Investing in REITs
Past performance is no guarantee, etc.

“An economist’s guess is liable to be as good as anybody else’s.”

Will Rogers
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- What Are REITs?
- Why Invest In REITs?
- Real Estate Fundamentals
- REIT Market Valuations
What Are REITs? (Legislatively)

- Corporations or Trusts that do not pay Income Tax if they follow certain rules
- Pass-Through Entity like Mutual Fund
- Asset & Income Tests: Must be Real Estate
- Dividends: 90% of Taxable Income
- All Real Estate Tax Shelter & Deferral Provisions Apply
What Are REITs? (Functionally)

- REIT Rules = Useful Disciplines
- Public & Private Market Entities
- Dividends Paid Deduction: Tax-Neutral, Market-Oriented Capital Structure
- Stock Market vs. Appraisal Pricing
REITs — Matured Structurally

- **Risk:** 90% Equity vs. 90% Debt in 1970's
- **Conflicts:** Internal vs. External Advisory and Management
- **Culture:** Return on Capital vs. Growth in Assets Mentality
- **Growth:** Taxable Subs, UPREIT Structure
REITs — Matured in the Market

◆ Largest Source of Real Estate Equity: 1% in 1990 to 40% in 2001
◆ S&P Index Inclusion
◆ Ibbotson Associates Validation
◆ Analytical Discipline and Sophistication: Analysts, CMBS, Rating Agencies
REITs Now Largest Equity Source

Real Estate Capital Flows

Equity

- REITs
- Pension Funds
- Foreign Investors
- Life Insurance Companies
- Commercial Banks

The graph shows the capital flows in equity from 1988 to 2002, with REITs becoming the largest equity source over time.
But Debt Still Dominates: 82%

TOTAL U.S. REAL ESTATE: $4.63 TRILLION

Institutional: $2.24 Trillion
Non-Institutional: $2.39 Trillion*

Equity = 18%

Debt = 82%

Total Equity: $402.8 Billion

Total Debt: $1.841.4 Billion

Savings Associations
$142.0B - 7.7%

Commercial Banks
$213.6B - 11.6%

Life Insurance Companies
$250.4B - 13.3%

Non-Government CMBS Issuers
$562.5B - 16.7%

REITs
$371.2B - 42.5%

Pension Funds
$148.7B - 36.9%

Other
$48.6B - 2.6%

Pension Funds
$44.1B - 2.2%

REITs
$30.0B - 0.5%

Commercial Banks
$766.3B - 42.0%

* Includes $445 billion of private equity partnerships, syndications, individuals, and family trusts

Source: Brown Consulting Group, Licensed Loan Real Estate Investments
A Georgia REIT Would Include:
A “Georgia REIT” Would Include:

- Apartments: 78,960 units
- Office buildings: 32.7 million SF
- Retail stores: 65.4 million SF
- Hotel rooms: 31,342 rooms
- Industrial facilities: 41.7 million SF
- Acres of Land: 7,005 acres
- Manufactured housing: 6,985 units
- Storage units: 13,291 units
- Health care facilities: 1,121 beds
- Golf courses: 72 holes
- Other buildings: 2,327
Why Invest in REITs?

- Total Return
- Moderate Volatility
- Low Correlation = Real Diversification
- Composition of Return: Yield, Dividend Growth, Portfolio Rebalancing
- The Simplest Way to Own and Manage Real Estate
Two Rough Years!

2001 - 2002 Performance of Equity Markets
(Total returns in percent through December 31, 2002)

(Note: Sectors ranked from lowest return to highest return based on 2002 returns)

1 Price appreciation only.
2 Total return through December 31, 2002.
Long Term Returns

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<th>Category</th>
<th>Return Percentage</th>
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<td>HY BONDS</td>
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<td>EQUITY REITS</td>
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<tr>
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Volatility Can be Unpleasant

Exhibit 3
Five-Year Rolling Standard Deviation of Monthly Price Returns
(January 1991 - August 2000)

Source: National Association of Real Estate Investment Trusts, Dow Jones.
Return & Volatility Tradeoffs

20-Year Average Annual Total Return v. 20-Year Standard Deviation of Annual Total Returns (December 1982 - December 2002)

Good Corner

Bad Corner

Source: National Association of Real Estate Investment Trusts®; Ibbotson Associates.
"Price only returns."
An Imprecise Inflation Hedge
Compounding is Crucial: Einstein

"COMPONDING IS THE MOST FASCINATING FORCE IN THE UNIVERSE." ALBERT EINSTEIN

$100 in 1972 = $3,526 in 2002

Avg Yield = 7.9% = $412

Avg Capital = 3.3% = $272

$100 in 1972 = $3,526 in 2002
Compounding: Paid-in-Full

- 1993 IPO = 100%
- Dividends: +102%
- Capital Gain: +110%
- Total = 312%???
- Reinvest, tax-free was 390% at 12/02
- Past performance is no guarantee, etc.
Stock & Bond Yields since 1870’s

Stocks

Bonds

<REIT Median at 2/7/03: 7.61%
Dividends Aren’t for Wimps

The Dividend Deficit

By JEREMY J. STEIGLITZ

The Enron scandal has brought to light the realities of corporate greed and the need for strong regulation of corporate behavior. The scandal has also highlighted the importance of dividends in the context of the stock market and corporate governance.

Dividends are a crucial aspect of the stock market and corporate finance. They represent a portion of the company’s profits that is paid out to shareholders. Dividends are an important source of income for many investors, and they are a key factor in determining the value of a company’s stock.

However, the dividend system is not without its flaws. One of the main issues is that dividends are often seen as a way for companies to avoid paying taxes. This is because dividends are taxed at a lower rate than capital gains, which are the gains made from selling stocks. This creates a disincentive for companies to pay dividends, as they would prefer to retain the money and pay taxes on it at a lower rate.

Another issue is that dividends are often paid out of profits that are not sustainable in the long term. This can lead to companies paying dividends that they cannot afford, which can ultimately lead to financial distress and even bankruptcy.

Despite these issues, dividends remain an important part of the stock market and corporate finance. They provide a source of income for many investors and can serve as a barometer of a company’s financial health.

Dividends once gave tangible evidence that a firm’s earnings were for real. But the tax system forced them out of favor. Hence the Enron problem.

Dividends paid from these earnings are taxed at the individual level. Firms would like to minimize tax deductions with interest costs, but inventories and capital gains do not look favorably upon companies with high levels of dividend payments. Earnor’s incentive to manipulate its balance sheet was brought to light by this newspaper on 1st, 4 in an article that showed how inflationary periods and decreases in the interest rate are more profitable for firms that convert profits to a higher level of debt. Moreover, firms paid to maintain a higher level of debt and equity. Henry Ford would be referred to as an artist and Enron could commit a disaster in exchange.

Why should we believe that corporations who do not provide investors with a clear view of their capital structure and earnings are likely to mislead their clients and exploit loopholes in our current tax laws? Tax reform alone will not fix the earnings credibility problem. Reforming and regulatory reforms are also necessary to work. They are accompanied by strong enforcement of accounting standards, especially in the area of executive compensation and incentive programs. The tax system encourages companies to do just the opposite. Why should we believe that corporations who do not provide investors with a clear view of their capital structure and earnings are likely to mislead their clients and exploit loopholes in our current tax laws? Tax reform alone will not fix the earnings credibility problem.

Mr. Steiglitz is a professor of finance at the Wharton School and author of “Stocks for the Long Run” (McGraw-Hill, 1997).
Diversification=Low Correlation

CORRELATIONS vs. ALTERNATIVES, 1992-2001
Correlation for Dummies

REITS VS. S&P 500 RETURN DIFFERENTIAL

2/3 = >10 % POINTS
1/3 = POSITIVE VS. NEGATIVE
Correlation for Dummies, Part II

Major Stock Total Return Indexes
(End of month, December 1989 - December 2002)

December 1989 = 100.0

- NAREIT Composite
- S&P 500
- Russell 2000

A Bubble >

< Bubble Popping
“From a legal perspective, (REIT’s) inclusion in pension portfolios or 401(k) plan options should significantly bolster the fiduciary’s prudence position”

Evan Miller, ERISA Attorney, The Journal of Pension Planning & Compliance
The Simplest Way To Own Real Estate

- Diversification: Geographic and Property
- Transaction Costs: Entry, Exit and Timing
- Management: Ongoing Infrastructure and Time
- Reinvestment: The Key to Compounding
Management Simplicity

- Alignment of Interests: 13% Insider Owned
- Transparent Track Record and History
- Most have all Functions In-House:
  - Development
  - Leasing
  - Property management
  - Finance
Current Real Estate Fundamentals

- Better than Early 1990s — but not Perfect
- Demand now vs. Supply then: Sublease and Bankruptcy Factors
- New Supply in check, but a little late
- High Real Yields mixed with Cheap Debt
- Real Equity, Less Debt: Industry Balance Sheet better than Tenants
“We’re the least bad play . . .”

**CAPITAL FLOWS**

*Interviewer:* “How do you explain the apparent increase in flow of funds to real estate?”

**Emerging Trends Respondent:** “We’re the least worst asset class. We’re the least bad play, compared to bonds and the stock market.”

*Interviewer:* “Does that make you feel better about touting real estate performance?”

**Respondent:** “Not really. It feels sort of odd.”

By all accounts, more capital is finding its way into the real estate markets — there's no shortage of sources. On the equity side, REITs and REIT mutual funds have attracted a flood of dollars from both institutional and individual investors. Pension funds are looking more seriously at upping real estate allocation targets, although that may be a drawn-out process. Foreign institutions — particularly German — have stepped up activity markedly. And an array of private syndicators are returning in force after a long absence, successfully raising money from individual investors.

On the debt side, CMBS conduits and domestic banks remain the larger players, joined by the familiar life insurers, an increasing cadre of foreign bankers, and varied mezzanine debt lenders.

“Everyone has been pleased with real estate performance,” says a pension fund advisor. “It's been the best-performing asset. Clients are so beat-up right now they'll slap you on the back and congratulate you if you give them any return that doesn't show up in red or have brackets around it.”

Debt investors expect delinquency and default rates to increase — from near-record lows — but express only modest concern. Better underwriting, more borrower equity in structures, and low interest rates should temper discomfort. CMBS markets “have yet to be tested and may not be.”

Ample capital has kept the markets liquid and lubricated values even as vacancies have increased. But what happens when empty space actually starts to hurt cash flows? “The
The Real Estate Cycle . . .

Exhibit 7
Office Market Conditions 1982 - 2004
52 Largest U.S. Markets

Source: RREEF Research and Torto Wheaton
Construction Finally in Check ...
With Varying Levels of Sensibility

- Multi-Family
- Industrial
- Office
- Other Commercial (Retail)
Banks Learned the Hard Way

Change in Lending Standards for Commercial Real Estate Loans
(Quarterly, 1990:Q2 to 2002:Q3)

Note: Percent of banks reporting tightening less percent reporting easing.
and Lent to Worldcom & Enron

Change in Demand for Commercial Real Estate Loans
(Quarterly, 1995:Q2 to 2002:Q3)

Note: Percent of banks reporting stronger demand less percent reporting weaker demand.

Source: Federal Reserve Board
Record High Spreads at Record Low Nominal Rates

10-Year Prime Mortgage Rate Spread
(January 1990 to December 2002)

Spread calculated by taking the 10-year prime mortgage rate less 10-year constant maturity Treasury yield.
Source: Barron's/Levy National Mortgage Survey.
Insurer Loans: Doing OK So Far

Delinquent & In Foreclosure

0% 2% 4% 6% 8% 10% 12% 14% 16% 18% 20% 22% 24%
65 70 75 80 85 90 95 2000
Some Hard Lessons Ahead?

CMBS Yield Spreads
(AAA-rated, 10-year CMBS less 10-year Treasuries)

Basis Points

Source: Morgan Stanley Dean Witter.
REIT Market Valuations

- Modest Discount to NAV
- Liquidity: Yield Panic vs. Fundamentals
- Cash Flow Plateau After Good Run: Big Sector Variations, Mark-to-Market & a Lot of Refinancing
Yield Spread vs. Treasuries

Monthly Equity REIT Dividend Yield Spread
January 1990 - December 2002

Average dividend yield spread:
1.05

1 Yield spread calculated by taking the Equity REIT dividend yield less 10-year constant maturity Treasury yield.
Source: NAREIT.
II. REIT Pricing vs. Bonds*

Earnings yields on REITs slightly exceed the yield on low investment-grade corporate debt...

and the relationship between these yields is in line with historical norms.

[Graphs showing REITs vs. Bonds over time]

[Note: Average yield-to-maturity on selected Baa-rated long-term corporate bonds, as selected by Moody’s Investor Services.]
REITs vs. Stocks

III. REIT Pricing vs. Stocks*

Earnings yields on the S&P have risen in recent years; REIT earnings yields have trended down.

which has caused the previously wide yield premium on REITs to shrink back to normal levels.
Real Estate Inflection Point: Furniture for the Economy

Yields tell only part of the story: earnings growth is also important. Consensus expectations are for the S&P to turn in better growth than REITs.

Graph showing earnings growth projections for REITs and S&P 500 from 1993 to 2003.

[1] Green Street AGPU growth estimate
Cash Flow Growth Hits the Wall

Note: Data for 1994-1999 based on partial information for the top 100 equity REITs.
Dividend Coverage has Peaked

REIT Payout Ratios
(Quarterly, 1994-2002:Q3)

1 1994 - 1999 quarters are based on partial data for the Top 100 Equity REITs
Balance Sheets Mostly Healthy

Equity REIT Leverage and Coverage Ratios
(End of quarter, 1996:Q1 to 2002:Q3)

Coverage Ratios

- EBITDA/(Interest Expense)
- EBITDA/(Interest+Preferred)
- Debt/(Total Market Cap)

Source: SNL Securities, National Association of Real Estate Investment Trusts®.
Atlanta In Penalty Box: 4 for 4

Exhibit 15
U.S. Industrial Markets and the Timing of Recovery

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<thead>
<tr>
<th>Early 2003 Early Recovery</th>
<th>Late 2003 National Recovery</th>
<th>2004 - 2005 Late Recovery</th>
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Columbus
Honolulu
Indianapolis
Memphis
Nashville
San Jose
St. Louis
Don’t Try To Read This, But Higher is Better

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<th>City</th>
<th>Vacancy Rate 2002</th>
<th>Vacancy Rate 2003</th>
<th>Jobs Forecast 2002</th>
<th>Jobs Forecast 2003</th>
<th>Jobs Forecast per Unit Delivered</th>
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Source: RREEF Apartment Supply Forecast, Sorted by Jobs Forecast per Unit Delivered.
Signals from the Public Markets

- Retail
- Index
- Apartments
- Office
- Hotel
Last Three Months
Southeast (Mostly): One Year

- Retail
- Index
- Apartments
- Office
- Lodging
SE, 3 Months: Trying to Bounce
The Sequence of Recovery?

Exhibit 2
Timing of Market Recoveries

- Economic Recovery
- Warehouse/Distribution
- Retail
- Apartments
- Office and R&D
“... one should live for the great deviations, and this was the mother of all deviations.” Jeremy Grantham, GMO
Bush’s Tax Plan and REITs

- Not a Zero Sum Game
- Half as Expensive to Treasury
- Still Competitive after-tax
- A Drop in the Tax-Exempt Liquidity Bucket
- Would You Put Muni-Bonds in an IRA?
- Capital gains or income tax?
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Suite 200
Atlanta, Georgia 30303
404 654 1245
jimgrissett@aol.com
Investing in REITs
Relative Valuation

<table>
<thead>
<tr>
<th>Earnings Yield</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GSA REIT AFFO:</strong></td>
<td><strong>6.5%</strong></td>
</tr>
<tr>
<td>8.4%</td>
<td></td>
</tr>
<tr>
<td><strong>DJ 30 Industrials:</strong></td>
<td><strong>1.7%</strong></td>
</tr>
<tr>
<td>3.5%</td>
<td><strong>1.1%</strong></td>
</tr>
<tr>
<td><strong>Nil</strong></td>
<td><strong>4.0%</strong></td>
</tr>
<tr>
<td><strong>DJ Utilities:</strong></td>
<td><strong>1.4%</strong></td>
</tr>
<tr>
<td>6.7%</td>
<td></td>
</tr>
<tr>
<td><strong>S&amp;P 500:</strong></td>
<td></td>
</tr>
<tr>
<td>3.3%</td>
<td></td>
</tr>
</tbody>
</table>

As of March 8, 2002
Our Approach to Investing

- Value Investor: NAV Focus
- Compounding: Dividend Growth and Yield Advantage
- Balance Sheet Quality, Dividend Coverage
- Management Matters
- Seek Inflection Points and Underfollowed Stories
Why Invest With Us?

◆ Real Estate Background and Approach
◆ Track Record: +600 BP per year vs. Index last Four Years — Bull and Bear Markets
◆ Will Tailor Product to fit Your Goals
◆ Will Co-Invest with You