

**REITS - Forward-Looking Opportunities**

**October 19, 2009**

Last week I saw Bob Steers of Cohen & Steers speak on the current situation with commercial real estate. Steers and his partner Marty Cohen have built one of the pre-eminent real estate fund management firms in the country (and now the world). Their products include several REIT mutual funds, a fact that was reflected in the bias of the presentation toward making REIT investments. Nevertheless, his view of the world is consistent with ours. Real estate is on the precipice of price devaluation, but it will not be the quite the catastrophe that the press would have us believe—maybe a 5.5 on the Richter Scale as opposed to a 7 (remember, that scale is logarithmic, so there is a big difference).

First, on REIT pricing, Bob pointed out that the public equities markets are leaders in any cycle, which we know to be historically true. In the public REIT markets share prices dropped 77% between the end of 2007 and March of 2008—an exaggerated and correlative move with the rest of the world markets. Cohen and Steers were largely responsible for the appropriate yet somewhat counter intuitive reaction taken by REITS—recapitalize by raising both debt and equity capital. They talked the management of REITS into making these moves that would result in shareholder dilution and require dividend cuts using their fund capital to prime the pump and influence these decisions. Fortunately the markets cooperated and it worked. With the perception that the REITS' balance sheets were now firmed up and that these entities would have tremendous power in a down market to buy bargains, REIT shares rose (along with the rest of the market).

Remember, public markets lead cycles. So, these same REITS must endure declining fundamentals in their underlying assets as well, albeit with stronger balance sheets than they had a year ago. So, the question is, do you buy into REITS now when prices have already firmed up and fundamentals (the tenant demand that drives earnings) are still declining?

Bob also pointed out that many of the private equity managers, Colony Capital, The Carlyle Group, and others are “frozen” meaning that they cannot raise additional capital and are saddled with purchases in the '06 and '07 vintage that are devaluing daily. Recall the article in the WSJ on Wednesday of this week about the Peter Cooper Village, the Manhattan apartment mega-complex, heading toward foreclosure. Investors in the funds of Tishman Speyer and BlackRock will likely lose 100% of their investment in that property.

Those investors—CALPERS and others will not be back to invest for some time.

So, REITS are primed to take advantage of the downturn, but their prices are already up. Private equity is down and out. What does this mean for the small investor looking to make hay? REITS have hundreds of millions to invest. Generally (I normally hate generalizations), they will be looking at larger purchases, well north of the size properties we are pursuing. Private equity funds that are not “frozen” such as Barry Sternlicht's Starwood Capital, will also be aiming at deals that justify their time and effort. By example, Starwood just purchased an entire bank loan portfolio (with the FDIC as a partner) from what was Corus Bank.

So, how much private equity is out there at the broad end of the grid? It is difficult to say, but it can be generalized (there I go again) that the amount of capital chasing real estate is way, way down from two years ago—hence, vastly lower prices.

Our feeling is that there will be plenty of opportunities. How we find them and act on them is the art. We have purchased a lot of data in the last six months. Among this data is information on real estate loans that are bad or going that way. We also have purchased lists of buildings in our target markets that are “non-chronically” vacant. This classification of assets was developed by Pace and Torto Wheaton Research (TWR). TWR can provide us with these lists of buildings that are currently 20% or more vacant, but have not been so during their lifetimes. The building profiles that we seek are readily identifiable and are similar to assets where we have had prior successes. As we match these “non-chronic assets” with bad loan data we can find prospective purchases. This alone does not yield a successful investment. There are a lot of prospects, a lot of work to get in touch with the right people—vet them, etc., and the yield may be quite small—but it is a head start about which we are enthusiastic.

There will be opportunities to make large risk and liquidity adjusted returns in the next 5 years. Execution will, as always, be a key to success as will ready capital.

If you have any questions, please feel free to contact Larry Reed or Rob Sherwood. Thank you.