Heard on the Beach

Beware the Dynamism Sirens
April 29, 2011

Executive Summary

REIT business models of today are more dynamic than those of the past, and though dynamism brings opportunity, it is also accompanied by dual alter-egos, complexity and risk. There is no one-size-fits-all answer for this inherent trade-off, but track records are now long enough to gauge how well the more dynamic business models have performed. Unfortunately, when it comes to one of the key activities — property development — that differentiates dynamic REITs from their less active peers, the report card shows simplicity is, more often than not, a virtue.

The most active REIT developers have generally disappointed, as they have delivered pedestrian total returns during good times and sub-par returns through a full cycle. Potential explanations: 1) ever-larger bets as cycles get long in the tooth and asset bubbles form; 2) overly optimistic long-term return expectations lead to excess supply; and 3) under-appreciation of the substantial costs of carrying a platform through a full cycle. Not surprisingly, manufacturing a commodity-like product in a mature, competitive industry just isn’t very lucrative, and it is therefore no surprise that plenty of ships lured by dynamism sirens have hit the rocks.

Two groups of REITs stack up more favorably: a small number of companies operating in core property sectors with excellent track records and big fish operating in small, niche-property ponds. Because membership in both groups is very limited, investors are likely to continue to give a thumbs-down to many REIT development stories.

| RMZ: 848 | DJIA: 12,811 | 10-Year T-Note: 3.29% | Baa Yield: 5.9% |

Important disclosure on pages 3-6

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Beware the Dynamism Sirens: The visionaries that legislated the REIT industry into existence in 1960 subscribed to a view that REITs should be little more than passive owners of properties. Like mutual funds, REITs were designed to afford exposure to a diversified portfolio of assets, and numerous restrictions were put in place on the businesses they could conduct and the types of income they could receive. In-house property management, development, operationally intensive business lines, and active capital recycling were all either difficult or explicitly verboten for the 1.0 version of REITs. However, two-and-a-half score and Lord-knows-how-many acts of Congress later, the REITs of today are allowed to operate dynamic, fully integrated business models. For the most part, the loosening of the rules has been a good thing. By way of example, REITs are clearly better off having the ability to manage their own properties. However, while it’s easy to dismiss the original REIT model as quaint, it’s worth pondering whether the founders were actually prescient. After all, the REIT sector has subsequently provided numerous demonstrations of a simple maxim: just because you can do something doesn’t necessarily mean that you should.

Developers: The Rodney Dangerfields of REITland

Evidence that today’s REIT investors believe simplicity is a virtue is on clear display in the way the market values development franchises: active developers currently trade, on average, at slightly smaller premiums to asset value than other REITs. Said differently, the market apparently believes that the average REIT development platform is worth nothing, perhaps even less. Considering that the REIT sector is populated by a number of
companies with highly touted development capabilities, this comes as a head
scratcher. Is the market really voting that development platforms are worthless?
Do the weak development franchises negate the value of the good ones? Or, is
this just a case of the market not “getting it”?

That last question is the easiest to address, and, unfortunately, the answer is a
resounding “No!” The charts on the following page show all too clearly that the
market has good reason to be wary of REIT development stories. A typical REIT
developer operating in one of the major property sectors was no more likely than
a non-developer to generate outsized total returns when conditions for
developers were favorable (’02-’06), and the preponderance of
development-oriented REITs substantially under-performed through
a trough-to-trough cycle (’02-’10). As a result, the market’s refusal to
ascribe a premium to the average development-oriented REIT makes
perfect sense.

Why has development been so disappointing? In the first place, developers, like
most humans, have a trait that can be observed at any blackjack table: success
begets bigger bets. REIT developers trebled their activity level between ’03 and
’07, and they were stuck with huge bets on the table when the deck turned cold
in ’08/’09. There is little risk that pipelines will get out of hand in the near
future, but given the fact that earnings-focused executives will likely up their
bets as time goes on, an eventual repeat seems inevitable. Considering that
development is a strategic business line, as opposed to a switch that can be easily
turned on and off, the benign near-term outlook provides little comfort about
the value of the platforms over the long run.

It could also be that commercial property development is just not a very good
business. With limited exceptions, the world of commercial real estate
development fits perfectly into the textbook description of a mature, commodity-
like, highly competitive industry where the best that most manufacturers can
hope to achieve is to match the cost of capital associated with the business line (a
cost that is higher for development than owning). Making iPads this is not.

But there are two reasons why even this view of development may be charitable.
First, if, as we believe to be the case, most real estate market participants have
unrealistically high expectations for the returns that real estate can deliver
through a full cycle, systematic errors in the form of excess building during
booms are inevitable. In addition, most developers we’ve encountered justify
development based primarily on the incremental returns from particular
projects, and insufficient attention is paid to the substantial cost of carrying the
infrastructure and overhead of a development platform through a full cycle.
While impossible to prove, it could well be the case that commercial
property development is a business that is fated to offer inadequate
risk-adjusted returns over the long run.
Developers have Disappointed: Active developers should deliver substantially better total returns when times are good, yet the active REIT developers* in the major property sectors generated only average returns from ’02-’06. The results have been especially disappointing over a full, trough-to-trough cycle (’02-to-’10).

% of REITs that Delivered Better Total Returns than Sector Peers

Development Nirvana: ’02-’06
Least-Active Developers: 54%
Most-Active Developers: 46%

Full Cycle: ’02-’10
Least-Active Developers: 66%
Most-Active Developers: 31%

* The 27 REITs for which data exists back to ’02 are broken into least-active and most-active groups based on average pipeline size as a % of operating assets over the time period.

Oops! A key reason developers have fared so poorly through the full cycle is that they greatly increased their activity during the go-go years. Is there any reason to think this behavior will not repeat itself in future cycles?

REIT Development Pipelines ($ BN)

Sum of development pipelines of REITs in major sectors only (apartment, industrial, mall, office, and strip center).

There May be Hope: Most of today’s active developers fall into one of two camps: 1) successful mainstream (i.e., in a major property sector) developers that have generated superior total returns; or 2) attractive niche developers that are often the big fish in a small, but growing, pond. Development stories of either type deserve the benefit of the doubt. Most other REIT developers, including numerous companies not shown below, don’t.

<table>
<thead>
<tr>
<th>Today’s Active Developers</th>
<th>Pipeline as a % of Operating Assets</th>
<th>Benefit of the Doubt?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Campus Crest Communities</td>
<td>24%</td>
<td>No</td>
</tr>
<tr>
<td>Dupont Fabros Technologies</td>
<td>19%</td>
<td>Yes</td>
</tr>
<tr>
<td>Corporate Office Properties</td>
<td>17%</td>
<td>Yes</td>
</tr>
<tr>
<td>Glimcher Realty Trust</td>
<td>16%</td>
<td>No</td>
</tr>
<tr>
<td>Alexandria Real Estate Equities</td>
<td>11%</td>
<td>Yes</td>
</tr>
<tr>
<td>Regency Centers</td>
<td>9%</td>
<td>No</td>
</tr>
<tr>
<td>AvalonBay Communities</td>
<td>8%</td>
<td>Yes!</td>
</tr>
<tr>
<td>American Campus Communities</td>
<td>7%</td>
<td>Yes</td>
</tr>
<tr>
<td>Boston Properties</td>
<td>7%</td>
<td>Yes!</td>
</tr>
<tr>
<td>Health Care REIT</td>
<td>7%</td>
<td>No</td>
</tr>
</tbody>
</table>

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The idea that it might be better to own than to manufacture is hardly radical. Indeed, evidence from another hard asset class is currently on full display: gold mining stocks are up only half as much as gold itself over the last five years. That is certainly counterintuitive amidst a raging bull market.

It is, however, possible to prosper in a business where others struggle, and a more nuanced view on development is appropriate when it comes to individual companies. Successful REIT development businesses can be found in two distinct groups: uniquely talented developers operating in mature property sectors and talented big fish operating in small property-niche ponds.

A search for members of the first group can be conducted by identifying companies that have been more active on development than the average REIT (i.e., average historic pipeline >7% of assets) since '02 and have generated superior total returns over that time frame. This is a short list, and the only two REITs that unarguably meet its criteria are AvalonBay and Boston Properties. Other REITs that deserve honorable mention include Taubman and Kilroy, as they each outperformed peers while being fairly active on development. Even in a mature industry, companies that have development expertise embedded in their DNA should still outperform, but genetic testing would likely show that many REITs that think they have this gene don’t.

On the smaller pond front, development in niche sectors (e.g., data centers, factory outlets, lab space, student housing, etc.) has been both profitable and a source of meaningful wealth creation for shareholders of Digital Realty, Tanger, Alexandria, American Campus and Corporate Office Properties. Simon’s Chelsea division would head this list as a stand-alone company, but it’s hard to move the needle at Simon. As long as a property sector has a dearth of sophisticated developers and/or a robust demand-growth curve, companies with expertise probably deserve the benefit of the doubt.

What about everyone else? Considering that active developers in general haven’t fared well, but the companies referenced above did, it doesn’t take a PhD to figure out how most of the other active developers performed. To be sure, the analysis employed herein may overlook some decent development franchises that were either too small to move the needle or were offset by other factors that suppressed total returns. Regardless, investors are likely to continue to take a skeptical view toward most development stories and boards should ponder whether simplicity might be preferable.

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