Quarterly Update

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Diminished Expectations

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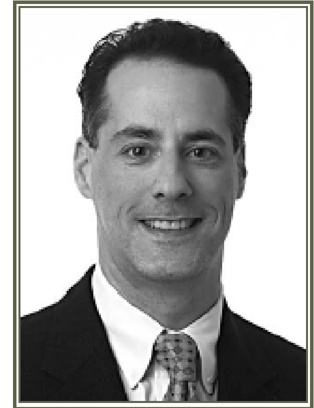

I am fascinated by economic history because similar patterns tend to repeat themselves over and over. As long as people have incentives to take risk, capital is accessible, taxation does not stifle capital formation, and there is minimal government interference in global trade and domestic commerce, then the economic path of a nation and the world will be one of increasing prosperity and higher standards of living. Since the actors are fallible human beings, however, then those powerful human emotions of fear and greed will periodically enter into people's decision making processes and occasionally create staggering disequilibria. To get back into balance, it is often required that the system be cleansed of excessive optimism or pessimism.

The 1920's represent a fascinating time when very few investors thought anything could go wrong and people made investment and career decisions accordingly. There are many similarities to our current investment climate. Money is flowing to all asset classes, wealth is being created at an unprecedented rate, and liquidity seems to be endless, just to name a few similarities. To be fair, there are notable differences as well. For now, however, I want to focus on the similarities by sharing a couple of anecdotes from this decade that I believe have some applicability for today's real estate investors. It's only fitting that the first one involves an individual born in Texas, the state in which we have our largest holdings.

Clarence Dillon was born in San Antonio in 1 882. Given his Texas upbringing he wasn't a typical Harvard student. While there he succeeded, was well liked, and proved himself a genius at poker. He took a somewhat unusual route to Wall Street. After graduating, he settled in Milwaukee with one of his classmates to work in industrial businesses. While there, he was a weekend guest at the summer home of a wealthy and prominent family. On a Monday morning he was waiting for the train to take him back to Milwaukee when a huge Newfoundland dog walked out on the track and was struck by an express train. The animal's body was hurled in the air and smashed into Dillon with such velocity that he was knocked to the ground unconscious. For three weeks he was extremely ill, close to death, and was finally nursed back to good health by the daughter

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of the house. Like a fairy tale, they were married a year later.

Not long after their marriage, a relative of Dillon's wife who once resided on the east coast passed away. Dillon went back east to help look after the settlement of her affairs. The estate attorney was so impressed by Dillon that he recommended him to a close friend, William A. Read, president of William A. Read & Company, a Wall Street bank, who was always looking for talent. Dillon was eventually persuaded to join the firm. When he was nearly 34 he was named a partner in William A. Read & Company. On the very same day, April , 91 6, Read was stricken with a fatal illness and died three weeks later. Within three years Dillon was named president. In 920 he restructured Goodyear Tire & Rubber, which had over $00 million in debt and was on the verge of bankruptcy. This made Dillon a major player on Wall Street.

In 925 Dillon organized a syndicate to purchase the automobile business of Dodge Brothers, representing the largest cash transaction in industrial history at that point. The purchase price was $46 million and he managed to beat out a joint venture between General Motors and J.P. Morgan & Company to win the company. Three years later, Dillon sold Dodge Brothers, Inc. to the Chrysler Corporation for a profit in excess of $40 million. Dillon was 43. The name of the firm was changed to Dillon, Read & Company.

Let's flash forward 79 years to 2007. After nine years of ownership, DaimlerChrysler announced that it was reducing its stake in Chrysler to 1 9.9% and forming a joint venture with Cerberus, one of the premier private equity companies. The value of Daimler's ownership is valued at $.6 billion. It paid $36 billion to purchase the company in 998. This was one of the worst investments in history.

In 997 Dillon Read was acquired by Swiss Bank Corporation for $600 million and merged into S.G. Warburg & Co. to become SBC Warburg Dillon Read. In 998 United Bank of Switzerland (UBS) purchased SBC Warburg Dillon Read. On May 3, 2007 UBS announced that it was shutting down its Dillon Read Capital Management hedge fund unit. UBS lost $300 million in disbanding the unit after the fund incurred very large losses due to bad bets on sub-prime mortgages.

Two venerable businesses with long histories succumbed to the realities of the marketplace and some boneheaded decisions by their owners. Before trying to tie all this together, let me introduce one more anecdote.

When Babe Ruth was in Cuba sometime in the 920s he was forced to cancel his passage home because he owed $65,000 to bookies. "But," according to The New Yorker magazine, "out of the orgy of spending and earning, his wife, unknown to him, had… swept up the dust of a greater sum of money than he had ever known before; and without

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a word she sat down, wrote a check for $65,000, resisting even tears." In addition, "on her own, unknown even to the Babe, out of the wreckage of his earnings, she saved enough to buy a few apartment houses in Boston."

So what's the point of these trips back to the 920s? Bad things happen. From stupid investments to flying dogs, there are identifiable risks and others that come totally out of the blue. Without recognizing that bad things can happen, whether self-induced or exogenous, individuals and businesses will not be prepared when they inevitably manifest themselves. Helen Ruth, The Babe's wife, understood this completely. She knew the risks her husband's impulsive tendencies introduced to the financial stability of their marriage. She took the appropriate precautions to help cushion the blow. Daimler and UBS apparently didn't. After six years of tremendous returns in real estate, it is time for real estate investors to focus much more on downside protection and preservation of capital, rather than upside maximization.

We are at one of those points in the world of leveraged investing, of which real estate is one of its subsets, that a focus on having a margin of safety is becoming very important.

Warren Buffett defines risk as a permanent loss of capital. This is the time to focus more on risk than reward. With interest rates rising, lender underwriting standards tightening, the cost of money has risen while the quantity of it has decreased. As an example, we refinanced a property in March 2007 which generated loan proceeds of $32.5 million. If we were to put new financing on that property today, the rate would be nearly 1 % higher and the loan proceeds only $29.0 million. This is a dramatic change and should lead to some property owners with a high degree of leverage and loans coming due, potentially having difficulty in refinancing their debt. Since one man gathers what another man spills, this could lead to some interesting investment opportunities for those who become aware of these distressed situations and have the capital to take advantage of them.

As a sign of the more challenging debt markets, Archstone-Smith, one of the largest and best apartment real estate investment trusts (REITs), is being taken private by Lehman Brothers and Tishman Speyer in a transaction valued in excess of $20 billion. Prior to this fairly significant increase in interest rates and tightening of lending standards, this deal would have been a slam dunk for it to have been consummated. If the market price of Archstone is any indication, then investors are not so sure and have factored this uncertainty into the price.

How does one divine this? It's pretty simple logic. If one is certain that a transaction will take place on a specific date and price, then the buyers of the stock should get a very similar return to a risk-free Treasury security

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with the same maturity as the time frame for the buyout to be completed. In Archstone's case, the transaction is scheduled to close some time in the third quarter at $60.75 per share. Assuming that it closes on the last day of the quarter, then an equivalent Treasury yield would be approximately 4.70% annualized (as of this writing). Archstone's price, however, would generate an annualized return of approximately 0.8%, a significant premium over the risk-free rate. Obviously the market has concerns about whether the deal will get done on time and/or at the negotiated price.

Archstone is not alone. Other companies being taken private offer similar annualized rates of return. With over $300 billion of leveraged buyouts in the pipeline needing financing on fairly aggressive terms, it appears that the pendulum has finally swung to lenders. Hunger has finally been sated and indigestion is beginning to take over. As a point of reference, the largest buyout in history will be KKR's purchase of Texas Utilities, a transaction in excess of $45 billion. Clarence Dillon would be very proud.

One of the realities of this situation is that cash flow on new acquisitions will be very small.There is no way to purchase a property at an unleveraged yield of 4.5% and finance the acquisition with debt costing 6.25% and produce meaningful cash flow. If the financing terms require the loan to amortize on a 30-year schedule, then debt of 61 % of the total cost will consume all of the cash flow. As a frame of reference, we typically like to finance our properties with 75% to 80% loans. This will pose challenges for us, particularly with regard to our 1 031 exchanges. One way we have been navigating around this is to focus on good real estate with the ability to assume a loan that is in place that can offer us more leverage and a below market interest rate. We are currently doing this with a prospective acquisition in San Antonio in which the interest rate is below 5% and the loan to purchase price is approximately 75%.

We are going to remain very selective in what we are buying given the more challenging capital markets. Despite this, we are still bullish on apartment fundamentals. To reiterate the story, jobs continue to grow, interest rates are rising and credit is tightening up for home purchases. The sub-prime loan market has imploded, which should keep more people renting. Construction costs have risen quite significantly without a corresponding increase in rents so the risk-reward relationship for developing is not as favorable as it was a year or two ago. Although home builders still have a lot of inventory to work through and will probably continue to discount these homes very aggressively, which could draw people out of the renting market, building permits have plummeted so the supply of new single-family homes will grow far more slowly than it has over the last five years. In addition, the weaker dollar is making U.S. real estate much more attractive to foreign investors.

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Although the financing market is more challenging than it has been in a long time, apartments still represent a compelling asset class in our opinion. Occupancy and rent growth prospects remain strong for the reasons listed above, the asset class represents a hedge against inflation, it has proven to be a good place to store wealth over long periods of time, and should still offer attractive appreciation potential. Unfortunately, the continued strong demand for the asset class and positive outlook for rent growth and occupancies have led investors around the world to want U.S. apartment assets despite the higher cost of debt. As a result, cash flow is being sacrificed in the short run. Nevertheless, we will not sacrifice location quality for cash flow. Like Helen Ruth and Clarence Dillon, however, we will keep our wits about us and be very opportunistic to make sure we are adding value.