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# Hybrid Mortgage REITs Balance Risk/Returns

DOUGLAS HARTER — CREDIT SUISSE GROUP



**DOUGLAS HARTER, CFA**, is a Vice President at Credit Suisse Group covering the mortgage REITs and mortgage insurers. He joined Credit Suisse in 2000 covering the specialty finance sector. Mr. Harter has a B.S. in accountancy and a B.S. in finance from Villanova University.

## SECTOR — REAL ESTATE

**(ACR801) TWST:** Please start with a quick snapshot of your coverage universe.

**Mr. Harter:** I am primarily focused on the residential mortgage REITs, both the agency-only REITs and nonagency REITs. I do cover one commercial mortgage REIT, and in addition, I also cover the mortgage-insurance companies as well.

**TWST:** What is your overall sentiment and outlook for mortgage REITs and why?

**Mr. Harter:** I have a positive stance on the mortgage REITs. I believe that while the shares are generally fairly valued, the stocks are going to be able to continue to deliver about a mid-teens dividend yield, and that's where the majority of the total return should come from. As to why I think the current environment is very favorable, on the agency side, that's because they have a steep yield curve, and on the nonagency side, credit spreads are still very wide from a historical standpoint, even though they have tightened quite a bit since early 2009. And also today on the nonagency side, the availability of credit, of financing, for those positions is much more available today than it has been really at any point over the past couple of years. And that's leading these companies again to be able to generate midteens returns today. I think that the level of return is sustainable given the weaker economic data points we've seen, which should leave the Fed on hold at least until midyear of next year and probably longer than that. So that's the near-term positive for the group.

The longer-term positive opportunity I see is that, clearly right now, the government has been very involved in the mortgage market. And as the government starts to step back from the mortgage market, I do think that the REITs are going to be a provider of capital to help absorb some of that extra opportunity that should arise.

**TWST:** You mentioned you cover a REIT focused more on commercial property mortgages. It seems there are fairly significant differences investors should consider when looking at a residential mortgage REIT versus a REIT focused on CMBS.

**Mr. Harter:** The end markets are definitely different. The risks are different as well. The CMBS REITs, or the commercial mortgage REITs, tend to have less interest-rate risk than the residential REITs. They tend to also be generally less levered, and so that fits into the less interest-rate risk. Obviously, you have the risk of the end market of the commercial real estate market, which would be the primary risk, which is obviously a factor of the health of the economy.

**TWST:** On the residential side, nationally it seems that maybe the worst is behind us, but it's not exactly improving at any great clip.

**Broadly speaking, how are the residential mortgage REITs faring today, and what are the key macroeconomic factors, market events and/or government policies you watch carefully that could impact these companies?**

**Mr. Harter:** The majority of the residential REITs that take the credit risk through the nonagency securities that they own

## Highlights

*Douglas Harter gives an overview of residential and commercial mortgage REITs. He shares insights on why he believes mortgage REITs will deliver sustainable dividend yields. Mr. Harter also discusses the factors he says are driving the securities' performance — home prices and employment. Mr. Harter provides an outlook on the potential effects of interest-rate increases and inflation on REITs. He also includes his favorite names, both hybrid REITs, in the sector. Mr. Harter says in the upcoming quarter investors may continue to limit their risk in REITs by raising capital.*

*Companies include: Invesco Mortgage Capital (IVR); Two Harbors Investment Corp. (TWO); Annaly Capital Management (NLY); Crexus Investment Corporation (CXS); American Capital Agency Corp. (AGNC) and MFA Financial (MFA).*

that I cover have been formed post crisis, so when they are owning the legacy securities, they bought them at a significant discount to par value, and therefore have already priced significant weakness into that. So this continued weakness has been in line with what the companies were expecting when they bought these bonds. I think that's a key distinguisher versus a lot of the other mortgage REITs that we were around precrisis that owned these bonds at much higher costs, and a lot of them didn't make it through the crisis because of higher leverage or credit issues.

As far as the macro trends that are important, home prices and employment really are the factors that are going to drive the performance of the underlying bonds, probably employment being the biggest driver. The continued weakness really plays into the agency REITs' hands, as they are not taking the credit risk. Continued weakness will likely leave the Fed on hold for longer and likely allow these companies to earn peak returns for a longer period of time.

**1-Year Daily Chart of Invesco Mortgage Capital**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST:** What's the likely impact on this space of potential interest-rate increases and inflation in the future?

**Mr. Harter:** As owners of fixed income securities, if long-term rates are to go higher, the value of those securities would likely go down and their book values would go down. So rising long-term rates would be a negative for the book values of this group and likely the performance of the stocks. And if short-term rates rise, the profitability will compress, as they are generally funded on a short-term basis, so that will compress their net-interest margins, and again, lead the dividend yields to be lower.

The agency-only REITs are going to be more impacted from the rate moves than the nonagency REITs or the REITs that do a combination of those two strategies, because the nonagency securities are more credit focused and less rate sensitive. You could probably even argue that if rates are starting to rise, then the economy is improving, and those nonagency securities could actually be faring better. It's been my viewpoint that I've favored the hybrid REITs that do both. To me, it offers a little bit more balanced risk to

any of the potential outcomes.

**TWST:** What names do you like in the space right now and why?

***"Like I said as we started, I'm generally constructive on the group as a whole, but the two favorite names that I have right now would be Invesco Mortgage and Two Harbors. Those are both hybrid mortgage REITs."***

**Mr. Harter:** Like I said as we started, I'm generally constructive on the group as a whole, but the two favorite names that I have right now would be **Invesco Mortgage (IVR)** and **Two Harbors (TWO)**. Those are both hybrid mortgage REITs. **Two Harbors** invests in both agency MBS and nonagency residential mortgages. They tend to focus on more-credit-impaired nonagency bonds. They like subprime. They like option ARMs. They feel like those offer better risk/returns given what the assumptions

they are able to price into those bonds.

**Invesco Mortgage** is also a hybrid. In addition to the residential area, they invest in CMBS as well. They tend to focus on less-credit-impaired nonagency bonds. They take a different opinion. They think that those offer better relative returns. But both are seeing better relative opportunity in the nonagency side today, and both recently raised capital to take advantage of some of those opportunities.

**TWST:** How readily do these companies have access to capital?

**Mr. Harter:** Lately, it's been pretty readily available. **Two Harbors** has raised a combined \$700 million between May and July, and **Invesco** raised about \$400 million in June. They both raised money in the first quarter as well. So they have found that the equity markets have been very open to them over the past year.

**TWST:** There have been others raising capital, also, such as **Annaly** and **Crexus**?

**Mr. Harter:** Correct. **Annaly (NLY)**, **Crexus (CXS)**, **American Capital Agency (AGNC)**, **MFA (MFA)** have raised some money over the past year. The space as a whole has been very active from a capital-raising standpoint.

**TWST:** Overall, do you see balance sheets being healthy in this space?

**Mr. Harter:** Yes. The amount of leverage that the players are holding today is down significantly from precrisis levels. If you look at the agency side, the players used to lever that asset about 10 times debt to equity. Today they are more about seven times debt to equity. So they have definitely reined that in. The nonagency side is typically leveraging around one to 1.5 times debt to equity.

The one question mark that some people have on the balance sheet side right now, which should be resolved by the time this gets published, would be the whole issue with the U.S. debt ceiling and potential for raising that and the effect that would have on the short-term capital markets.

**TWST:** Do you see a lot of concern among investors regarding that?

**Mr. Harter:** I think they are definitely aware of it. I think most people generally feel that it's going to be resolved some way, and that the government is not going to let us go into default. So I

think people are aware of it as a tail risk, but generally believe it's not going to be the most likely outcome.

**TWST: What were the key themes from last quarter's earnings, and what are you looking for as we head into earnings season for the second quarter?**

**Mr. Harter:** I think one of the key themes is you have started to see some companies look to increase the amount of hedges that they have against their interest-rate risk, and to look to better position themselves to protect the returns they have today and to really build or extend the current level of returns further out to the future, and to mitigate some of the impact of interest-rate risks. We started to see some of the beginning of that last quarter. I would expect to see some additional moves along those lines in the coming earnings. I think the other key thing, as evidenced by the capital that's been raised recently, would be the opportunity that these companies continue to see, and how and where they're seeing the opportunities to put that money to work.

**TWST: Do you have any other advice for investors?**

**Mr. Harter:** Make sure you understand the specific strategy of the individual mortgage REIT. While in the big picture they all are going after the same return strategy, they do have nuances, and within those nuances there is an ability for investors to match up the nuance of what the company is looking to do with the underlying macro assumptions that an individual investor is bringing to the table.

**TWST: Do you find people have a hard time understanding the distinction between a mortgage REIT and other REITs? Do most investors, when they think of REITs, think of property owner/operators?**

**Mr. Harter:** I would say the level of knowledge from investors around this space has definitely been increasing over the past year, as there has been more capital coming into the sector. So you definitely have a lot of people who are much more savvy to the distinctions. I would say the typical investor has tended to be someone who looks at broader financials, as opposed to the typical property REIT investor.

**TWST: Thank you. (MN)**

*Note: Opinions and recommendations are as of 07/19/11.*

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# Improving Fundamentals for Commercial REITs

ALEXANDER D. GOLDFARB — SANDLER O'NEILL + PARTNERS, L.P.



**ALEXANDER D. GOLDFARB** is a Managing Director and the Senior REIT Analyst in the research department of Sandler O'Neill + Partners, L.P. He joined the firm in 2009 after two years as a Director and Senior REIT Analyst at UBS AG and five years at Lehman Brothers Holdings Inc., where he was a Vice President and REIT Analyst. Mr. Goldfarb holds an MBA from the F.W. Olin Graduate School of Business at Babson College and a B.A. from Wheaton College.

## SECTOR — REAL ESTATE

**(ACR803) TWST:** Please start with a snapshot of your coverage universe.

**Mr. Goldfarb:** Collectively at Sandler O'Neill we have 27 REITs under coverage. I cover 23 and my colleague, James Milam, has launched on the health care space, and he covers four. We cover across apartments, student housing, shopping centers, malls, office, industrial and health care, and we continue to grow the platform.

**TWST:** That's broad coverage in terms of property types. Is there an overall tone or theme you hear from management teams now that we're roughly halfway through the second-quarter earnings season?

**Mr. Goldfarb:** I think the general takeaway is that there is a disconnect between what you read in the newspapers about the how the economy is doing and how commercial real estate is doing. People are back shopping at the malls. Retailers are taking space. Industrial tenants are once again looking for space. New York office continues to improve. I can't say the same for suburban office, but certainly New York office. The apartments continue to do very well. Student housing is doing well.

I'd say there are two areas of two areas worth noting. One, industrial this quarter was stronger than we anticipated as far as interest from tenants, and again it's juxtaposed against the economic headlines, which suggest that businesses are scaling back. Two is Washington, D.C., is slowing down. The pace of office leasing has slowed. The rent growth that apartment landlords have seen there this

year has decelerated. That is not a surprise for this earnings season, because we were down in D.C. in June, and that's what we heard when we spoke to the different landlords. The point is that if you look at commercial real estate, those are two areas where, one, it's obviously

positive that there is activity in industrial, and two, the budget debate is having an effect on the Washington market.

**TWST:** In your view, what are the most and least favorable property types or geographic markets or niches right now?

**Mr. Goldfarb:** Let's first say that, one, we still have a 3% Treasury, and two, you have a positive spread between the cost of buying real estate and financing it. As long as those two things remain in place, commercial real estate is going to continue to do very well. To that, the economy is still growing. Obviously the pace of growth has slowed, and as you and I have spoken about before, there is very little incentive for businesses to hire given the level of uncertainty that has come out of Washington. I mean, well before the budget debate, there was just so much regu-

lation coming out and so much uncertainty of what it meant that businesses, not surprisingly, scaled back the hiring.

But you definitely have the haves and have-nots. People who survived the Great Recession have returned. They're renting apartments. They're shopping at the mall. They're leasing office space. They are leasing some warehouse space, and they are going back to college. So you have that level of demand continuing. You

## Highlights

*Alexander D. Goldfarb shares his outlook for apartments, student housing, shopping centers, malls, office, industrial and health care REITs. He discusses the stronger-than-expected industrial sector and the deceleration in apartments in Washington, D.C. Mr. Goldfarb expects the real estate market overall to grow if it is supported by a slowly recovering U.S. economy, no new supply and a low Treasury. He favors the apartment, student housing, malls and New York office.*

*Companies include: Equity Residential (EQR); American Campus Communities (ACC); Simon Property Group (SPG); Developers Diversified Realty Corporation (DDR); SL Green Realty Corporation (SLG); Essex Property Trust (ESS); EastGroup Properties (EGP); Liberty Property Trust (LRY); The Home Depot (HD); Wal-Mart Stores (WMT); Kohl's Corp. (KSS) and Best Buy Co. (BBY).*



don't have any new supply that is going to change — and apartments are certainly on the forefront of the supply wave — but right now there is no new supply. Real estate is a finite asset, and as supply gets eaten up, the incremental price that people are willing to pay for what's remaining goes up exponentially. That is what we're enjoying right now — the lack of supply has more than offset the lack of job growth. Clearly, if you get a double dip, another recession, major job losses, that's obviously bad. But in the current environment, if this sustains, real estate will continue to do well because of those three metrics: slowly recovering economy, no new supply, and a low Treasury and a positive spread between acquisition and financing costs. To your question, our preferred sectors are apartments, student housing, malls and New York office.

**TWST: What are your top investment picks right now?**

**Mr. Goldfarb:** Our top pick for the year is **EQR** (EQR).

We have a fair number of "buys," but some other key picks that I'll highlight would be **American Campus** (ACC) in student housing, **Simon** (SPG), **DDR** (DDR), **SL Green** (SLG), and I am happy to throw out another apartment, **Essex** (ESS). As I said, we have more "buy" names, but that's probably enough for this discussion.

#### 1-Year Daily Chart of Equity Residential



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Would you mind highlighting some key points about a few of them?**

**Mr. Goldfarb:** **American Campus** is a preeminent student-housing landlord. They focus primarily on off-campus housing, and these aren't like the sardine boxes that we lived in when we went to school. I would say that the kids are doing more than just studying. These facilities are that nice. I mean they're night and day, phenomenal what they have. But it reflects the modern generation, which is used to air conditioning, having their own private bathroom, having all the amenities — pool, gym, tanning beds, and Wi-Fi and all that stuff. When we went to school, each room had more kids than was probably legally allowed. There were communal bathrooms, communal showers and that was the way it

was. Obviously times have changed.

But the bottom line is that **American Campus** focuses primarily on off-campus housing, but they are increasingly getting into partnering with universities to build on campus, and that's a huge avenue of growth because, one, school budgets are under pressure; and two, schools have a lot of that old housing that is not attractive to today's students. To be able to partner with a private, well-capitalized entity that's the premier operator in the sector and have them come on campus, build a dorm, help finance it and be in partnership with the university — that's very attractive.

And kids are constantly going to college, and colleges only seem to raise tuition, and it's certainly in excess of CPI. So you have tuitions constantly going up. You have a demand for improved and better quality housing, and you have a company like **American Campus**, which is very well capitalized. They are going for their investment-grade rating, which hopefully they'll get by early next year. And once they do attain that, not only will it lower their cost of funding, but it will also put them in a clear leadership position above peers, both public and private. So it's a very compelling story, and it's been from the get-go one of the few genuine real IPO success stories in recent times.

**DDR** is a power-center operator, a shopping-center company focused primarily on big-box power centers, that's where you have the **Home Depots** (HD), the **Wal-Marts** (WMT), **Kohl's** (KSS). At the peak they did a lot of things that they shouldn't have done, a lot of joint ventures, a lot of high leverage, merchant build one-time gains, a lot of fee activity. So when the Great Recession happened and the credit crisis happened, the company got hit badly. They had a management shakeup. They had a heart-to-heart with themselves, and they are in the process of turning the company around.

Over the past two years the company has made tremendous strides in, one, divesting of bad investments; two, getting the balance sheet back in order; and three, focusing the company and aligning management's goals with shareholders' goals as far as creating long-term value in the company and not just trying to make the next quarterly earnings.

They are investment-grade rated by Moody's, and they've done all the heavy lifting to get the investment-grade rating from either Fitch or S&P. It's just a matter of when those agencies come around to upgrading **DDR** back to investment grade. But they have done a great job of exiting some investments that they shouldn't have gotten involved with and cleaning the balance sheet.

And the other thing is, there is no new supply, and retailers are continuing to take space despite the headlines. Their tenant focus is primarily on national credits, whether it is big box or smaller, franchiser-type business models. If you think about a classic grocery-anchored shopping center, a lot of the small tenants — the card shop, the pizza shop, the barber, etc. — are mom and pops who don't have access to credit the way a national operator would.

***"You don't have any new supply that is going to change — and apartments are certainly on the forefront of the supply wave — but right now there is no new supply. Real estate is a finite asset, and as supply gets eaten up, the incremental price that people are willing to pay for what's remaining goes up exponentially."***

Those tenants are still having trouble getting credit. Not all, obviously there are some who are very well capitalized, and they're taking space. But by and large, a lot of the mom and pops are still having trouble on the credit front.

By contrast, **DDR's** tenancy relies on the opposite. They have very little exposure to the real mom and pops. So as they are leasing up their portfolio again, they are leasing to a stronger tenant base. And even while there is talk of **Best Buy (BBY)** scaling back stores or scaling back square footage because they are selling more online, the fact of the matter remains that if a tenant is under a lease, they can't just arbitrarily give back on the lease. Either they have to strike a deal with the landlord or wait until the renewal process. And if they want to strike a deal, the landlord obviously isn't going to give up rent, but they may take back space that the store doesn't want and re-lease that space. The company has done a very good job of, one, turning itself around both as a business model and as how the company operates; two, restoring the balance sheet and working to regain investment-grade rating; and three, making sure that they're focused on decisions that create long-term value and focused on their core business. The company has done a very good job on all fronts.

**TWST: What about SL Green?**

#### 1-Year Daily Chart of Developers Diversified Realty



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**Mr. Goldfarb:** **SL Green**, New York office, they did a lot of investments over the past few years buying up vacancy, getting involved in buying discounted debt on buildings and just making some very good acquisitions when cap rates were higher. Now that the market is tightening, they have an opportunity to, one, lease up the vacancy that they have acquired; and two, benefit from that tightening market.

Their focus is very much in Midtown, a lot around Grand Central. So unlike Penn Station, which is going to take years before that submarket gets redeveloped just because of all the government approval and capital involved, Grand Central has already been redeveloped. There is still a lot of opportunity in redeveloping indi-

vidual buildings, but as a submarket it's very strong. You're obviously right next to Park Avenue, which is one of the best areas

to be in New York, in the country for that matter, for office. And the company has shown an ability to find some really good deals. They got involved in 3 Columbus Cir., with Joe Moinian, and 280 Park Ave., which the more we learn about the more we like it. Initially we were lukewarm to it, but we're learning a lot more about what the redevelopment is going to be, and it sounds pretty impressive.

And the valuation — it's one the few REITs we cover that actually trades at a discount to NAV. And we

continue to believe in the New York recovery, assuming the Wall Street layoffs remain more of the trimming variety rather than wholesale, and these guys have a pretty good track record of creating value.

**TWST: You mentioned earlier that it was a surprise that industrial space seems to be stronger than anticipated. Would you talk a bit more about what you're seeing, and is this an area investors should be looking at now in terms of value?**

**Mr. Goldfarb:** The tenant activity is picking up. Just two months ago at the NAREIT conference, we met with the companies that we cover, and it was still pretty much a lukewarm environment. But that's changed in the past two months. People are out looking to take space. It's still a renter's market with rents still below the peak. But landlords are improving occupancy, and as you start to tighten the market, that starts to give the landlords more pricing power, so suddenly they're no longer willing to just offer whatever concession they need to get the tenant. Then they start to firm up the rents, and then they start to move the markets. Right now we're in the early stages of that, which is a positive.

In that space we cover two stocks, **EastGroup (EGP)** and **Liberty (LRY)**. We have a "buy" on **Liberty** and a "hold" on **EastGroup**. Both are good companies. **EastGroup**, we'd note that they never did the overseas expansion or joint venture activity or huge development programs, so they are one of the few that actually never had to recapitalize during the downturn. **Liberty** as well played it fairly conservatively. On a valuation basis, we like **Liberty**. We find it more attractive than **EastGroup**, but both are fine companies.

With industrial, I don't know that you have to run out and buy it today, because the market changes slowly. But while it may not have been on people's radar a few months ago, right now it's starting to look interesting in that there are signs of life, which is clearly a good thing. That said, it takes a while for that to flow through to the bottom line.

**TWST: For suburban office, are there still no real signs of improvement?**

**Mr. Goldfarb:** Correct. If you think about what's going on, there is a general shift toward people working in more infill or urban settings. I'll use New York as a clear example. In the 1950s, 1960s and 1970s, generally speaking, a lot of companies left Manhattan and went out to the suburbs. Now everyone is coming back

***"With industrial, I don't know that you have to run out and buy it today, because the market changes slowly, but while it may not have been on people's radar a few months ago, right now it's starting to look interesting in that there are signs of life, which is clearly a good thing."***

in. Again, that's a gross generalization, but thematically that's what's happening.

The thought process behind that is, it's hard to attract the younger talent to work in places like Stamford. Certainly if you have a family, if you're a parent, there's a good chance that you live in the suburbs and it's probably an easy commute. But if you are thinking about the college grads and the MBA grads who come into the investment banks every year, and they have a choice between working for a firm that's based in the city versus one where they have to commute out to the suburbs, it makes the recruiting a little tougher. I think you see businesses asking: What's the best way to retain talent?

If you look at what **Liberty** is doing, they're part suburban office, part industrial, but they're busy selling their suburban office to focus on more infill office sites. It doesn't necessarily mean that they're going to be CBD, but they are focusing on sites that are where people want to work. That's a theme that will continue, much like if you think about what's going on with apartments and housing. Even though mortgage rates are low, people know what a burden it is to own a house, and that's why you're seeing people stay in apartments longer. It's the same dynamic with suburban office versus CBD office. There is a shift going on, and suburban office tends to be very commodity like.

**1-Year Daily Chart of Liberty Property Trust**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Do REITs overall still have fairly pretty healthy balance sheets, and is the access to capital that they've had in the past continuing?**

**Mr. Goldfarb:** Yes. REITs have no trouble getting capital. There are umpteen number of banks that want to offer REITs various types of credit, the life companies, the capital markets. They are not wanting. That said, roughly half of our coverage universe has leverage, defined by net debt to adjusted EBITDA, higher than 2005. Thus, we continue to advocate delevering and duration extension.

**TWST: You spoke earlier about some of the macro issues that are out there. How concerned are you about the pos-**

**sibility of rising interest rates and inflation? What do investors need to keep in mind in terms of how that impacts REITs?**

**Mr. Goldfarb:** If you think we're going to have stagflation, then you probably don't want to be in REITs. If you think that we're going to have inflation because of economic growth, REITs are a good spot. If you think that we're going to have sustained low rates and low growth, REITs are a good spot. So really it's a stagnation environment — where businesses and individuals do not have an ability to absorb rent increases, and yet there are cost pressures on the REIT, namely from rising financing costs — that doesn't do good things. It crimps earnings and crimps valuations. That would be the environment that you would not want to own

REITs in, except maybe student housing, because kids go back to school, or malls, because people want to forget what's happening outside and just shop and make themselves feel good. But in the traditional inflation sense where you're getting economic growth, real estate should do well.

Clearly if Treasuries suddenly backed up in a meaningful, sustained way — I don't know what the number is, but if we're 3% right now, let's say they went to 4.5% or 5% and stayed there and that became the new baseline — yes, that would reset real estate valuations. But just spiking up and then coming back down probably wouldn't do anything. It would have to be a sizable shift that's sustained.

**TWST: A lot of REITs cut their dividends a few years ago. What are you seeing now? Do you expect REITs to raise their dividends?**

**Mr. Goldfarb:** Yes, absolutely. We updated our estimates as we went through our earnings last week, and there are companies, just generically, where we're looking at 10%, 15%, 20% dividend increases next year. It's really a function of, one, a lot of companies cut their dividend back, so now they're raising them once again; and two, the real estate has recovered a lot stronger than any of us would have imagined. So it's restoring dividends. And you have growth, and that raises taxable income and dividends come up.

**TWST: Is there anything else you'd like to add?**

**Mr. Goldfarb:** Our outlook is that we're probably in this low growth through the 2012 election. We think that within New York office, the Wall Street layoffs are more trimming. We're not looking for wholesale layoffs, which should mean that New York Office continues to hold up. I think an area of focus would be apartments, because everyone knows how good apartments are. You're seeing a lot of people pulling permits, ordering lumber and getting ready to start building again. In 2013, 2014, I think that supply is going to surprise on the upside. Right now and into 2012, apartment fundamentals look very good. As we wrote in our 2Q earnings outlook, we thought that estimates would come up for 2012, and that's what's happening, and that will provide continued support for the group momentum. But sometime probably in early



2012, we'll have a better handle, on one, how the economy is doing; and two, how that supply is looking. And the market is a forward-discounting vehicle, so if the supply looks like there is going to be a lot in 2013, stocks will reflect that. If it looks like no, it's probably more 2014, then there is probably still some more room. But certainly from now into next year, the prospects for apartments are very good.

**TWST: It's been the favorite sector for a couple of years now, and it doesn't seem that it's going to end anytime soon.**

**Mr. Goldfarb:** Not in the near term. Eventually, all good things must come to an end. At some point that will happen, but not right now when you look at the earnings growth. As we went through our numbers last week, stocks that have looked a little bit on the full side, suddenly the valuations readjusted and it made sense where the stocks were trading. As long as the apartment landlords continue to push rents, the incomes from the properties are going to go up, and that's going to be good for the stocks.

**TWST: Thank you. (MN)**

*Note: Opinions and recommendations are as of 08/01/11.*

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#### **Disclosures:**

*This interview took place prior to the sustained multi-week stock market selloff and S&P downgrade of the U.S. While it's too soon to tell the impact on the economy, it clearly has the potential to slow down business and consumer decision-making.*

*American Campus Communities, Inc.: Sandler O'Neill was a man-*

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# Macro Factors Favor Short-Term Lease REITs

DAVID TOTI — FBR CAPITAL MARKETS



**DAVID TOTI** joined FBR Capital Markets as Managing Director and Group Head of REIT research. Before joining FBR, he spent a combined eight years as a Senior REIT Research Analyst at Citi Investment Research & Analysis and Lehman Brothers Holdings, Inc. During that time, he covered an array of real estate sectors, including office, retail, multifamily, storage and health care. Additionally, Mr. Toti practiced as an Architect for 10 years with Pelli Clarke Pelli Architects, and worked as a Senior Designer on several large

commercial projects, domestically and abroad, including the Reagan National Airport in Washington, D.C., and the Bloomberg L.P. headquarters in New York City. Mr. Toti holds a bachelor's degree in architecture from Syracuse University and an MBA in real estate from the University of Wisconsin-Madison.

## SECTOR — REAL ESTATE

**(ACR802) TWST:** Please start with a quick snapshot of your coverage universe.

**Mr. Toti:** At FBR, we have nine people covering commercial real estate, covering over 70 stocks that span almost all of the subsectors in the property REIT arena — office, retail, industrial, data centers, self storage, multifamily, etc. We also have analysts covering lodging and gaming stocks, as well as triple net, specialty finance and mortgage REITs. So it is quite broad, comprehensive real estate coverage. My direct universe is the short-lease space, which includes multifamily and self storage at the moment. I am the Group Head as well.

**TWST:** What is your overall outlook and sentiment right now for the apartment and self-storage REITs, and why?

**Mr. Toti:** Our outlook right now for the RMZ is 890. We maintain a rolling 12-month forward RMZ target that we update every few months, or if there is a significant move to GDP or rate projections or anything macro oriented. It was May 2011 when we last updated our outlook. So at the current level, those returns are look-

ing high single digit, which is comparable to the S&P.

The last couple of days we have seen a significant pullback in the REIT space, which in our view has made the group a little bit more attractive. Up until very recently, we were thinking that the space was relatively fully valued. We have had a “neutral” view of the index since the beginning of the year, as compared to a “positive” view last year. Obviously, that has not quite worked, because the index has continued to outperform for a variety of reasons, including flows and so forth. We have maintained a “neutral” position, but believe the current pullback could be a little bit of a select opportunity in different pockets.

**TWST:** Multifamily has been the favored, or at least one of a few favored, property sectors for REITs for the past couple of years.

**Mr. Toti:** We have a variety of ratings within multifamily. We do not make subsector calls. We stock pick, so we set our macro view, and then we do a bottom-up approach. We have a number of “outperform”-rated stocks in the multifamily space.

For a while now there have been lots of reasons to like the group. The housing backdrop, what

## Highlights

*David Toti discusses the recent themes in the short-lease space of REITs, which includes multifamily, self-storage, lodging and some health care properties. He says he will maintain his “neutral” rating of the sector for the rest of the year, although he shares several “outperform”-rated stocks and the specific reasons for the rating. Mr. Toti also discusses the appeal of multifamily REITs and the macroeconomic trends that are fueling the sector’s rental rate growth.*

*Companies include: Camden Property Trust (CPT); AvalonBay Communities (AVB); Sovran Self Storage (SSS); U-Store-It Trust (YSI); Home Properties (HME); Colonial Properties Trust (CLP); Associated Estates Realty Corp. (AEC) and EquityLifeStyle Properties (ELS).*

is happening with single-family housing, the shift from owning to renting, is one. Limited supply is painting a very favorable operating backdrop for the multifamily operators, even in the context of weak GDP growth and high unemployment. The other thing that has drawn a lot of investors to this space

— and keep in mind that we see lots of different investor types from the long-only dedicated to the generalists and hedge funds — is if one is building a thesis around inflation or stagflation or any kind of rate volatility, the short-lease space is going to be relatively attractive because of its ability to pass-through price increases or cost-of-capital increases. There are a number of groups that fall in that category: multifamily, self-storage, lodging — although a little bit different — and certain pockets of health care.

Those have been very consistent themes among investors for the past six to nine months, and that has drawn investors to the space.

In addition, if you look at the data that has been reported by the multifamily REITs for the past few quarters, the portfolios have been producing same-store NOI in mid- to high-single-digit ranges at this point, which is pretty attractive to investors in the context of a fairly low-growth world.

***“Across the board, the move-out levels to purchase single-family homes continues to fall in almost every region in the country, despite falling home prices. So net net, it does really highlight that the apartment operators hold a lot of pricing power.”***

**1-Year Daily Chart of AvalonBay Communities**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST:** Multifamily seems to be the one sector where some rental rate growth is realistically anticipated and realized. Do you see continued confidence in that, and is that largely a function of what you referred to earlier, that shift from owning to renting, which is keeping occupancy rates up?

**Mr. Toti:** I think we are seeing revenue growth in multifamily for a variety of reasons. The multifamily operators have occupancy levels, on average, in the mid- to upper-90% range, which is historically very elevated. And what that does is facilitate the ability of the operator to push rents higher, because they can afford some occupancy loss, some churn, to achieve those higher rents. In many markets now street rents have surpassed the in-place rents, and there is positive upward momentum. I think to the surprise of

everyone, despite the rising rent increases, we are not seeing occupancy numbers fall and move-out turnover is still dropping, which is highly counterintuitive. I think the message there is that the renter is still very tolerant of price increases and resistant to move, resistant to bear the transaction costs of moving, and may still feel that high-single-digit rent increases are acceptable relative to the alternatives, which is moving or buying a house. Across the board, the move-out levels to purchase single-family homes continues to fall in almost every region in the country, despite falling home prices. So net net, it does really highlight that the apartment operators hold a lot of pricing power.

**TWST:** Are these positive fundamentals leading to a lot of new construction? Camden recently discussed a fairly sizable development pipeline.

**Mr. Toti:** We are going to start to see supply increases. If one looks at the last couple of months' permit data, one will see that the permit numbers have popped up, which is always the first signal. These numbers still remain very much below historical averages, and a lot of the permit numbers are actually comprised of the REITs, which are all selectively ramping up their development pipelines. **AvalonBay Communities (AVB)** is obviously at the forefront, followed by a number of other REITs that are ramping up activity. **AvalonBay** was the most prescient. They never dismantled their pipeline and were able to turn it on relatively quickly several quarters ago, just as the recovery took hold. Many of the other operators have started their development ramp-up now, because they wanted to see that pricing power was in fact in place for a while. I would not exactly say they are late. All the public companies that are starting development today are still going to be well in advance of what we will see in the private market.

There is one primary reason why we are not seeing development activity in the private market really accelerate, and that is the lack of construction lending. Banks are still relatively unwilling to make construction loans to private developers, and that's partly because their lending overall is crimped and partly because construction loans were historically very high loan-to-value, with very little equity from the developer.

So development is picking up, but we are still a long way away from there being a heavy supply problem in most markets. But I would assume by the end of next year we'll be discussing which markets are supply threatened. That is not happening yet, but I think if you fast-forward, it is inevitable. As these fundamentals become more attractive, it is going to, one way or another, attract new construction.

**TWST:** As long as the REITs continue to have financing options available to them?

**Mr. Toti:** Exactly, because the REITs do not have to get construction loans. They can self-fund. In other words, any REIT that has an unsecured debt rating or access to equity and other funding sources can use those proceeds to indirectly fund that develop-

ment pipeline. They do not have to essentially match funds with their construction, like the private developer would, which is an enormous advantage in today's world.

**TWST: It seems the multifamily is by far the easiest to finance.**

**Mr. Toti:** Yes. I think there are a couple of reasons for that. Number one, everybody knows that the backdrop is attractive, so there is a little bit less constraint relative to risk. Number two, the GSEs have pretty much owned that lending market for a long time now, with multifamily loans underrepresented among the other lender types — e.g. commercial banks, regional banks, life insurance companies and so forth. There is a sense that some of these lenders will step into the market because they really do not have appropriate multifamily loan books, because they have been locked out by the GSEs. As the REITs wean themselves off the GSEs and borrowers look elsewhere, we may see some non-GSE lenders step in.

***"There is a pretty high level of bullishness among the multifamily-operator management teams. Rightfully so, fundamentals have not looked this attractive in a very long time."***

**1-Year Daily Chart of Sovran Self Storage**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: What trends or themes are you hearing from the multifamily management teams so far during the second-quarter earnings season?**

**Mr. Toti:** There is a pretty high level of bullishness among the multifamily-operator management teams. Rightfully so, fundamentals have not looked this attractive in a very long time. The last time the economy was growing, the early 2000s, we were also witnessing a massive move-out to single-family housing. This is currently an alignment of the stars for these firms, so they are all rather pleased. If one looks at the levels of external growth that are taking place both through acquisitions and development, that acceleration is indicating that the companies are betting on really strong fundamentals for a long period of time.

At the margins, I think the more prudent management teams are being cautious. If you are exposed to the Sunbelt, you are going to be cautious about supply, because inevitably in the next

couple of years the low-barrier markets will see a construction lift. If you are cautious, you are going to say, "Look, we have great pricing power now, but in the absence of job growth, or wage growth for that matter, eventually the renter is going to become intolerant of these very large rental rate increases and we are going to start to see churn increase, and that drives up operating expenses and so forth." I would say that you have to be cautious absent any kind of major change in the direction of the macro view. You have to be cautious about the trajectory of rent growth.

**TWST: What about the self-storage REITs? What are you seeing in that subsector?**

**Mr. Toti:** Self-storage is a group that I like a great deal. We launched coverage of the space last summer, but I have covered those REITs since the early to mid-2000s. It is a group that was generally overlooked by many investors. All the short-lease attention was on the multifamily space, and I think many investors overlooked the fact that the self-storage REITs actually have a cash flow structure that is very similar to the multifamily REITs. You do not have the same phenomenal operating backdrop that you do in multifamily.

Self-storage still has some problems. There is a lot of oversupply, it is still somewhat of a discretionary product, which means that if you have a sensitive consumer, it is going to be tough to hold pricing power. You also need a robust housing market to really drive self-storage demand.

So the operating backdrop with self-storage is not quite as robust, but what we are seeing is a different dynamic play out that is pretty fascinating, and that is the selection of self-storage by the consumer is increasingly done over the Internet. The four public companies essentially own Internet search results, so they are seeing their demand numbers rise. They are essentially stealing demand from private operators as people increasingly use their computer, their PDA, their smartphone — whatever it is — to find storage. That means that while they may not have massive amounts of pricing power at the top line, they are building occupancy and holding rents.

There are a couple of outcomes we see from that. Number one, the public operators' occupancy levels are now significantly higher than the total market, despite the overall demand weakness. Number two, many of the REITs are ramping up third-party management platforms, and this is an indication that some of the private players are just capitulating and saying, "Look, we cannot compete with the public operators, we are not big enough, and we do not have the scale to own Internet searches, and we are willing to take a cut in our return to have one of the big public companies operate our assets."

If one drills down to the asset level, a typical storage-asset performance depends on the demographics found within a three-mile radius. If one goes back five-plus years and looks at that three-mile radius, a significant percentage of the customers were from that three-mile catchment area. Draw that same diagram today and



ask where do the customers come from? They are coming from, in many cases, far outside that original circle. That is the impact of the Internet. The operators are getting customers from farther away because they are sourcing storage in a different way.

Self-storage has a lot of the short-lease qualities that you find in multifamily and lodging with lower valuations. The problem with storage is that there is a limited selection of stocks — there are only four — and they are very different, whereas in multifamily, there is a certain uniformity and homogeneity among the different operators. In storage, they are radically different companies, different balance sheets, different market caps and so forth, so it makes it a little bit harder for the investor.

**TWST:** The third-party management platforms you mentioned, does that result in substantial fees for the REITs, and perhaps ultimately lead to acquisitions?

**Mr. Toti:** Number one, it is about brand extension. Most investors do not apply high multiples to the fees, because it is all contract based and cancellable. It is not like a lease, so it ends up garnering a lower multiple. At the end of the day, however, the implicit and captive acquisition pipeline is very important, and we are seeing some of the companies continue to acquire through that pipeline. If you add up all those small-scale wins, it is a pretty meaningful addition to an operating platform.

**1-Year Daily Chart of Associated Estates Realty**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST:** What are your top investment picks right now, both for multifamily and self-storage REITs?

**Mr. Toti:** Here at FBR, we have a very different approach relative to our sell-side peers. We have a more quantitative methodology in terms of stock picking that tends to lead us to relative value. Within storage, **Sovran Self Storage (SSS)** and **U-Store-It Trust (YSI)** are both rated “outperform.”

Within multifamily, our picks are generally a little bit more defensive in nature. We have **Home Properties (HME)** at “outperform.” Other “outperform”-rated stocks include **Colonial Properties Trust (CLP)** and **Associated Estates Realty Corp.**

(AEC). **Equity Lifestyle Properties (ELS)**, which some people may or may not include in the multifamily subsector, has been one of our top picks for a while, as an attractive variation on the multifamily theme.

Some of our other picks are relatively more consensus. **AvalonBay** we have had at “outperform” since December. That has been an interesting call. We do not disagree that the core real estate

value is pretty full, but we do believe that this is the time to back the developers, and **AvalonBay** had a pretty enormous advantage going into this cycle. In our NAV, we include a pretty sizable contribution from the development pipeline that is not present in many peer valuations. When we launched on the name in December, our thesis was this: By the end of 2011, we expected **AvalonBay**’s development pipeline to be significantly larger, and expected that investors would increasingly ascribe higher

value to the pipeline. Seven months into the year, that is pretty much how it has played out. That has been a good call, despite the fact that it is not multifaceted.

**TWST:** For the group overall, what are you expecting in terms of dividends? Are we likely to see dividend increases this year, and what are your expectations for overall returns?

**Mr. Toti:** Over the past few years, dividends have been cut pretty sizably. Coverage is therefore much more attractive today. I would say for the retail investor, or the institutional yield investor, it is a much safer yield today than it has been in the past. In many cases the REITs have cut the dividend down to a minimum payout, so there are lots of instances where the REITs have to increase the dividend to maintain REIT status.

I do not think we are going to see a lot of dividend increases as a signal of business health necessarily, or as a signal of positive momentum, which we saw in the past. I think management teams are much more cautious today relative to cash flow safety and volatility, given their recent experiences. I do not think we will see significant dividend growth. Dividends should pretty much track core earnings or cash flow growth for some time, which at this point remains still low single digits across the entire group. The issue we have with the REITs today is that they are trading at relatively high multiples historically. Cap rates are very compressed, so it has made the aggregate yield even less attractive than it has been historically. Now if the 10-year keeps dropping, if we have the 10-year at approximately 2.5% in the next couple of weeks, then it is a different conversation.

**TWST:** What are the big macro trends or issues you keep an eye on, and what are your thoughts in terms of the country’s debt situation, the overall economy and the potential for rising interest rates and inflation?

**Mr. Toti:** We watch all those very carefully. Going back to the way we approach the world, our macroeconomic models are very rate sensitive. We have three proprietary valuation models that we use, and two of them are very sensitive to the forward curve, the

interest-rate environment assumptions going forward. So we really watch that the most carefully, and we monitor spreads from the short end to the long end pretty routinely, and then anything that would impact adversely — obviously employment, GDP growth, government activities, fund flows, events in the macro landscape, the global landscape, etc. As long as we are in a low-rate, low-growth environment, it remains a pretty fertile space for the REITs.

A mentor of mine coined the phrase “Goldilocks economy,” describing the economy as not too hot and not too cold. That is really a perfect environment for the REITs. When S&P growth becomes more attractive, capital should theoretically flow out of the REITs and into more attractive multiples with higher growth prospects. That did not happen at the beginning of the year as we had projected. When the economy is looking a little weaker, I think there is concern that REIT valuations are elevated relative to potentially softening fundamentals. As long as we stay in that in-between zone, however, where the REIT core earnings growth looks attractive relative to the S&P, and there is also a hint of defensiveness around the long-term nature of the lease, and you layer over that the fact that the REITs continue to have a massive capital advantage in the market, that all looks pretty good to most investors.

You also have secondary and tertiary dynamics at play. Capital flows remain positive and very strong, especially international capital flows into the group, which is really creating a lot of demand for the securities. Some of that is increasing real estate allocation from overseas funds, some of it is performance chasing. We have seen two years of outperformance by the REITs, and many believe we will see a third. Or they have not watched the REITs and have missed out on the outperformance and feel the need to pay attention now. So there are lots of dynamics that are positive for the group overall, but again, I would caution when valuations reach these levels, volatility increases, as we are seeing today with the RMZ down 2.2%. Net net, we remain relatively positive, but with increasing caution.

**TWST: Is there anything you’d like to add, any final thoughts or advice?**

**Mr. Toti:** I would say for investors, stay focused on value. I think that is the important part of picking the right REITs today. That has been our thesis since launching last July, and it has played out quite well. I think for most REIT investors, especially the dedicated investor, where you go from here is the hard question to answer when the space has been bid up so much. First, REITs are being driven by macro calls much more today than they have ever

been, so it is very critical to get your macro call right and then stock-pick from there. And then our other recommendation is to generally find relative value or undiscovered growth in the group. Those have been some winning strategies in terms of picking the right REITs.

**TWST: It seems the stock market in general is much more affected by global issues and events than in the past for a lot of sectors, not just REITs.**

**Mr. Toti:** I think this is true across the board. The old days of being an equity analyst, when you just knew your sector and that was it, are over. I think everybody, from the sell-side analyst to the buy-side PM, has to be a macroeconomist and then an analyst too, especially for any of the rate-sensitive sectors, like the financials, it is particularly true. I think as long as there is above-average risk in the macro landscape, that is going to be the driving call. In multifamily, we hem and haw about picking the right stocks, but at the end of the day, if you made a macro call about multi, and you just put money on almost any of the stocks, you would have been fine. In some instances, the macro call really is the key. Until the world is a little less risky, that is going to remain true. And with unemployment around 9% and GDP growth sinking, it is still a pretty risky environment.

**TWST: We can only hope that improves.**

**Mr. Toti:** I like to think we are just in a bad patch now, and investors will be optimistic again in a few weeks if things start to turn around. Obviously putting this debt issue behind us is critical — a stable U.S. government and financial system backdrop is not an option in today’s world.

**TWST: Thank you. (MN)**

*Note: Opinions and recommendations are as of 08/01/11.*

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# Office & Industrial REITs Focus on Pricing Power

JOHN W. GUINEE III — STIFEL, NICOLAUS & CO., INC.



**JOHN W. GUINEE III** is a Managing Director and Member of the REIT equity research team of Stifel, Nicolaus & Co., Inc. He joined Stifel's research team in connection with its acquisition of Legg Mason's capital markets group in December of 2005. He joined Legg Mason in February 2005. From 2003 to 2005, Mr. Guinee was Executive Vice President and Chief Investment Officer of Duke Realty, an \$8-billion company that is the largest office and industrial REIT in the United States. He was responsible for leading the company's

acquisition and disposition efforts. From 1997 through 2001, Mr. Guinee was an EVP and the Chief Investment Officer of Charles E. Smith Residential Realty. He was responsible for formulating and executing the company's investment strategy. The company sold to Archstone for \$3.6 billion in May 2001. From 1985 through 1997, Mr. Guinee was a Managing Director with LaSalle Advisors — Alex. Brown Kleinwort Benson Realty Advisors Corporation prior to a merger. During that 12-year period, his functions included serving as the Head of the investment department, Co-Head of the asset management department and leading the REIT securities private placement effort. Additional responsibilities at LaSalle Advisors included portfolio management, capital raising and investor relations. From 1982 through 1985, Mr. Guinee was a development manager with Gerald D. Hines Interests in San Francisco. He has an MBA from the University of Virginia Darden School of Business and a B.A. in economics from the University of Virginia.

## SECTOR — REAL ESTATE

**(ACR800) TWST: Please give us a quick snapshot of your coverage universe.**

**Mr. Guinee:** I cover all of the publicly traded office and industrial REITs, with a couple of minor exceptions. Coverage also includes roughly a third of the diversified REITs, specifically those with a strong office focus.

**TWST: What's your overall take and outlook for REITs and why?**

**Mr. Guinee:** Our overall outlook for REITs is that it's all about positive fund flows — individual investors chasing dividend yields and positive returns. The \$450 billion sector is so small and is heavily influenced by the fund flows we're currently seeing. Regarding the overall REIT space, our team has an investment strategy and thesis that growth and quality are the places to be, which has worked very well year to date and worked very well in 2010. To some extent, investing in REITs right now is a process of elimination, where once you eliminate the companies which can't

grow rents, can't grow earnings, are having trouble covering the dividend, your investable universe is rather small. Regarding office and industrial REITs, as an extension of our overall REIT theme, the ability to grow rents and an ability to grow earnings prevails, as those companies which can't grow rents and therefore can't grow earnings in a meaningful way continue to be out of favor.

**TWST: Does that result in the stronger names being highly valued or even overvalued at this point? How are valuations trending?**

**Mr. Guinee:** It is important to note that the REITs overall have the most concentrated ownership of any stock sector in the broader market, and therefore it's a relative valuation situation, where the REIT-dedicated investors are looking at relative value, and to a large extent they're eliminating the companies which can't grow earnings and are essentially value traps. And when you eliminate the companies that can't grow earnings, your focus is on an investable universe of, say, 40 or 50 names. And those names continue to be priced up or bid up as funds flow into this very limited

universe. It is not a situation of overvalue versus undervalue. It's a situation of relative value.

**TWST: Where do you see the growth and quality that you mentioned?**

**Mr. Guinee:** We think that within the office and industrial world, ability to grow rents is very, very limited to some of the well-known office markets, such as Midtown Manhattan and Midtown South, but not Lower Manhattan. And the metro-oriented submarkets within Washington, D.C., and some of the better submarkets in San Francisco, Boston and Los Angeles, specifically, Back Bay in Boston, West L.A. and the South San Francisco Financial District. Additionally, some of the better industrial markets have an ability to grow rents, specifically the Los Angeles Basin, Northern New Jersey and the Baltimore-Washington corridor. So we tend to like those companies which own portfolios where they can grow rents. The other side of the equation is those companies that can't grow rents and are in a situation where their portfolios are 85%, 88% occupancy are going to be stressing the dividend as they have to come up with a lot of cash to regain occupancy up into the 93% to 95% range.

**TWST: What are some of your top picks right now?**

**Mr. Guinee:** We like **Boston Properties (BXP)**, **SL Green (SLG)**, **Douglas Emmett (DEI)**, **ProLogis (PLD)**, **Washington REIT (WRE)** and **Lexington (LXP)**.

**TWST: Is there a significant difference between looking at those gateway-city office markets and the REITs that are more focused on suburban offices?**

**Mr. Guinee:** Yes. If you look at 2010 and then look at 2011 through May, the gateway-city names significantly outperformed. Over the last month or two, the performance has been relatively the same, as there has been a slight but clear shifting into a more balanced portfolio. We think that the upcoming earnings will be very telling as to potential for earnings growth in 2012, and most investors are looking past 2011 and into 2012 for earnings growth.

**TWST: Is that because underlying fundamentals are improving? What are you seeing in terms of economic recovery and the drivers of those fundamentals — leasing activity, rental rates and such?**

**Mr. Guinee:** We see a few themes. One is, we see a clear orientation by employers and those making the leasing decisions to want to be in high-quality space close to public transportation and close to strong amenities, because the types of employees they want to hire demand that. For example, there are numerous examples of relocations from suburbs into more urban, public-transportation-oriented locations in both New York City and the Washington, D.C.,

MSA. Therefore, our focus is on companies which have the highest concentration of assets in submarkets where we think there is a chance to grow rents. Again, the issue is, unfortunately, those submarkets with 20%-plus vacancy are five to 10 years away from having any chance to grow rents, given the relatively anemic job growth in those submarkets.

**TWST: That's a fairly long time horizon.**

**Mr. Guinee:** Unfortunately a healthy economy can, at best, eliminate 1% to 2% per annum of office or industrial vacancy in any particular marketplace, and you have to get down to below 10% vacant to have any chance of landlords having pricing power and having the ability to grow rents.

**TWST: We talked a little bit about suburban versus the gateway-city markets for office. What distinguishes the strongest industrial markets, and therefore landlords, from the weaker?**

**Mr. Guinee:** It is land constraints and inability to purchase land in the right location, such that you can't build any more product. Industrial is a very, very high user of land between parking and truck courts, but you simply have to have landmass usually in the range of 40 acres to build a decent-size industrial building, versus you can put the same amount of square footage on an acre of land in an urban location for an office building. Unfortunately, the fact is that by far there is an unlimited amount of good interstate access land in a vast majority of all industrial markets, with a few exceptions being Washington, D.C., Miami, South San Francisco, Los Angeles, Northern New Jersey and Seattle.

**TWST: Is new development still in check for that property type? It's fairly easy to turn it on or off.**

**Mr. Guinee:** There is so much undeveloped land on the balance sheets of well-capitalized, publicly traded office and industrial companies that they will turn the spigot on and start developing at the earliest possible moment. With their cost of capital being so low and required yields being so low, it just takes a little bit of an uptick in rental rates for the spigot to come on.

**TWST: What about sales transactions? Are you seeing a pickup in activity, and what are property prices and values looking like?**

**Mr. Guinee:** Over the last two years, you have seen a 30%-plus increase in value for any asset with what we call institutional bones, which means a market with growth prospects and a decent-quality physical structure. So that 30% uptick in value has caused transactions to come out of the woodwork, and they're now at 2006 levels in terms of assets on the market for sale. Correspondingly, equity capital oriented for real estate that was on the sidelines for years all of a sudden realized that they have missed the boat, and

### Highlights

*John W. Guinee III offers an overview of his coverage of publicly traded office and industrial REITs. He says REIT investors look for relative pricing power among REITs, and pay special attention to positive fund flows. Gateway cities have outperformed in the last few years, he says, as employers favored better-located office spaces in metro-oriented areas, but lately there has been a return to a more balanced portfolio. Mr. Guinee also says access to capital remains strong among REITs, and the industry is currently more affected by macroeconomic trends rather than particular REIT fundamentals.*

*Companies include: Boston Properties (BXP); SL Green Realty Corp. (SLG); Douglas Emmett (DEI); ProLogis (PLD); Washington Real Estate Investment Trust (WRE); Lexington Realty Trust (LXP) and Simon Property Group (SPG).*



they are aggressively trying to get their money invested for a variety of reasons, such as safety, backed by a hard asset, good inflation hedge, as well as the typical allocation issues.

**TWST: What are your thoughts on the ProLogis and AMB merger? Was it a positive for their shareholders and their business model? Does it have any effects on the broader market?**

**Mr. Guinee:** The devil is in the details on the AMB-PLD merger. We think that the investment market, the institutional investors who invest in REITs, will continue to endorse the merger, thereby providing the merged entity with a low cost of capital, which is necessary for them to run their business in a very competitive environment. The reason that they are endorsing the merger and continuing to push the stock price up has as much to do with how they invest relative to various REIT indexes, investors continue to want to be in all different property sectors, as much as our opinion of the underlying fundamentals. With the exception of a handful of markets globally, it's very difficult to grow industrial rents.

**TWST: How will the merged company perform?**

**Mr. Guinee:** We have a very high opinion of management along all levels within **ProLogis**. We think that they'll get the most out of what the weak global industrial fundamentals will allow them to produce.

**TWST: That was a pretty sizable deal for the REIT universe. Was it an anomaly, or do you expect more M&A activity?**

**Mr. Guinee:** We clearly think of it as an anomaly. If you look back at 2005, 2006, for REIT managements the grass was greener on the private side of the fence. Today, the grass is clearly greener on the public side in that, despite improvements in the overall real estate capital markets, the cost of capital is still very much lower for public companies than it is for private companies, with the exception of apartments. And the risk/return in terms of compensation and wealth creation is highly favorable toward running a public company versus trying to be a private operator.

**TWST: REITs have certainly had good access to capital, both debt and equity. Do you see that continuing to be strong?**

**Mr. Guinee:** We think that will continue to be strong, indefinitely.

**TWST: What about IPO activity? Last year was a fairly active year, but 2011 seems to be a quieter year.**

**Mr. Guinee:** As we talked about earlier, the ownership concentration by the REIT-dedicated investors in publicly traded REITs is very, very high relative to the broader equity markets. The REIT-dedicated investors are the gatekeeper as to what comes public and what doesn't come public, as investment bankers clearly need a majority of the two dozen or three dozen REIT-dedicated investors to endorse the IPO for it to get done. If the REIT-dedicated investors like the portfolio of assets and like management, they will extract their pound of flesh and then beat down the price even fur-

ther, extracting another pound of flesh, but will ultimately allow the company to become public. If they don't like the portfolio and they don't like management, it's an uphill battle.

**TWST: You mentioned if whether they would like the portfolio. Does that mean the few blind pools we saw last year are not realistic this year?**

**Mr. Guinee:** The blind pool window opened and shut very quickly, where some high-quality, well-regarded management teams were able to get blind-pool capital raised. But that was something that is unlikely to be seen again.

**TWST: What are your thoughts on the potential for rising interest rates and inflation going forward? What's the potential impact of those factors on REITs in general?**

**Mr. Guinee:** We think that in the broader REIT market, when you have a slow increase or decline in interest rates, the fundamentals will tend to trump interest-rate movement in terms of investor interest, and therefore, share price movement. In a case where you have rapidly increasing interest rates, which is the scenario that has everyone concerned, it will most likely have a dramatically negative effect in fund flows and changes in people's computation of net asset value for REITs, both of which will cause the hedge funds to jump in and short the space. This will not be pretty.

**TWST: Are there any other broader economic factors or trends that investors should pay attention to?**

**Mr. Guinee:** What we think is happening right now is that global macro forces are having a much more significant impact on REIT pricing than the particular fundamentals for a specific REIT. For example, hotels move much more on global factors, people's perception of the global economy, than they do on the underlying fundamentals of the specific portfolio. **ProLogis** will, in the future, be more and more tied to global economic conditions than the specificities of their largest submarkets. **Simon** (SPG) and the large-cap REITs are in the same situation, where their stocks are moved around much more by global factors than by the specifics of their underlying portfolios.

**TWST: Thank you. (MN)**

*Note: Opinions and recommendation are as of 07/15/11.*

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# Investing in Core Real Estate

V I C T O R B U C C H E R E , C B R I C H A R D E L L I S I N V E S T O R S



**VICTOR BUCCHERE**, Managing Director and Head of U.S. MAG Acquisitions for CB Richard Ellis Investors, is responsible for all aspects of investment acquisitions in North America, including sourcing, underwriting, negotiating, due diligence, investment committee presentation and closing of investment transactions. Mr. Bucchere has been the Senior Acquisition Officer for more than \$8.0 billion of industrial, residential, office and retail investments, and he is the Regional Manager of CB Richard Ellis Investors'

Boston office. In prior positions during 24 years with CBRE Investors, he has been the Lead Acquisition Officer for approximately \$4.0 billion of joint venture development transactions for industrial and office properties throughout the United States and has led the negotiations of several joint relationships with major national development partners. In addition to his acquisitions responsibilities, Mr. Bucchere has served in various asset and portfolio management roles during his 24-year career with CBRE Investors. As a Portfolio Manager, he oversaw and provided strategic direction for one of the firm's largest separate account relationships. Prior to joining CBRE Investors, Mr. Bucchere was Manager of Benefit Plan Investments for the J.C. Penney Company, Inc., and he was responsible for the investment of over \$1.7 billion in defined benefit, contribution and health plans. Mr. Bucchere received a B.B.A. in accounting from Pace University in New York City. He was a Founding Member of the The U.S. Department of Labor and the U.S. Department of Housing and Urban Development's ERISA Committee on Mortgages, was a Charter Member of NAIOP's Industrial Development Forum and is certified as an Environmental Risk Auditor by NAERA.

## SECTOR — GENERAL INVESTING

(ACR504) **TWST:** Please tell us about CB Richard Ellis Investors and the services and products you provide.

**Mr. Bucchere:** CBRE Investors is a wholly owned but separately operated subsidiary of the CBRE Group, which is the world's largest commercial real estate services firm. CBRE Investors is in effect their investment management arm. We currently manage about \$39 billion globally, about half of that is domestically. About two-thirds of the domestic assets are in separate accounts, which is the business that I am involved in on the acquisition side. The remaining third is in commingled funds, in the form of value-added and opportunistic funds and private REITs.

**TWST:** What is your role with the company?

**Mr. Bucchere:** I head up acquisitions, new investments,

for our separate account clients.

**TWST:** Who are your clients?

**Mr. Bucchere:** Our investors are primarily pension funds and other institutional investors, including nontaxable or sovereign wealth entities. We are also an adviser to a public nontraded REIT — CBRE Realty Trust.

**TWST:** How has the market changed for you and your investors with everything that has happened in real estate investing in the last three years?

**Mr. Bucchere:** I am focused on core-plus through core investments. Obviously, core real estate was marked down horrifically after the height of the market in 2007. Values were down as much as any other risk type, in the area of 40%. Those markets, those specific properties in that core risk profile have come roaring

back. These tend to have long-term leases with credit tenants, and as such, the segment has come back quite well — nearly to their highs, and in some cases beyond. That's a function of the fact that the category remained leased. There really has been very little realized transactional experience.

Core real estate also provides stable long-term growth opportunities. It is a good alternative or diversifier to typical portfolios. Being risk averse by nature, it's a place where many real estate investors want to put money now, and that's driven cap rates down and values up. When you combine that with the absolute lack of new supply caused by the credit crunch, the markets are relatively healthy from the supply side. This has been a demand-driven — or lack of demand driven — real estate down cycle in terms of where vacancy rates are. So if we get any bit of growth, stock growth or consumer demand growth that will drive the industrial markets, we are going to see vacancy rates plummet pretty quickly. Now obviously, we've had a couple of hiccups in that in the last bit of time, and more recently over the last week or so, but overall core real estate is still a very good haven. It's acting almost commodity like rather than being cyclical in terms of real estate.

**TWST: How do you define core real estate investments?**

**Mr. Bucchere:** Core real estate would be real estate that is typically leased longer term to credit tenants, so you have very little NOI variances because the leases are relatively long term. So it's fully leased, typically longer term, typically good credit and low risk — thus core.

**TWST: Do the accounts you manage invest in properties, REITs or both?**

**Mr. Bucchere:** We have a separate real estate securities department that invests in real estate investment trusts or REITs. I'm buying real estate. That could be in the form of just outright purchases, through joint ventures, or investment in partnerships and the like. If we were to buy REIT shares, it would be very unusual. Our team does find acquisitions for our REIT. We act as the acquisition and the investment arm of a public nontraded CBRE Realty Trust.

**TWST: So CBRE Investors offers multiple investment programs for investors, including the REIT and some fund-like vehicles.**

**Mr. Bucchere:** Yes. They can invest on the debt side. They can invest through securities. We have a myriad of investment vehicles across the risk spectrum of institutional real estate investing. We invest in all property types too.

**TWST: Would you give us a sense of the investment philosophy you follow, the things you focus on right now?**

**Mr. Bucchere:** For core real estate — and we'll take it from a macro level and then I'll drill down a little bit — certainly we always focus on the large gateway cities such as New York,

Washington, Boston, San Francisco, Los Angeles, Seattle, some of the Texas markets. But those markets being as large and as liquid as they are have the most compressed cap rates, so the opportunities are not as available there as they may be in next-tier markets. I'm talking about markets that are not necessarily known to be 24-hour cities, or not necessarily known to be as liquid as the previous cities that I just mentioned. These are cities such as Denver, Austin, Texas, Minneapolis, that have significant economic and demographic drivers to them — whether it be technology related, medical related or just living related. We're focusing in on identifying those markets where investor demand hasn't driven down yields, where we still see fantastic opportunities for growth. So we're focusing in on those next-tier opportunities. I gave you examples on the office side. We've similarly identified those for industrial as well as multifamily.

**TWST: What are some of the other key macro trends that are affecting things right now?**

**Mr. Bucchere:** Certainly interest rates and debt availability as always have had a direct impact on pricing, and right now there is still a lot of available debt for core real estate. As a result, leveraging this real estate is actually creating yield opportunities, because there still is a spread between where you can borrow and where you can buy. If you can leverage that up or create a multiplier effect for this next-tier concept that I just mentioned, you can get some pretty attractive cash-on-cash yields on a leverage basis with modest amounts of leverage, which will keep it within the core risk profile. So we are utilizing leverage in modest amounts. We are matching debt maturities to lease maturities in a way that would enable us to still exit these properties conservatively. We're also, for some of our investors, buying on an all-cash basis.

**TWST: There's always a lot of chatter about interest rates. And for a long time, we've heard they're going to go up. What's the environment like surrounding interest rates?**

**Mr. Bucchere:** Rather than comment on the direction of interest rates — because that's almost more of a political/economic issue than supply/demand or demographics at this point — let's talk about spreads. The spreads, based upon the term that you want, compressed quite a bit, and with the relatively low interest rates, we have seen very attractive debt. I think what we're seeing over the last 10 days or so is that some of the lending institutions are putting floors in, so that if we have a prolonged period of low interest rates, at least they will go to a floor and stop at that point. Many of these lenders are at least protecting themselves in that matter. Now if this stock market correction goes far beyond where it has gone so far, all bets could be off. We don't know. We'll have to see how the lenders react to that. But we are still seeing a flight to real estate and certainly to core real estate.

### Highlights

*Victor Bucchere discusses CB Richard Ellis Investors' real estate investing strategy, and he focuses on core real estate, which is leased longer term to credit tenants. The firm manages \$39 billion globally, with about half in domestic assets, for a clientele primarily composed of pension funds and other institutional investors, including nontaxable and sovereign wealth entities. Mr. Bucchere shares about his firm, its offerings and his impressions of the real estate market, from trophy buildings in major cities to second-tier markets where CBRE Investors is invested in today. He discusses current investor interest in the sector, and he discusses specific geographies.*

**TWST:** And that has been going on for the better part of two years?

**Mr. Bucchere:** I think it's certainly been going on for about 18 months, and it's created a significant cap-rate compression over the last nine to 12 months.

***"I think investors will still flock to core real estate. It's still very attractive on a yield basis and on a risk basis."***

**TWST:** Where do we go from here? What is your broad-brush outlook for this core real estate segment?

**Mr. Bucchere:** I think it continues to be very rosy in terms of investor appetite. I think investors will still flock to core real estate. It's still very attractive on a yield basis and on a risk basis. It will make it more difficult to buy in the future, I think, because there will be more of an imbalance between available core real estate and the amount of funds searching for it — and in effect chasing it. I won't use the word bubble, but certainly in some markets, returns for core real estate — such as trophy buildings in Manhattan or Washington, D.C., or Seattle or San Francisco — would yield projected internal rates of returns that are below most people's hurdle rates. But their liquidity capabilities and the dynamics of the individual markets probably dictate that some investments in those markets do belong in large-investors' portfolios. We are seeing that leak into other markets, into the less trophy buildings, so core real estate is still a very attractive investment alternative.

**TWST:** Does the second-tier focus play the other side of that coin a little bit?

**Mr. Bucchere:** There has been some spill into those second tiers of cap-rate compression. An example of that would be a Denver, an Austin or a Minneapolis, whereby there are quite a number of investors looking at those markets. I will give you another example: Pittsburgh office. In the last real estate boom cycle very few people invested in Pittsburgh, and Pittsburgh from a supply/demand standpoint is in very good shape. But if you were to look at the drivers of that market — multiple industries, very high educational system, medical system, clean energy as well as oil and gas — there are a lot of things driving that market. Pittsburgh is a very viable next-tier investment market, and as such there have been a number of institutional trades. Probably the top three or four buildings in that market have traded already, in terms of very large office towers, and there are other buildings that are being considered for sale.

**TWST:** The famous phrase is, "All real estate is local," is that largely about geography?

**Mr. Bucchere:** Certainly real estate, beyond where you can borrow money to acquire real estate, is certainly driven by the supply and demand factors, right? The future supply factors are

pretty much in check. So that means you've got to study the vacancy and the available product to lease. The absorption of that is driven by what is driving the markets, which industries are driving the markets that can create the jobs or the growth, which in turn occupy the space. All real estate investment is still local? Yes, it's still local to that degree, but it's more regional in terms of what's driving that market. And then once in that market, you look for the best available real estate.

**TWST:** Do you recommend investors to overweight certain segments, such as office or retail, and underweight others?

**Mr. Bucchere:** Retail tends to be a bit of different animal within real estate. Retail is very much local orientation. If you truly have a location where you have a dominant grocer, it is truly locationally driven, because you can always re-tenant the center in a way that meets the location. But if you have the dominant location — truly infill, where those locations cannot be reproduced — and you have a market — meaning buyers of the retail products within that shopping area — that's probably almost more locationally driven than most other real estate. So retail's kind of a little bit different. We do make market recommendations and product-type recommendations on a market-by-market basis.

**TWST:** "Market-by-market" meaning the geography.

**Mr. Bucchere:** Yes. But we source our investments not only from an top-end research approach — we're really a research-driven firm — but just based upon our acquisition team here, our contacts and the overall platform of CB Richard Ellis. We have a presence in or have invested in every major market and next-tier market, even secondary markets, certainly domestically and almost internationally. So we have a vast reach through the CBRE platform. That gives us an edge over any other institutional investor.

**TWST:** What else gives you a competitive advantage over competitors?

**Mr. Bucchere:** One is the tenure. Our acquisition team averages 20-plus years of working not only together, but in the markets. Two is the CBRE platform. Our parent company is the leading real estate services firm. In most markets, they will have the dominant share on leasing or investment sales or property management. So the information flow that we can get from them, in terms of what is going on in that market, is unparalleled.

**TWST:** And you mentioned you're seeing a lot of investor interest right now.

**Mr. Bucchere:** Yes, I would say that there is very significant interest in core real estate at this point in time. I think that is not an understatement.

**TWST:** What drives that versus other real estate?

**Mr. Bucchere:** There are very few things with the security and the low risk that core real estate offers for investors looking to counterbalance equities. Treasuries certainly aren't providing much of a yield. Cash isn't getting you anything. The bond market is scary right now, because interest rates are so low, so the potential for a rise in interest rates and a drop in prices for bonds can be very difficult. So buying core real estate, a hard asset with a yield from credit tenancy over term, is an attractive alternative. If you could potentially give someone a 6% yield on an annual basis off of a hard



asset with a contractual income stream, that's pretty attractive today.

**TWST:** It's hard to find low risk investments where you can make some money, especially on the yield end.

**Mr. Bucchere:** Yes.

**TWST:** What kind of allocation are you recommending for investors these days when it comes to real estate? How big of a piece of a portfolio should real estate be?

**Mr. Bucchere:** I don't make allocation decisions of real estate versus other asset classes because we only manage real estate. But certainly we are recommending to our institutional clients that core real estate should be a substantive part of their overall real estate portfolio — not all, but a substantive portion.

**TWST:** Are there certain holdings that are representative of your portfolio? Would you give us a snapshot of your portfolio?

**Mr. Bucchere:** I'll give you an example of some properties that we own that are representative of our investments. In New York City, we own 1177 Avenue of the Americas, which is a trophy asset in Midtown Manhattan. We also own a development site in Lower Manhattan that can be developed into very high-end condos, a Four Seasons Hotel. I think last year we may have been one of the larger buyers of core and core-plus and value-add multifamily properties across the nation. We have long-term net-leased industrial real estate across the country in a joint venture with Duke Realty Trust, where they are the operating partner and we are the controlling money on a portfolio with almost \$700 million worth of primarily industrial real estate. We have a large amount of core invested in most major markets.

**TWST:** Are you pushing into those next-tier markets?

**Mr. Bucchere:** We are pushing further into those next-tier markets in effect to attain the yield spread that we would like to maintain, and as yields compress — meaning prices go up — we are having to go a little further out into those next-tier markets.

**TWST:** What makes an attractive investment that's sort of on the outer edges of the markets you work in?

**Mr. Bucchere:** That's really two questions: What makes it attractive? And what makes it risky? Further out on the spectrum would be a market that is not typically a very liquid market from an institutional sense. Although I would say Pittsburgh right now is very liquid, probably nine months or a year ago Pittsburgh would have been questionable from a liquidity standpoint. There is an example of a market that has gone from a very illiquid institutional market to a very liquid institutional market on a next-tier basis. What would make us go there? Excellent drivers of growth, good market fundamentals in terms of supply and demand, fabulous real estate, and some premium in yield.

**TWST:** How about on the other side of the coin? When the yields are low, what makes an attractive investment in those major, 24-hour-city markets these days?

**Mr. Bucchere:** Our larger investors need investments in the larger markets, and they should have a presence in them. But right now, I am not sure we can necessarily justify a core, high-quality investment in New York City, for example, or Midtown Manhattan because the yields may be too low. But if you can find an opportunity, a core-plus opportunity — meaning maybe it's got two or three leases or 20% or 30% of the leases rolling over in the short-term, and we feel that the building lends itself to those tenants being renewed or we may have a tenant that doesn't fit in one of our other buildings that could be targeting those type of buildings — it may be a good opportunity. In other words, if the rollover risk is mitigated in some degree, we may be willing to pursue something like that. We may also have a joint venture opportunity whereby just by structure the risk is lower.

**TWST:** Are there any segments you're concerned about these days, or is everything within the core universe pretty solid?

**Mr. Bucchere:** I think the core universe is pretty solid. I mean we are certainly worried about the FIRE segment of employment — finance, insurance and real estate. Obviously, there have been some recent layoffs and some earnings pressure in that segment, and we're seeing some cutbacks there as well as space consolidation there, and that segment is a major space user.

**TWST:** Are you concerned about employment and how that would affect the core real estate market?

**Mr. Bucchere:** I'm worried about markets that have an exposure to the FIRE category of lease occupancy. For example, Lower Manhattan has a large exposure to financial services. They may not need as much space in the short term as they originally thought they did. We may see some pullback here. Washington, D.C., suburbs may see some cutbacks related to the budget deficit reduction. We're certainly aware of those kinds of things.

**TWST:** On the whole, is this an area that holds up pretty well regardless of the overall economic climate?

**Mr. Bucchere:** I think our company view is, although our projected recovery in rental rates may have flattened a bit and may be pushed out a little bit further — caused by this time of economic uncertainty — that the recovery will still occur.

**TWST:** Thank you. (MJW)

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# Investing in Private Mortgages

ALIM KASSAM, RAMA CAPITAL PARTNERS, LLC



**ALIM KASSAM** is the Chief Executive Officer of Rama Capital Partners, LLC, and the President of Athas Capital Group, Inc., both companies that he co-founded. Mr. Kassam began his career as an Investment Banker with Lehman Brothers Holdings, Inc., where he worked with private equity firms to source and finance leveraged acquisitions and to develop strategic alternatives for their existing portfolio companies. He also worked with global industrial companies across a range of corporate finance projects including mergers

and acquisitions, all branches of debt offerings/underwriting, and public and private equity offerings. Mr. Kassam then joined CapitalSource Finance, LLC, where he focused on making secured debt and mezzanine investments in health care companies. After CapitalSource, he joined Pacificor, LLC, where he was the Senior Credit Analyst focusing on stressed, distressed and special situations credit opportunities. Over his tenure, Pacificor's returns outperformed the high yield indices by over 10% per year and the firm's assets under management grew to \$600 million from \$200 million. Mr. Kassam then joined Quality Home Loans, the nation's largest equity-based residential mortgage lender, as its CEO one week after the company filed for Chapter 11 protection. In addition to managing the day-to-day operations of the company, he was responsible for navigating the bankruptcy process and architected a \$167 million securitization. Mr. Kassam serves on the advisory boards of LoanMLS, Inc. and iVision Mobile, Inc. He graduated cum laude from the University of California, Los Angeles, with a B.A. in business economics and a minor in accounting.

## SECTOR — GENERAL INVESTING

(ACR500) TWST: Please give us a background of Rama Capital Partners.

**Mr. Kassam:** Rama Capital Partners is the managing member of our fund, The Rama Fund, which is a private mortgage fund. We lend nationwide and help borrowers who can't get traditional financing from a bank. Our Fund was formed 34 months ago, and we've made money for our investors every month since our inception. We average about 0.81% a month net returns, which translates into about 10.2% a year. The company was formed three years ago by myself and my partner Brian O'Shaughnessy. Brian has been in the mortgage business for 25 years, and I was formerly an Investment Banker and worked at a distressed hedge fund. I became involved in a mortgage company, where Brian was the President, and then we formed our own venture. Our Fund focuses on trust deed/mortgage investing. A trust deed is essentially a mortgage.

**TWST:** Your literature mentions you allow investors

to overcome the traditional hurdles to participation in this asset class. What are the traditional barriers to entry in this class?

**Mr. Kassam:** Normally, if you are a certain individual and you want to invest in a mortgage or a deed of trust, you have to find a borrower that wants to borrow the money. You have to underwrite the asset and the cash flows and the borrower's ability to repay. That is an extremely high barrier to entry. What we do is offer our investors a fund where we have many trust deeds in the Fund, so an investor can invest in the Fund and own a piece of each of the mortgages that we already own and a piece of all of the ones we will own in the future, very similar to a mutual fund. When you invest in a mutual fund, you own a small piece of all the stocks that they own in different companies. So it's a very similar pooled concept. It alleviates the burden of the individual investor having to find a borrower and underwrite that particular mortgage loan. They can invest in our Fund and get a pure passive investment and still have exposure to this secured, uncorrelated asset class.

**TWST: Why is this a good place to invest right now?**

**Mr. Kassam:** As I mentioned before, we've been paying our investors 10.2% a year on average, net of all fees. When you stack that up against other asset classes, I think that's a very good absolute return. And then when you look at it on a risk-adjusted basis, I think pound for pound, it is the best investment that I'm aware of. In addition, we know what our investors earn, but on average, we're lending our borrowers about 42 cents on the dollar against their collateral. All of our loans are in first-lien position. All of our loans are personally guaranteed by our borrowers. Real estate would have to go down about 60% from today's prices before our portfolio would get impaired. So you have a lot of equity cushion buffering our investments, and we're getting very good absolute and stellar risk-adjusted returns.

**TWST: There is obviously a lot of negative press about the real estate market. Is this type of investment significantly related to the state of the real estate market?**

**Mr. Kassam:** We're not actually investing directly in real estate. We're lending money to people who own real estate. So we're one derivative away from actually investing in real estate. We're lending on average around 42 cents on the dollar, based on what a property is worth today. We believe that there is still room to go down in real estate nationwide. We're cautiously pessimistic still about real property prices. But again, we're banking in such a large equity cushion that buffers our investment that if we're lending somebody 42 cents on the dollar that means that real estate would have to decline 58% before we would potentially be impaired.

**TWST: What in general is your investment philosophy and strategy?**

**Mr. Kassam:** Generally, we are pairing people who have excess capital with those who need it. Our investment philosophy is that there are a lot of good borrowers out there that can't get a bank loan for a lot of different reasons right now, either because they're a good credit borrower that is getting a good deal on a property and they have to close in 30 days, where a bank might take three or four months, so they need money quickly and we can close as fast as two weeks. The borrower might be self-employed, which makes it difficult to qualify for a bank loan. We will underwrite a loan looking at the cash flow of the property relative to our interest payment. So where a bank looks at DTI, or debt to income of the borrower, we look at DSCR, or debt-service-coverage ratio, which is the cash flow of the property relative to our interest expense. So we can help people who are self-employed that don't show a lot of income. We can help people who need to close a loan quickly that need financing, and we do help people that may not have perfect credit where a bank might turn them down, but we will look primarily at the equity value of the property and how much

equity cushion is buffering our capital. Secondly, we will then look to the borrower's credit score and their income and the strength of the borrower. Our primary focus is on the underlying collateral.

**TWST: How do you get those mortgages to fund?**

**Mr. Kassam:** There's a couple of different ways. We have a database here of over 600,000 brokers and realtors nationwide that we directly market to in e-mail campaigns at least once a week or more. We advertise in a lot of trade publications, and we've been on the radio and other forms of advertising.

But I think the important thing to really drill home is that recently **Fannie Mae** (FNMA.OB) put out their expectations for 2011. They expect a little over \$1 trillion of residential mortgages to be originated nationwide. Furthermore, Ben Bernanke came out and said that one out of four mortgage applicants today will be denied who could have been accepted for conventional financing two years ago based on FICO and different income documentation requirements. So \$1 trillion is actually expected to be funded, and

we know 25% of the people get rejected. That would imply that there's over a \$300 billion market of people that need a loan that won't be able to get it from traditional sources just this year alone. We are trying to fill that void in the market and trying to help those people who otherwise wouldn't be able to get financing.

We lend on residential and commercial properties nationwide, and the figures I just mentioned were on only addressing the residential side. So the total market opportunity for private mortgages is tremendous, and we do well for our investors. But at the same time we're helping borrowers who otherwise would have been faced with hard times if we were not able to provide them liquidity they needed.

**TWST: How do you select which of those mortgages go into the****actual Fund?**

**Mr. Kassam:** For the most part, every loan that we approve here gets funded by our Fund, and we vet it thoroughly. For example, we might get 20 loan applications, and maybe we issue a LOI, or a letter of interest, on say 10 of them, maybe five of those 10 execute, and maybe we'll fund one of those. We're extremely selective. It's kind of like mining for gold right now, where you get a lot of stuff coming in the door, and you have to sift through it, and filter it down to find the mortgages that we feel offer a good risk-adjusted return for us to put our discretionary capital to work.

**TWST: How many mortgages would you like to have in the Fund at one time?**

**Mr. Kassam:** As I alluded to the size of the market earlier, it's a tremendous opportunity to the tune of several hundred billions dollars per year. The market is huge, and our dream is to one day have a \$1 billion loan portfolio or larger. I certainly think that the demand is there, and we just have to keep working to raise

**Highlights**

*Alim Kassam explains the strategy of The Rama Fund, which focuses on trust deed/mortgage investing. His company makes loans to commercial and residential borrowers who may be unable to get traditional financing from banks. He says the Fund averages about 0.81% a month net returns, which translates into about 10.2% a year. Mr. Kassam also discusses his outlook on the real estate market, and he says the Fund does not directly invest in real estate, but the mortgage holders. He shares how thorough vetting of borrowers helps mitigate the Fund's risk.*

*Companies include: Federal National Mortgage Association (FNMA.OB).*

capital to meet that demand.

**TWST: Do you sell your mortgages?**

**Mr. Kassam:** Sometimes we do sell our mortgages.

**TWST: So then they would go out of the Fund at the point they are sold?**

**Mr. Kassam:** Correct.

*“Every investor’s investment portfolio should have some allocation to trust deeds. It’s a great opportunity to get exposure to the fixed income arena. It’s a secured investment, and very importantly, it’s uncorrelated to the rest of the investors’ portfolio and the broader market.”*

**TWST: Your Fund is relatively new, but how often do you anticipate turning mortgages over in the Fund?**

**Mr. Kassam:** It’s really a function of the market and our liquidity needs to some extent, but we underwrite every loan from the perspective of a portfolio lender. And if it were up to us, if we had unlimited liquidity, we would hold everything that we originated. Now, we do sell things from time to time. Everything that we do sell we retain the servicing rights to, and we actively master-service those loans. We do have some investors that do not want to be in a comingled fund but want an exposure to this asset class. So we offer them separately managed account options, where they can buy an individual trust deed from us, and we will manage it for them.

**TWST: How many mortgages are in the separately managed accounts?**

**Mr. Kassam:** We have some investors who have a few mortgages, and we have some investors who just have one. And whether they have one or three or five with us, we will manage everything that they purchase from us, then from the time they make their investment all the way through the time that they get repaid.

**TWST: You talked about your outlook for the real estate market, but in terms of the mortgages, what are the most important factors you’re watching right now?**

**Mr. Kassam:** Certainly we follow the unemployment rate. I think it’s historically been correlated with home purchase activity and refinancing, and indirectly that translates into the direction of home prices. We follow vacancy rates and follow all the general macroeconomic indicators of where the economy is going.

**TWST: What types of investors should consider trust-deed investing?**

**Mr. Kassam:** Every investor’s investment portfolio should have some allocation to trust deeds. It’s a great opportunity to get exposure to the fixed income arena. It’s a secured investment, and very importantly, it’s uncorrelated to the rest of the investors’ portfolio and the broader market.

All the loans that we are writing today are short-duration loans with fixed interest rates. So interest rates can go up or down, but in our portfolio we know what the yield is that we’re going to

earn. The stock market can go up or down. Coffee prices, gold prices, all of these things can move, and we are very much uncorrelated to them. Every loan that we make is like it’s own individual private investment with a defined yield that’s going to be delivered to the investor or our Fund. Since everything is secured by underlying real property, if a borrower ever breaks their promise to deliver to us, our agreed-upon yield, then we have a mechanism to enforce it. We hope all our borrowers make their payments to us, and in fact, we’ve had very low delinquency rates and default rates, and we’ve had very few loans go to foreclosure. But in an event that that does happen, our investors are well protected given our very conservative loan to values.

**TWST: How do you mitigate that risk in your Fund?**

**Mr. Kassam:** Before we fund a loan, we do a lot of homework. We’re much different than other bridge or hard money lenders or other private mortgage lenders, and I always tout my partner’s extensive background in the industry, but we thoroughly underwrite our files. They are much more complete than many of our peers, and our investors and other banks that we work with have testified to that.

Our packages are very thorough. We do a lot of work upfront to verify, and get comfortable that a borrower is going to have the ability to make all of his interest payments and principal payments to service our debt. And then we’ll have a good exit strategy on how they will be able to repay us. And even after all of that underwriting on the borrower, we do a lot of work evaluating the collateral value that’s securing every loan that we make. We do not just rely on appraisal values. We do a lot of work in-house to come up with our own internal value for every property that’s securing every mortgage that we invest in. The combination of stringent underwriting on the borrower, in-house determination of the value of the collateral, combined with very conservative loan-to-value metrics has helped to insulate our investment portfolio, where we’ve funded hundreds of mortgages over the last 34 months. And not only have we never lost money in a single month: We’ve never lost even a penny on a single transaction. By the way, our returns have been fully audited every year since our inception.

**TWST: Geographically, are there certain areas that you tend to avoid right now?**

**Mr. Kassam:** Yes, on the residential side we only lend currently in Nevada, Arizona and California. We’ll soon be expanding into some other states like Utah and Oregon. On the commercial side, we lend nationwide except Michigan and Vermont.

**TWST: Why do you only participate in Nevada, Arizona and California on the residential side?**

**Mr. Kassam:** We’re here in California, so we wanted to be able to lend here. There are licensing requirements that define our area, and right now we’re working on expanding into some of the other Western states. We really like California, and in fact, a lot of the Western states have been some of the hardest hit, particularly California and Arizona and Nevada. We think that those areas have bled a lot, and it’s a good time to start gaining exposure to them.

**TWST: And why don’t you lend commercially in Michigan and Vermont?**



**Mr. Kassam:** On the commercial side, we're licensed to lend in all 50 states. It's our decision to stay out of Michigan and Vermont. We just are weary about where real property prices are going in those areas.

**TWST: Do you do first and second mortgages?**

**Mr. Kassam:** We only invest in first mortgages. If we do take a second lien, it's usually as additional collateral, where we are cross-collateralizing a first mortgage with another property that we will take a second on. Opportunistically, we will evaluate second liens, but we've never singularly invested in a second lien transaction to date.

**TWST: Please tell us about your background.**

**Mr. Kassam:** I went to UCLA, and then I worked for Lehman Brothers in investment banking for a couple of years. I spent some time at a company called CapitalSource, which is a big public specialty finance lender. And then I spent a little over three years at a distressed debt hedge fund in Santa Barbara called Pacificor, where I was one of three Principals managing over \$600 million.

**TWST: What particular area of investing is interesting or exciting to you? What do you like about it?**

**Mr. Kassam:** Through my time at Lehman Brothers, I was involved in issuing all kinds of investments and securities, whether it was bank debt, secured corporate bonds or high yield

junk bonds, working on equity offerings, IPOs and things of that nature totaling several billions of dollars. When I was on the hedge fund side at Pacificor, I was involved in buying a lot of the same types of securities that I was selling and underwriting while at Lehman Brothers. So I've been involved on both sides of the equation, the buy side and sell side, all up and down capital structures. When I look at the opportunity for mortgage investing today, it is pound for pound the best risk-adjusted return that I've seen in my entire career. Every investor should have an allocation to trust deeds, whether they achieve that exposure through my company or not. This is the time for smart investors to seek alternative investment platforms, particularly those that are uncorrelated to the fickle capital markets.

**TWST: Thank you. (LMR)**

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# Campus Crest Communities, Inc. (CCG)



**TED W. ROLLINS** is the Co-Chairman of the board of directors and the Chief Executive Officer of Campus Crest Communities, Inc. Together with Mike Hartnett, he founded Campus Crest Group in 2004. Mr. Rollins' core focus has been on operations and finance, while working together with Mr. Hartnett to source development opportunities and oversee construction. Prior to founding Campus Crest Group, Mr. Rollins and Mr. Hartnett cofounded and managed companies that successfully developed and operated service-enriched housing properties. Mr. Rollins is an Owner of MXT Capital, which is a holding company whose primary holding is its interest in Campus Crest Group. Mr. Rollins has also led several private real-

estate-focused investment funds. From 1998 through 2002, he was President of St. James Capital, an investment company focused on research-based structural land investment and niche income property opportunities. From 1991 to 1996, he served as President of The Balance Group, a private equity investment group focused on investing in and providing advisory services to small operating companies. Mr. Rollins founded The Balance Group in 1991. He was President of Rollins Investments, Inc., a real estate development and property management company with investments in retail, hospitality and mixed-use developments from 1988 to 1991, and Chief Financial Officer of RealtiCorp, a research-based land fund which focused on procurement of land for multisite users such as retail chains, restaurants and convenience stores from 1996 to 1998. He began his career at Drexel Burnham Lambert as a real estate investment banker in 1985. Mr. Rollins received his BSBA from The Citadel and his MBA from the Fuqua School of Business at Duke University.

## SECTOR — REAL ESTATE

**(AVG600) TWST: Please give us a brief history of Campus Crest Communities and an overview of the company and its operations today.**

**Mr. Rollins:** We started about seven years ago. We basically looked at the student housing market, and it was apparent that there was a real need for our product — not only in primary markets, but even more so in secondary markets, which is our main focus. If you think about it in terms of any given state, you'll have a flagship campus — for example, in North Carolina, where we're based, UNC Chapel Hill is the flagship — but you'll also have a lot of great schools like UNC Wilmington, UNC Charlotte, UNC Asheville, these are all schools that need additional beds to continue to grow or to replace some obsolescent beds on campus. That really has been our primary target. We've spent seven years working on these markets, such as UNC secondary schools, or in states such as Texas, where we have a large number of properties.

If you look at the industry as a whole, there are two general comments that you can make. One is that there is a limited supply. It's constrained because of the lack of capital available, and it's constrained with state budgetary cuts over the last few years. But at the same time, there is a growing demand. There are more kids going to college. They're staying longer. And although the Baby Boom's children, the Echo Boom, growth is dipping slightly over the next few years, this attendance is still at record levels. In addition to that, if you look at total enrollment, growth is continuing

because the graduation rate at high schools is up. And of these graduates, a higher percentage are electing to attend college full time. In addition, foreign enrollment is on the rise. So those components are pretty compelling.

For us, it was important to create a company that could deliver a standard product in any market across the United States. And so what we did was we made a decision in the beginning to create a portfolio of companies that could execute this strategy and control the process from start to finish. We have five primary operating companies that support this effort: a development company, a general contracting company, a wholesale supply company, a property management company and an asset management company. We refer to all of this as a vertically integrated enterprise, and we've worked hard to build that over seven years. We believe this vertically integrated business model enables us to deliver properties economically while maintaining consistency in our building design, construction quality and amenity package. We continue to refine our processes and systems in an effort to reduce costs and improve quality.

If you look at us today, we have five solid portfolio companies that design, build, supply, manage and asset manage 33 properties with a robust pipeline of new projects. Six of the 33 are under construction, but they deliver next month, so I count them in the mix. Over the last seven years, we've grown at an average compound annual growth rate of about 93% a year. The next step for us is to continue to broaden our national footprint. We believe that there are 200 markets that fit our profile. It's about going out there

and providing great service and a great product to our residents and being a responsible member of the local communities in which we operate, and over time continuing to grow our footprint.

Furthermore, unlike a traditional apartment complex or a lot of student housing complexes, we focus on the life-skills portion of the residents' experience, so we tend to be a little more residence life and hospitality focused than most. And by that I mean we have an ongoing residence life program that we think makes a big difference. If you look at the students, they basically have the whole academic experience at school, but on the life skills and social infrastructure of the whole college experience piece, we use our programs to complement the academic experience and round out the entire experience. We have a proprietary program that we've developed over seven years called SCORES, which stands for Social, Cultural, Outreach, Recreational, Educational and Spiritual. And if you look at our properties, on any given day we're running those programs constantly. What that really does is it creates a social infrastructure for the students. We have happier residents who are more connected. They build their social infrastructure at our properties, and they overall have a better experience and stay longer. So it's a great thing that we do, and it has taken quite a bit to develop. We're fortunate enough to attract and retain some great people that work for us. Nowadays it's even more exciting, because many of the leaders and future leaders of our company are folks who started off with us as a resident.

**TWST: I believe you recently added someone specifically to head development efforts. Would you introduce us to some of your key senior team members?**

**Mr. Rollins:** We have a great leadership team. Mike Hartnett and I started the business together. He is our Chief Investment Officer, and he has a great feel for where to put the projects and how to develop them. On our finance side we have Donnie Bobbitt. Donnie is our CFO, and he is one of the best I've ever worked with. He is very focused, and he understands the operational side of the business as well. And so he is not just another accountant that's keeping score. He's very interactive with the senior leadership team. Then we have Earl Howell, who is our President and Chief Operating Officer. Earl is a seasoned operational veteran. He's done a great job. Then we have Rob Dann, who heads our property and development companies. Rob is one of the team members who just joined us. He came from CSM Lodging. At CSM he oversaw 2,500 employees and approximately 40 properties with a wide footprint, so he has extensive experience with all facets of development and property operations. And then we have Brian Sharpe, who heads our construction company and makes the magic happen out in the field. He has, year after year, designed and improved our projects. He is the reason we have such great projects — anything from the details of the design, to integrating with our operations team to make our projects better every year, to actually delivering the projects each year. He is very passionate about what he does.

In addition to these people, we have a great group at the VP level supporting us, as well as the hundreds of associates in the field that make things happen every day for our customers. With us it's all about the human element, and I can confidently say that our folks have gotten better and better every year. I would also tell you that our team and the guys I just told you about have a great

ability, capacity and focus on improving us each year. For our team, it's all about being the best we can be and focusing on getting better year in and year out.

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***"Unlike a traditional apartment complex or a lot of student housing complexes, we focus on the life-skills portion of the residents' experience, so we tend to be a little more residence life and hospitality focused than most. And by that I mean we have an ongoing residence life program that we think makes a big difference."***

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**TWST: Please give us an example of a property that typifies a typical Campus Crest asset.**

**Mr. Rollins:** We build a prototypical property, which means that market to market they are very similar. Our projects all have a common brand that's called The Grove. So typically you get the same experience property to property. We strive to keep the experience consistent. One, for example, would be our newest-generation project we have opening in Valdosta, Ga., this year. Our latest prototype properties have approximately 600 beds and a full complement of amenities to engage the residents in our residence life programs. These amenities range from fire pits to grilling areas to resort pools to sand volleyball and basketball courts. We have a clubhouse that has evolved over the last seven years to one of the better clubhouses in the industry, and it's designed with a lot of function in mind, creating spaces for our residents to study, socialize, exercise and engage in a variety of activities.

If you think about all that in one building, it's a fairly interesting exercise putting that program together. We've added things over the years such as tavern-style game rooms, which look like a tavern and really have a great feel to them. We've added coffee bistros with fireplaces and soft seating, kind of our version of a coffee shop. We have libraries where they can study with long wooden team tables, just like those you would find in an Ivy League library. Then we have state-of-the-art exercise rooms that are a great place to work out. All that's kind of in the center of activity hub, which centers around the clubhouse. As mentioned earlier, we also have a complete array of outdoor activity areas as well. For us, it's about creating spaces where the residents can socialize, enjoy themselves and build lasting friendships and memories of their college experience. Creating an environment that caters to the needs of today's college student helps us attract new residents and retain existing ones.

This year we are focusing on adding a sustainability component to our projects. This includes everything from the way we think at our corporate support center to the way we build our projects to the way we educate our residents on sustainability. And there are some really interesting things evolving out of this, such as alternative building designs, alternate power sources and new residence life programs. Stay tuned as we are just getting going here.

Our goal is to engage every resident and to get them active in both our community and the community at large. One way we accomplish this is through one of our more popular programs,

the GO Team — “GO” stands for “grove outreach.” We develop programs at each property for our residents and work with them to do different projects in their community, anything from Habitat for Humanity to blood drives to tutoring kids to hosting a day for the local orphanage to bring their kids to the pool. It’s really about teaching our residents the value of thinking about how they can help others and creating that outreach mentality. It’s a very popular program in our projects.

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***“We’re on our guidance, and we had a solid margin at the property level. And although our teams are never satisfied, this continues our trend of year-over-year improved performance.”***

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The biggest part of what we do is creating an unparalleled living experience for our residents. We have some of the nicest projects you have ever seen from a bricks-and-sticks perspective. Our properties feature some of the biggest bedrooms, bathrooms, closets and living rooms in the industry. All with our custom-made furnishing we design to have a Pottery Barn-like feel so it’s not just some institutional tube-steel stuff.

There are many great things about our projects from mom and dad’s perspective as well. They all rent by the bed, so there is no liability for your suite mates. They all include furniture and all utilities, including Internet/cable. So everything is one-stop shopping for mom and dad. If you send your son or daughter to live with us, it’s one check every month that’s all inclusive. You don’t have to lug stuff up stairs. And then while they are there, it’s a great way for them to create a social infrastructure with life skills and memories that will last them a lifetime. Parents can also feel good about security as all our communities are gated.

**TWST: Would you say that’s one of your main competitive advantages? Is it offering all those amenities and that lifestyle?**

**Mr. Rollins:** Yes, I think there are several competitive advantages. First, we have tremendous buying power and cost advantages from our internal general contractor and supply company that passes along value to our residents in the form of a better project. This also creates compelling value for our investors who experience a higher return on assets. Second, we have developed a place for our residents to grow and have a fuller college experience. Our residence life programs are first rate and they create the resident experience. Third, we have some of the best and brightest people that work for us in our various entities, and they work tirelessly to continually improve our company for all its stakeholders. I think all this creates a powerful combination.

**TWST: I believe your most recent quarterly results you are able to discuss are from the first quarter. What are the key takeaways?**

**Mr. Rollins:** If you look at it, we’re on our guidance, and we had a solid margin at the property level. And although our teams

are never satisfied, this continues our trend of year-over-year improved performance. The takeaways are that the team in place is focused on the properties and running the business, and I think they are doing what they said they were going to do. We are also focused on delivering our next group of development properties. As a company, we’re going to continue to focus on executing our plan, try to find ways to lower costs while improving operations and work to create long-term value for our shareholders. Our team is very excited about our business and its long-term prospects.

**TWST: There was a net loss, although it was lower than the prior year’s comparable period. Would you discuss that and when you think you’ll turn the corner into profits?**

**Mr. Rollins:** That’s interesting because it really gets into talking about our REIT structure. Keep in mind, REITs make a tremendous amount of cash flow from operations, FFO, and the reason there’s a loss for a REIT is because there is a large amount of depreciation coming from all of the buildings we own. This depreciation is noncash, but creates the loss on a GAAP basis. That is why as a REIT, we’re measured on what our FFO or cash flow are versus our earnings. So if you look at our first-quarter FFO, we made \$5.1 million. We have great positive cash flow. We pay an annual dividend, which produces a yield of about 5% for our shareholders. This is in the higher end of the range for what most companies pay. In addition to that, we’re lowly leveraged. We only have somewhere on the order of 30% leverage. As a REIT, we’re managed by — and the Street watches — our FFO. So that’s really the key number, and we have solid FFO and our balance sheet is in great shape.

**TWST: The next academic year is around the corner. How is leasing looking for this academic year, and what’s your outlook for the company overall for the rest of the calendar year?**

**Mr. Rollins:** As of the beginning of June, our leasing on our operating properties was ahead of last year by more than 10 percentage points. And that’s attributable to our teams in the field, our improved systems and getting an earlier start. Also, if you think about the average age of our properties, it’s 2.5 years. So out of our portfolio there are a meaningful percentage of them still stabilizing. So as they continue to stabilize, you should get higher occupancies in the year-over-year numbers across the portfolio. Looking ahead, I can tell you for us it’s just all about continuing to grow our human capital, our portfolio and increasing our FFO. Our teams are focused on that.

**TWST: Would talk a bit about your development pipeline and your joint venture with Harrison Street?**

**Mr. Rollins:** We have two types of projects, the ones we wholly own and then there are the ones that we joint venture with Harrison Street. The reason we joint venture with Harrison Street is to manage our balance sheet risk. We maintain a development pipeline of approximately 80 potential projects. Although this may sound like a big number, it actually works well with our program, so allow me to explain. At any given time, we’re working on roughly 80 given markets. And for us, it’s important to note we typically do not buy land that’s on the market. We’ll look at the market, we’ll understand the market, and then we’ll find the land that best fits what we want to do — 90% to 95% of the time, that property is not for sale, so we spend a lot of time speaking to owners of the land and working in the market. So out of that 80, there are roughly 50 markets that we’re still trying to get the right piece of

land under control in. Then there are 20 opportunities where we are finalizing the terms of our agreement and beginning diligence and our entitlement process.

Some markets may take two years to get entitled, some may take one year, some may take three years. But that 20 is basically on average what we have working, going under contract, through diligence or in entitlement. So you've got 50, 20, and the remaining 10 are ones that are generally ready to build in any given year. These are the properties that are going through their final stages of entitlement and getting their permits. So it's a pretty robust pipeline we've built over seven years. Mike or I and our senior leadership team have personally been in every one of these markets. This process is managed by a great team of people. We have made some recent hires to round this out and promoted a great person from within. I like to call them our development dream team. They are really hard workers, have great experience and are very focused. They just keep making it better every day.

**TWST: What criteria do you look for when selecting that land? Proximity to campus must be number one.**

**Mr. Rollins:** Yes, it is. We do quite a bit of research on the market. Typically we'll underwrite the market, and then we'll underwrite the specific piece of land. In any given transaction, we're underwriting a couple of parts of the market — the demand generator, which is the school, obviously, and then the competitive set within the market — and then the land specific. We have a very thorough due diligence checklist that goes through everything, from water/sewer availability, tap fees, water rights if you're out West, future tax implications, cost to build, climate zone, what's the fall in the land, where is the sewer invert, everything from soup to nuts. And most of that we've built up over a career. We've done this for 25 years in different industries. Basically, every time you make a mistake you write it down so you don't make it again, and so we've developed a checklist that's pretty comprehensive.

The team works very diligently on different levels of underwriting. When we're underwriting the school, we're meeting with the school's administration, we're meeting with the school's professors, we're meeting with the athletic department, we're shopping at the bookstore. We are pretty grassroots and hands on, and I think that makes a difference. All of our companies — whether it's development, construction, property management — share that same mentality. In this office here, which we call the support center, we realize

that our operations are centered around supporting our teams in the field. Our culture here has always been very field oriented. So if you think about us, we're out every week at our properties, both those in operation as well as those under construction, as well as our future projects. I would say we spend at least 200 days a year out in the field, and that's the senior leadership. We spend a lot of time, and that's encouraging. We want that hands-on approach.

**TWST: What led to the company's decision to go public late last year? Was it to help finance the growth you have in mind?**

**Mr. Rollins:** If you look at many companies' life cycles and growth, it's important to have the right capital structure given the context of the market. And if you look at the overall capital markets in the real estate business, it's pretty compelling that you want to have a lower leverage business as you grow over time. As we grew, first we started with friends and family equity, then we went to institutional equity with Harrison Street, and then the next natural step in our evolution was to go public and lower our leverage even more. As we grew our business and had new and increasing capital demands, it became apparent that what we really wanted to do was raise enough equity to lower our debt down to a low percentage. That gives us a strong balance sheet, which is a competitive advantage on the banking side of things. This allows us to continue to grow. We need to have efficient access to capital, and that's what this provides.

**TWST: Is there anything else that you'd like to add about the company?**

**Mr. Rollins:** I would just say the driving force here is our people, and they are energized. It's all about growing and being responsible as we grow. For us, it's been a great seven-year run, and we're looking forward to the next seven years and beyond.

**TWST: Thank you. (MN)**

**TED W. ROLLINS**

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# Entertainment Properties Trust (EPR)



**DAVID M. BRAIN** is President, Chief Executive Officer and Trustee of Entertainment Properties Trust. He acted as a consultant to AMC Entertainment in the formation of the company in 1997. He served as Chief Financial Officer from 1997 to 1999 and as Chief Operating Officer from 1998 to 1999. Previously, Mr. Brain served as Senior Vice President in the investment banking and corporate finance department of George K. Baum & Company from 1996 to 1997 and Managing Director in the corporate finance group of KPMG LLP from 1984 to 1996. He earned a B.A. in economics with honors and an MBA from Tulane University. Mr. Brain is a Certified Business Appraiser with the American Appraisal Association and the Institute of

Business Appraisers. He is a member of the board of governors of the National Association of Real Estate Investment Trusts and a Director of Segway Experience, LLC, and previously served on the boards of Capital for Entrepreneurs, Inc., Center for Business Innovation, Inc., and Council for Entrepreneurship at the University of Missouri-Kansas City.

## SECTOR — REAL ESTATE

**(AVG601) TWST: Please start with a brief history of the company and an overview of your operations today.**

**Mr. Brain:** Entertainment Properties Trust is about 14 years old. The company was started in 1997 at the dawn of the megaplex theater, which was pioneered by AMC Theatres of Kansas City. AMC changed the industry by shifting from the multiplex-theater model of six to eight screens to the megaplex-theater model of 14 to 24 screens, and by doing so created a high-selection, single-location development. Their efforts successfully established the megaplex theater as a new generation of property, which was a big-box retail equivalent.

The new model was very capital-intensive for an industry not used to a lot of capital formation, and which had historically operated by leasing their premises. The real estate industry was not familiar with this new concept. No one was really available or willing to finance these types of developments. It was very expensive, so AMC pioneered a couple on their own. They loved the results, but couldn't get anybody to build more for them because of how new the concept was, and thus I helped create an off-balance-sheet financing company. I was one of the people who formed Entertainment Properties Trust, one of the original shareholders, and raised capital for it.

So Entertainment Properties Trust started financing the development of this new generation of movie theaters, the megaplex theaters, and we followed that course of exclusively investing in them — not just with AMC, but with all the leading theater operators in the industry. We did this for about eight of our 14-year history. As that renewal cycle began to mature a little bit and opportunities slowed down somewhat and we enjoyed the track record of successfully investing in the new generation of properties in a very questioned — but actually very durable — industry, we began to ask ourselves: Could we do more than just cinema investing? So we began to look outside it. Now the company has expanded to in-

vest in multiple categories, including what we call metropolitan daily attended ski areas — these are ski areas without a lot of bed base. People tend to go to them on a daily basis. They very often look like terrain parks and snowboarder parks. They're not resort skiing as much as they are daily attendance that caters to metro areas — and charter public schools.

Although we invest in multiple categories, we don't consider ourselves to be a diversification-focused REIT, which a lot of net lease REITs are. They tend to focus on diversification as a hedge against risk. We focus on knowledge and depth of knowledge as a hedge against risk, and make big bets in very select areas we know a lot about.

We think the ski parks I just referenced are a new generation in skiing, and so too are charter public schools a new generation in public schools that are not connected with the traditional financing mechanism of school bonds for school districts. As a result, they need a mechanism to finance their real estate needs, and we have stepped in to fill that role. So that is really the company's history. We're a very specialized investor in multiplex theaters and in new generations of emerging and very durable, long-life industries of ski parks, and most recently, education. We also have some peripheral things we've invested in, but those are the main events that form the history and current status of what EPR is.

**TWST: You made reference to net leases, and you typically structure your properties with triple net leases. Would you explain what triple net leases are and what are their advantages?**

**Mr. Brain:** Triple net leases generally tend to be long-term, single-tenant leases, and they have very few moving parts, which is why we like them. The costs of maintenance, property taxes, insurance are all costs borne by the tenant and not by the landlord. The landlord has very little involvement, very little financial exposure. In fact, in the vast majority of our leases, even structural requirements that might be considered in some cases to be a

landlord's requirements, even those fall to our tenant's responsibility during the term of the lease. We tend to build a property for one of our customers. We negotiate a very long-term lease — usually 15, 20 or 25 years — with escalators and participation rents, and then we tend to get out of the way. They operate their business and they operate their property as they see fit. We have certain requirements to keep it best of class and up to standards, but otherwise they are free to do as they want, and we can move on to the next transaction, while staying in an ownership position.

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***“Even though people have questioned us about the cinemas, the fact of the matter is cinema attendance and the cinema box office has been extraordinarily durable in the face of all kinds of substitute products that people viewed as reasons for its eventual demise.”***

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Importantly, where some people in net lease are trading in those portfolios, we have tended not to be a trader. Rather, we are a very long-term owner, and we essentially have owned, for the duration of the company, everything we've invested in. We've only had two real sales of assets. One was small at about \$15 million, one very large at \$225 million. The large one was very recent, but that was a multitenant property that had more moving parts and is not the mainstay of what we do. But we happened to be involved with it as a silent capital partner with a developer, but that developer hit the rocks in the 2009 recession, and we had to take the property over. We decided to sell it, because managing multitenant properties is not what we typically do.

So to recap, our lease agreements have very few moving parts, and we make very long-term, stable investments. And that's the beauty of net lease investing: You have these very reliable income streams that grow over time with your escalators, and hopefully, with your percentage rents. One of the things that allows us to do this is we run the company very economically. Generally about 5% of revenues is our total expense ratio, and to manage some \$3.25 billion in assets, we only have about 30 employees. We're able to do that in a net lease structure, where you don't have a lot of moving parts.

**TWST: I know you follow what you call a “Five Star Investment Strategy.” What do you mean by that, and how on a practical level does that apply to your underwriting and investment choices?**

**Mr. Brain:** The Five Star strategy is a result of a retrospective look we took about six or eight years into the success of the company. As we began thinking about doing more than just cinema investing, we began to ask ourselves: What is going right? What are the ingredients for the success of the company in our investments to date? We codified that kind of reverse engineering of success. Through that process we identified five key components to our success. Those five things are: We invested in a new

generation of property, and that was we're buying very long-life properties that are supported by attractive industry fundamentals. So we're focused on very long-term contributing properties without a lot of costs associated with them. Secondly, we invest in very durable industries — industries that have been around a long time and that we think have a long future. Even though people have questioned us about the cinemas, the fact of the matter is cinema attendance and the cinema box office has been extraordinarily durable in the face of all kinds of substitute products that people viewed as reasons for its eventual demise. It outlasted VHS and DVD, and so it will with downloading and other things. Next, we like an industry where we can tell who the best-of-class operators are. Our experience has been, if you pay up and buy the best properties, you have the most stable and durable performance, and we're willing to do that. We're not the cheapest. We're not looking for the lowest execution and the cheapest property. Rather we're looking at the best experience, because largely we focus on the customer experience, and a customer experience at a very high level and a very positive level is going to be correlated with a well-performing investment over a long period of time.

And then there's economics. We're not speculators. We're not traders. We don't buy a property thinking we could sell it to somebody else at a higher price, at a lower-cap rate, which we've seen other people do. Warren Buffett used to say when you deal in fixed assets, you're either a trader or an owner. We happen to be an owner. And the difference is, to a trader, something is worth what someone else will pay you for it. And as an owner, something is worth what it will earn you. We focus on what things will earn for us, so we're an owner, and we're oriented as an owner and not a trader. And where economics are clear, we're going to make a rate of return we're happy with, with the lease in place, and not having to bail out to somebody else.

And then lastly, all those other things being equal, we like to invest in categories where we think we can develop a leadership position and really have a competitive advantage. By seeing the field better than others, by having depth of relationships, by having access to capital associated with the industry, we believe we can achieve this. Like any market leader, you really are the go-to guy, and you get rounded up rather than rounded down. Those things were all, we felt, true of what happened to us in cinemas. We invest in a very durable industry at an inflection point, best-of-class properties. We're owners with lease arrangements that pay us well, and we have a competitive advantage because we are synonymous with the industry, ahead of the team, and most guys in that industry would rather do business with us because we know what we were doing. And then we asked: Can we take that and apply it in other areas? We continue to do that. Every quarter we ask ourselves: Are we investing in the right things? Are there new things we should be looking at? What are our candidates? And we have screens we put potential investments through, but our screens all derive from those five key themes, and that's what drives all of our growth and investment.

**TWST: You made reference to this, but I gather you are not worried about movie theaters being displaced by online streaming or vending machines.**

**Mr. Brain:** Not at all.

**TWST: What is your outlook for that particular industry? Which is a key tenant base for you?**

**Mr. Brain:** There are two things I tell people. There is an old song in Hollywood that says as long there are kids that want to get away from parents and parents that want to get away from kids, you're going to have a healthy movie industry. And there is another song that says, people have kitchens, but they still go out to eat. Just because you can do something at home doesn't mean you do it at home. People want to go out.

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***"Right now the largest area of investment we're reporting and we're exercising is our charter public schools. Charter public schools are becoming a big part of the landscape of public schools. "***

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Our original annual report in 1997 was called America Goes Out. It was all about the fact that people go out because people at that time were beginning to deeply question the durability of the industry. The fact is people spend a certain amount of their time out of home, and they're going to say: What to do? A movie is the way you get a \$100 million production value for \$8, which is the average U.S. ticket price. I know if you are in New York, people squabble about that, but that's the average U.S. ticket price. I can't deliver you live on a stage or on a ball field a \$100 million production value for \$8 any other way. People love to take that in. They're going to go out. It's a way for parents to enjoy time alone together, and for kids to experience freedom from their parents. Remember, kids getting away from parents is key because 50% to 55% of our turnstile will be 14- to 24-year-olds. I have 17- to 20-year-old kids, and they're not going to go on a date in my basement. They're going to go out somewhere. This gives them a place to go at a fairly affordable price for a high production value.

It's a great story, and we think it's very durable. We think it will evolve, and there are sporting events in theaters now that we are in a digital age, and we think there will be other kinds of live production events. You could see Cirque du Soleil productions in a movie theater that are simulcast from remote locations. And again, you could do that for an \$8 ticket that you can't do in a touring show live because the economics just won't support it.

Our original logo and our new logo, the Roman Colosseum, is the heart of our image because it says out-of-home entertainment has been part of the fabric of society for thousands of years — thousands of years, not hundreds, not for the last couple of decades, but the way civilization is built. This is what people do. Now, if you think that's going to change, we're going to have a fairly short conversation about being an investor. But if you think that people are going to go out, people are social beings and are going to go out to congregate places, what we have are the best real estate locations for that to happen, and we have the best mechanism for that to happen at an affordable price, being on the screen. So we

think this is going to be a very durable industry. You can change a lot of things, but those things are going to stay the same, and those things form the backbone of the durability of our income stream.

**TWST: What kinds of new investment opportunities are you finding right now? I believe you made a few relatively recent theater acquisitions.**

**Mr. Brain:** Yes. We've been an investor in the generation of megaplex theaters, and the theater population is going through a bit of a smaller generational change and now more locations are going luxury.

Going to the movies has been a single-class experience in North America really forever, and now that's just beginning to change to a multiclass experience. We have luxury theaters and what I'll call coach-class theaters, traditional theaters. In the luxury, there very often is liquor served and there is more in-theater dining. Some of our customers are experimenting with that while adapting existing properties to a certain number of other screens, and some are developing new locations just to focus on luxury with full bar and in-theater dining, and we're also investing in some of those locations. So that's another generation in our industry we're continuing to invest in, and we have several operators and several variations on that theme that we're investing with, and still gathering quite a bit of data. Again, these are very healthy things. We're 15 years into our life, so the fact that we're having a generational change again is something we're very open to and we're embracing, because that was really the genesis for the company.

Further to that, right now the largest area of investment we're reporting and we're exercising is our charter public schools. Charter public schools are becoming a big part of the landscape of public schools. The real estate involved in elementary education in public schools in America is somewhere about plus or minus \$1.5 trillion. And right now, charter public schools are about 5% of total public schools, and they're adding 500 a year. There are 5,000 charter schools in the industry and that is expanding by 10%, or about 0.5% a year, and it's moving toward 1% a year. So we think the charter schools could end up being triple, quadruple the size it is. There is a lot of growth there. There is a lot of opportunity, and these people all need financing to really have great executions in real estate since they don't have traditional school bonds. So this creates a huge opportunity for us, and we're very excited about it, and we feel like we're ahead of the curve — like we were in theater investing — in identifying and harvesting in this new and emerging category. That's one of our key growth elements.

**TWST: It seems like you probably don't have a lot of competition in terms of the charter school deals.**

**Mr. Brain:** That's one of the beautiful things. We have increased competition with theaters, because we have had now 15 years to prove the megaplex model, but originally we had almost no competition. We were sole bidding and negotiating deals. So too with our snowboard parks, and so too with charter public schools. Because we tend to be at the dawn of new generations of properties — and this is what we look for — it's a little higher risk and we get a little higher yield, but we're able to get that little higher yield because there aren't many competitors. They're aren't many alternative suppliers of capital in these categories. And that's the beautiful thing. I think it's a great thing for our shareholders. But you're

right, we don't have a lot of competitors.

**TWST: How is the Entertainment Properties Trust's access to and cost of capital?**

**Mr. Brain:** It's very good, frankly, right now. I've tended to think over our 15-year life that our average equity multiple is between 10 and 12 times cash flow. The height of the tech bubble correlated with the depth of our stock because people for a while were convinced we were going out of business, because movie theaters were all going out of business, and I'm talking about 1999 and 2000, not 2011. And that proved not to be true. Our stock went from \$20 to \$10, in half, and then it came back.

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***"So access to capital is very good for us right now, and we have every reason to look toward to a fairly good and robust growth of the company. The only thing that holds us back really is that the economy is quite slow, and you can't really get around that."***

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When we were going into the Great Recession, we were a stock operating at 12 times cash flow at \$50 to \$55. Today, our stock multiple — which really is the inverse of your cost of capital, so our cost of capital goes down as our stock multiple goes up — is about 14. So actually we tend to have a lower cost of capital right now than in most times in the history of the company. During the Great Recession we had very well-performing assets because people still went to the movies, people still sent their kids to school, and we still had well attended snowboarder parks. Our snowboarder parks tend to be about \$50 per day per capita versus \$120, which is resort skiing. So things went well for us, and we continued to raise equity because our stock held up for a while and we were able to do transactions when others weren't. We delevered the company.

Having never had a rating before, we went to the rating agencies to ask: What do you think of this record? We showed them the performance of our properties, and we got a BBB- rating. So we came out of the Great Recession with better access to capital.

Our cost of debt has come down, we've gone to an unsecured model, and our stock price has given us our lowest cost and best access to equity that we've ever had. So right now, it's a very, very good time. We are at the point where we have enough track record about the way we do business, which we didn't have for a long time because you need to have seven, eight, nine years of history before people really begin to see a trend in what you do, and now that we're 14, 15 years old, we have really begun to have that. We have a credit rating.

So access to capital is very good for us right now, and we have every reason to look toward to a fairly good and robust growth of the company. The only thing that holds us back really is that the economy is quite slow, and you can't really get around that. In some areas, we think in the school area, we can actually continue to grow quite handsomely while the economy is in the doldrums, but you can't add a lot of new theaters. In some of the areas, we're a little

slower in growth just because the economy is still in slow motion.

**TWST: What were the key takeaways from the most recent quarterly results you reported and can discuss, which would be the first quarter?**

**Mr. Brain:** We got back to raising our dividend. The company had put something on the order of 10% of its portfolio into the development side, more so than just the triple net lease side, as we got into the kind of extended exuberance of 2007 and 2008. And we had a couple of projects collapse on us, mostly because bank funding — not our funding, but banks that were supposed to fund part of the development with construction loans — failed or failed to honor their commitments. We had a couple of projects slow down, and so we had to bring down the dividend, because we weren't sure what was going to happen in 2009. We held the dividend constant in 2010, but in 2011 we got back to raising our dividend. That's a highlight.

Another one is we had one major multitenant project where we were a partner with the developer. That developer hit the rocks, and the property went into bankruptcy. We were able to take over the property and get it in good shape and sell that property — and get 100% of our investment. In fact, we made an \$18 million gain. That was a theater-anchored, multitenant property in downtown Toronto, Canada. So that was a key takeaway of the quarter, that we were able to come back, rehabilitate, recover our investment and make a return on it.

As I indicated before, we're not a trader of properties. We don't sell a lot, and people sometimes questioned the value of those things we bought even though they earn us handsomely. Are there other buyers for it? We demonstrated that is the case because we decided to liquidate that portion of our portfolio both as a kind of safety and really as a demonstration of what we could achieve, because people had questioned whether we really could. So we continued to grow, we raised the dividend, we rehabilitated and sold a big development property that we were involved in that was troubled. I think those were the big takeaways from the first quarter.

**TWST: Is there insight you could offer in terms of what investors can expect from the company for the remainder of the year? And do you have any particular goals for the company in the next 12 to 24 months?**

**Mr. Brain:** I'd say the watchword for us in 2010 was stability, and to make sure everybody stabilized. Mid-2010 is when we went out and sought and received our investment-grade ratings from Moody's and Fitch. S&P gave us a BB+. They gave us one notch below investment grade.

What we've said is we're returning to growth. We would look toward about \$300 million of property acquisitions, and during 2011 we would look to double down in those key areas of investment we have going now, the theaters and ski and the schools, particularly the schools. We probably wouldn't open new areas of investment right away, because we're still one step away of just trying to stabilize, when you're trying to get back to the growth pattern. I think investors can look for those things from us. We will continue to march along those targets.

We had been growing the company, even during 2009 and 2010, but not increasing FFO, funds from operations, and cash flow per share, because we had not really used any debt and we were

funding things with almost 100% equity. We brought down our leverage from 45% down to about 35% of our total capital. So we had grown the company, but not grown shareholder results. We said that's something in 2011 we will begin to turn around. We'll begin to grow FFO per share, continue to grow our asset base. We will not continue to delever the company. We will stabilize and actually move our leverage maybe up toward 40% — not a high-risk position, but using a little more debt, particularly at this time of very low-cost debt markets. So those are the things the investors can look for. Then we might think about new areas of investments, but right now it's continuing to focus and double down in those areas we know very well, have opportunities, and raise capital and raise results per share. Those are the mainstays right now, and we will continue to be very attentive to those balance sheet ratios that qualify us as an investment grade, BBB- debt issuer because we want to maintain that.

**TWST: Is there anything else that investors should know about the company?**

**Mr. Brain:** I think we've touched on a lot of it. Ours is a fairly nontraditional value proposition, where we invest in these less-than-mainstream categories. And it's not a diversification play like a lot of net lease, but as I say a knowledge play, an experience and competitive advantage play. That's our value proposition, and we buy things at better prices, better yields, that way. So that's probably the main part of the message that I often have to spend time on

because it's a nontraditional value proposition and an approach to shareholder value. We deal in these less-than-mainstream properties like cinemas, ski hills, charter public schools, and so people have questions about that. And frankly, particularly the theaters, there is misinformation and disinformation, so we spend a lot of our time dismissing that. Honestly, shareholders tell me a lot that the more time they spend understanding the company, the better they like it. But I know it takes a little bit of doing because of our less-than-typical nature and because we don't have a lot of direct comps. I would invite people to take that time, and certainly in the process, if necessary, contact the company, as we're glad to talk to them and supply them with information. We always love new shareholders, and we appreciate the opportunity to talk to you and get this message out.

**TWST: Thank you. (MN)**

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# Weyerhaeuser Co. (WY)



**DANIEL S. FULTON** was elected Chief Executive Officer and a Member of the board of directors of Weyerhaeuser Co. in April 2008. He remains the company's President, a position he assumed in January 2008. From May 2001 to March 2008, he was President and Chief Executive Officer of Weyerhaeuser Real Estate Company, a wholly owned subsidiary. Mr. Fulton joined Weyerhaeuser's investment evaluation department in 1976. He transferred to Weyerhaeuser Real Estate in 1978. In 1979, he transferred to the subsidiary's Weyerhaeuser Venture Company, where he held a series of investment management roles. From 1987 to 1988, he served as the Chief Executive Officer of Cornerstone Columbia Development Co. In 1988, he returned to

Weyerhaeuser Venture and its affiliate Weyerhaeuser Realty Investors. Mr. Fulton served in various management and investment positions before becoming President and Chief Executive Officer of Weyerhaeuser Realty Investors and Weyerhaeuser Venture from 1998 to 2000. Before joining Weyerhaeuser, Mr. Fulton served as an Officer in the U.S. Navy Supply Corps. He graduated with a B.A. in economics from Miami University in Ohio in 1970. He received an MBA in finance from the University of Washington in 1976, and he completed the Stanford University Executive Program in 2001. Mr. Fulton currently serves on numerous national boards, including the Business Roundtable, National Alliance of Forest Owners and Sustainable Forestry Initiative. He also is a Member of the Washington State Roundtable and serves as Chairman of the policy advisory board of the Joint Center of Housing at Harvard University.

## SECTOR — REAL ESTATE

**(AVG602) TWST: Please start with a brief history of the company and an overview of your current operations.**

**Mr. Fulton:** Let me start with our formation. Our beginnings go back to 1900, when Frederick Weyerhaeuser and a small group of investors acquired 900,000 acres of timberland in Oregon and Washington, and since then, land and timber has been the core of our company. Today, we own and manage more than 6 million acres of timberland in the United States. We also own timberlands in Uruguay, we have licensing rights in Canada for timber and we are involved in a small joint venture in China of approximately 15,000 acres. Our other businesses are wood products manufacturing, cellulose fibers manufacturing and real estate development.

**TWST: The assets outside the U.S., is that a relatively recent expansion?**

**Mr. Fulton:** The most recent is China, and we have been involved in our joint venture in China for approximately four years. Since 1960, we have been actively engaged in Canada, where the provinces license timber to an operator to source logs and fiber to manufacturing operations. Uruguay, where we have literally created a forest, we initially entered in the late 1990s. We own 317,000 acres and have long-term leases on an additional 26,000 acres in Uruguay.

**TWST: In a nutshell, how would you describe your overall business strategy and philosophy?**

**Mr. Fulton:** Our vision as a company is to provide superior

and sustainable solutions to the world. That's the way we describe it. To do that, our businesses must be top performers. We have to continue to innovate and provide solutions for our customers and most importantly, we must operate to the highest environmental standards. I would put our environmental performance up against anyone's in the world in the operation and management of timberlands. We have made progress in our operating performance over the last several years. Sometimes it's hard to see the progress due to the current challenging housing market that we find ourselves in, but I look at our operations every day. And I have to say that we are becoming more efficient across the board, and we are positioned to capture all the opportunities of the housing market as it recovers.

**TWST: Are there particular areas of growth or opportunity that the company is especially focused on right now, or particular initiatives that you are pursuing?**

**Mr. Fulton:** Given the challenging U.S. housing market, our current focus is on making changes and adapting to the environment that we find ourselves in today. Longer term, we are looking at ways we can grow our timberlands, which is our core asset, and then to continue to improve the ongoing competitiveness of our other operations.

**TWST: You recently sold your hardwoods business. Would you discuss how that fits into your corporate strategy?**

**Mr. Fulton:** Our primary focus is to grow softwood timber and sell that timber and to manufacture products from that wood. Hardwoods represented a very small portion of our portfolio,

and we ultimately decided that it was in the best interest of that, the business, if it was owned by someone interested in growing it. We view the transaction as another step in furthering our focus on our primary portfolio. So in that sense, the transaction is one that I consider a win-win for both us and the business.

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***"I think the biggest trend we've seen across the board at all of our businesses is increased interest in being green and sustainable. How we manage our timberlands and our businesses, or products that our customers provide to their customers, is a growing area of focus. But for us, it's not new."***

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**TWST:** Meanwhile, you recently launched a new Solutions subsidiary. Please tell us a bit about that. What opportunities do you see for this new part of the company?

**Mr. Fulton:** It's an exciting initiative for me. I mentioned earlier that the core of our company is and has been timberlands management. We are recognized as one of the leaders in the world at managing and extracting value from land. We have also recognized that we have an incredible amount of intellectual property that we've developed over the years associated with managing our lands.

In today's environment, more companies are beginning to look at the ownership of timber as a way to both capture stable returns from lands and tap into emerging green markets such as carbon credits and bioenergy. It is a way to offset, in some cases, the carbon footprint of manufacturing businesses for those that are not already in the business but that find buying forests to be an attractive alternative to reducing their carbon footprint. That's not their core expertise. They don't really have a way to extract the maximum value from the assets. Given our experience of over 110 years, we recognize that in addition to managing our own lands we could work in select cases with others to help them solve some of the same issues that we have dealt with, and at the same time, develop a new revenue stream for our company. Weyerhaeuser Solutions will be part of our timberlands segment and will focus primarily in consulting and management services. This is just a startup, so it will be some time before we see a lot of revenues coming through this new operation, but we are off to a good start.

**TWST:** What trends are you seeing among your customers and product segments? How do you take advantage of the opportunities you see based on those trends?

**Mr. Fulton:** I think the biggest trend we've seen across the board at all of our businesses is increased interest in being green and sustainable. How we manage our timberlands and our businesses, or products that our customers provide to their customers, is a growing area of focus. But for us, it's not new. Our founders envisioned the day when trees would be regrown. We were the first company in America to create a tree farm. That was back in 1941, and ever since, we've managed our timberlands in a sustainable manner. We manage the land to ensure clean water for

both animals and humans, and provide extensive areas for wildlife habitat in our timberlands.

We've also been leaders in reducing the use of fossil fuels in our manufacturing facilities, and we work to make sure that the air and water around those facilities meets or exceeds the health standards. But we're also looking for new ways to incorporate green approaches into our products as they evolve to integrate Energy Star energy-saving applications into the homes that we build, or helping to develop even thinner diapers to reduce landfill. Whatever approach is needed, I believe we're in a unique position to build on our history and leadership position in the area of research and development and our commitment to sustainability.

**TWST:** Your quarterly earnings results were announced recently. What were the key highlights or takeaways for you?

**Mr. Fulton:** Our second quarter continued to be challenged by the weak housing market. However, our timberlands business benefited from increased export activity. We had anticipated that as we ended the first quarter, as we had seen a continuing increase in export activity to China. We did note, however, that we have started to see some slowing of log exports to China. Our largest log-export customer is Japan, and we have seen some recovery from the impact of the earthquake. Results in our wood products and housing businesses will continue to be consistent with a slow housing market that has not yet picked up pace for recovery. Our cellulose fibers business had a solid quarter. We completed our planned maintenance outages for the year during the second quarter, and production and shipments should pick up in the balance of the year. More information on our second quarter, and outlook for the third quarter, is available on the investor section of our Web site.

**TWST:** How healthy is your balance sheet and your access to capital if and when you need it?

**Mr. Fulton:** We have substantial liquidity and a strong balance sheet, despite the challenging market conditions that we've found ourselves in over the last several years, and we continue to strengthen our position. During the second quarter, for example, we used \$551 million to retire debt, which was due in March of next year. In addition, we paid \$30 million of regularly scheduled debt maturities during the quarter. We ended the second quarter with cash of over \$880 million, and our debt maturities for the next five years total just over \$600 million, with an additional \$200 million due in 2012. Also significant during the second quarter is that we replaced our bank credit facility, which was set to expire at the end of this year. We have a new four-year facility with \$1 billion of credit availability, and we have no borrowings outstanding under that agreement at this time. So we're proud of the work that we've done during this challenging economic cycle to maintain our strong balance sheet.

**TWST:** The company converted to the REIT structure in 2010. What led to the decision to convert to a REIT, and what are the main benefits both for the company as well as its shareholders?

**Mr. Fulton:** The decision to convert to a REIT had its roots in the strategic work that we had undertaken several years ago. At that time, we looked at changes in the industry generally and the evolving market conditions, and asked ourselves: How can we best

position Weyerhaeuser to succeed in this new environment? As we conducted that review, it became clear to us that our expertise lay in managing land and timber and that that should continue to be the core of the company.

We recognized that long term, the domestic housing market provided significant opportunities to us. In spite of the very challenging housing market today, if you look at demographics, it's obvious that this country will need to build new houses and the building materials to build these houses will primarily come from domestic producers. We also recognized that our leadership position in absorbent pulp was key to our future. This recognition for us meant that we had to make some tough decisions and exit some businesses that we'd been in for a long time. The largest divestitures were that of our fine paper business and containerboard business. We've also had some smaller divestitures as well, such as the hardwoods business that you mentioned earlier.

At the same time we were taking those steps, we were examining how best to own our timberlands. Since they are core to our company, we wanted to make sure that we put ourselves in the best position to effectively manage and grow those assets. Some in our industry had already converted to an REIT, but our structure was going to be a little bit different because we also view our wood products, our cellulose fibers and our real estate businesses as core activities. No timber REIT has the same asset mix, and we wanted to make sure that we could continue to operate those that we had in a REIT structure. The more we studied REITs and learned about their requirements, the more obvious it became to us that we could structure ourselves as an REIT and maintain our portfolio.

The benefits for the company are obvious. We have a more efficient structure of owning and growing our core timberlands business, and we can maintain a portfolio that we believe is critical to our strategic direction. Shareholders benefit from the tax advantages that the REIT provides them and the ability to own Weyerhaeuser in a structure that allows us to increase revenues and therefore grow our dividend using cash flow from all of our company businesses. The primary benefit of the timber REIT structure is that we enjoy tax savings on qualified timber income at the corporate level. For shareholders, those dividends are treated as capital gains rather than ordinary income. Being an REIT puts us in a position where we are both more efficient on an operating basis, and positions us to grow our timberlands business.

**TWST: What is your current dividend payout?**

**Mr. Fulton:** As we made the conversion to a real estate investment trust at the end of last year, we announced we would target paying a dividend of 75% of funds available for distribution over the cycle. This policy recognizes that we have businesses that operate in different markets and face different market forces. Timberlands, wood products and real estate, for example, are tied to the housing cycle in the U.S. Our cellulose fibers business is somewhat countercyclical to the other businesses and is affected by exchange rates. The board established the policy with the intent of setting a sustainable dividend, one that could grow over time. The

dividend was set at \$0.15 for the quarter. Given where we are in our current cycle, that amount is likely to represent all of our 2011 funds for distribution. Over the cycle, we would expect to increase the quarterly dividend amount.

**TWST: Are there any particular goals you have for the company as you look to the next 12 or 24 months?**

**Mr. Fulton:** Our near-term goal is to continue taking the steps necessary to deal with prolonged challenges of the U.S. housing market. While that obviously includes measures such as reducing costs and managing our inventories, it also involves introducing new products and developing new markets. Our real estate company, for example, has introduced new housing lines and changed designs in response to market conditions. We also have opportunities to serve new and existing customers in emerging markets such as Asia. Longer term, our goal is to continue to position Weyerhaeuser to deliver strong sustainable returns for our shareholders. Given the narrower focus that we've developed for the company over the past several years, I'm confident we'll achieve that goal.

**TWST: Would you tell us more about new products and/or new markets you're looking at or you find most promising?**

**Mr. Fulton:** We look for new products in every one of our businesses. In the case of our timberlands business, one might think that there is no new product since we're growing and harvesting logs, but the innovation is the way we operate that business to improve our efficiencies and access new markets for our logs. In our homebuilding business, it's continuing to develop new designs that appeal to today's buyers, designs that are more efficient to operate for customers. In wood products, it's responding to the needs of our customers, helping them become more cost efficient and improve the quality of the homes that are built with our products. In our cellulose fibers business, it is continuing to innovate for our customers who are growing globally and provide them products that will meet the needs of their customers.

**TWST: Is there anything else you would like to discuss or make sure investors know about Weyerhaeuser?**

**Mr. Fulton:** It's been a challenging time for Weyerhaeuser Co., given the state of the U.S. housing market. I'm always impressed with the support that we receive from our investors. In addition to our traditional investors, we now have the opportunity to work with REIT investors. We have an exciting future to discuss with them, and I'm looking forward to the opportunity to continue to dialogue with investors as we fulfill our vision.

**TWST: Thank you. (MN)**

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