers, and welcome the opportunity to discuss them.

Investment advice proves to be wrong about as often as it is right. While we strive to do better than this, our recommendations will include bad calls and we are certain to make other mistakes as well. This document may well contain errors of fact. We have done our best to utilize data that we believe to be reliable, but no assumption should be made that the data has been verified, or is accurate and complete. This report should not be considered to represent an offer to buy or sell the securities discussed herein, and all opinions are subject to change without notice.

Green Street Advisors is an accredited member of the Investorgroup<sup>sm</sup> Research Association, whose mission is to increase investor and pensioner trust in the U.S. capital markets system through the promotion and use of investment research that is financially aligned with investor interests.

**Analyst Certification:** I, Jim Sullivan, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject companies or securities. I also certify that my specific recommendation(s) or view(s) in this report are in no way, directly or indirectly, influenced by the source or the structure of my compensation.

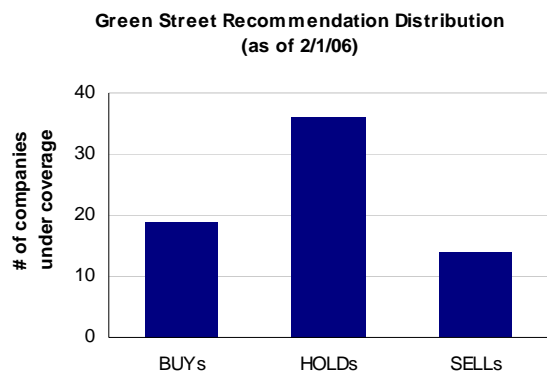


I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

### Terms of Use:

This report is the proprietary and confidential information of Green Street Advisors, Inc., and is protected by copyright. This report is not sold, but is licensed for personal, limited, non-transferable use as follows: You may use this report solely for reference for internal business purposes. You may not use this report for any other purpose. You may not reproduce, distribute, sell, lend, license or otherwise transfer or provide this report or a copy of it or any of its contents for any purpose. You may not disclose this report or any of its contents to any person except to fellow employees working at your work location. Except for the rights expressly granted to you above, all rights with respect to this report are reserved by Green Street Advisors, Inc.

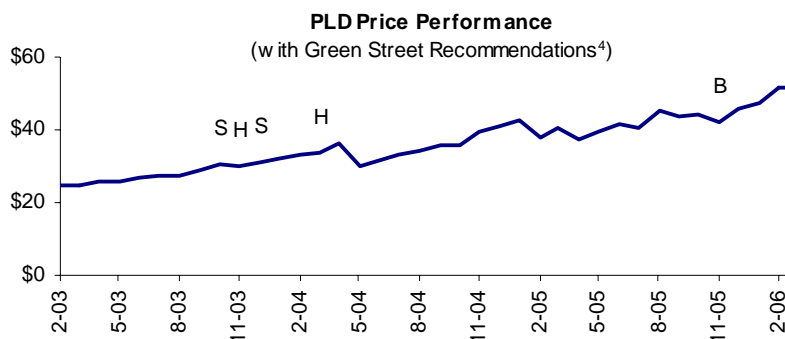
At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.



Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".<sup>1</sup>

Total Return of Green Street's Recommendations				
Year	Buy	Hold	Sell	NAREIT Eqty <sup>3</sup>
2006 YTD <sup>2</sup>	6.6%	4.5%	5.3%	7.3%
2005	26.3%	18.3%	-1.9%	12.2%
2004	42.3%	28.4%	15.5%	31.6%
2003	42.7%	37.2%	20.9%	37.1%
2002	17.7%	2.6%	1.9%	3.8%
2001	35.7%	19.1%	11.9%	13.9%
2000	53.6%	29.3%	4.4%	26.4%
1999	14.2%	-9.2%	-20.2%	-4.6%
1998	-0.6%	-15.1%	-16.4%	-17.5%
1997	37.1%	14.2%	5.8%	20.3%
1996	47.3%	30.2%	17.5%	35.3%
1995	23.6%	14.3%	-0.4%	15.3%
1994	20.5%	-0.7%	-9.3%	3.2%
1993 <sup>2</sup>	29.4%	5.4%	6.7%	12.4%
<b>Total Return<sup>2</sup></b>	<b>2860.4%</b>	<b>371.1%</b>	<b>37.1%</b>	<b>455.6%</b>
<b>Annualized</b>	<b>29.8%</b>	<b>12.7%</b>	<b>2.5%</b>	<b>14.1%</b>

The chart below shows PLD's price performance over the last three years, along with Green Street's recommendations during that time.



- (1) Historical results through January 3, 2005 were independently verified by Ernst & Young, LLP. E&Y did not verify stated results subsequent to January 3, 2005. Past performance results cannot be used to predict future performance. For a complete explanation of study, see 5/9/03 report "How are We Doing?".
- (2) Study uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 29, 1993 through February 1, 2006.
- (3) Not directly comparable to Green Street performance indices because NAREIT includes more companies and uses market-cap weightings (Green Street applies straight averages).
- (4) Green Street has only three recommendations: BUY ("B"), HOLD ("H") and SELL ("S").