

Are REITs Overvalued?

Why we think investors should trim their REIT portfolios.

It seems there's no stopping them. In 2006, for the seventh year in a row, the primary U.S. REIT index outperformed all the other major U.S. equity market benchmarks. The National Association of Real Estate Investment Trusts (NAREIT) reported that the FTSE NAREIT All REITs Index climbed 35% in 2006, compared with 16% for the S&P 500. We doubt REITs will continue their impressive run, however, and here's why.

A Closer Look at REIT Returns

Over the long term, dividends have accounted for a large part of total REIT returns. For holding periods of 10 to 35 years, dividends have contributed between 50% and 80% of total annual REIT returns on average—the longer the holding period, the larger the dividend contribution to total returns. As REITs must pay out at least 90% of their taxable earnings as dividends to shareholders, the income return from REITs has historically been high; in the last 10 years, dividend yields averaged 6.2% and grew at an average rate of 5.7% per year.

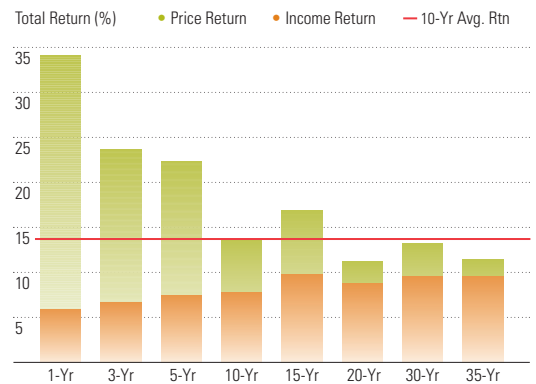
But in the last few years, dividends have played second fiddle to price gains in total REIT returns. From about 50% of total returns 10 years ago, dividends accounted for just 18% of total returns in 2006. The rest came from share price appreciation as investors doubled the price they are willing to pay for a dollar of REIT earnings, sending the price to FFO ratio (P/FFO) soaring from 10 to 20 times. (FFO, or funds from operations, is a REIT measure of earnings that adds back depreciation to net income.)

Granted, REIT earnings probably deserve a higher multiple given significant changes in the public real estate markets. First, REITs have become larger and more liquid; in the last 10 years, the equity market capitalization of REITs has soared from \$90 billion to \$430 billion, and average daily dollar trading volumes have risen from less than \$500 million to about \$3 billion.

Second, REITs are more flexible and better managed, the result of various regulatory changes. REIT managers have more leeway to pursue higher-margin activities such as developing properties for sale and managing space for third parties.

Finally, the increasing use of joint ventures (JVs) has opened up alternative sources of capital that have often been cheaper than raising money from the traditional capital markets. Additionally, JVs juice returns with lucrative management fees. These factors may justify paying a slight premium for REITs today compared with 10 years ago. Additionally, improving fundamentals and economic growth have no doubt played a role in the runup. But we believe the real story is the wave of consolidation that has taken place in the industry.

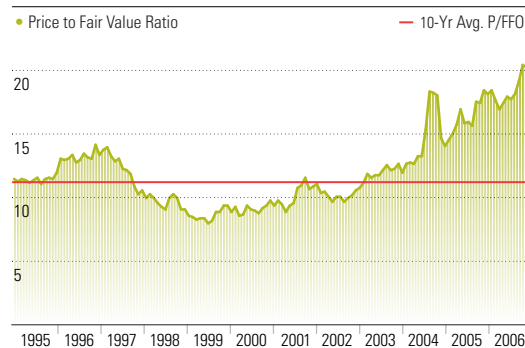
Composition of REIT Returns



Data source: NAREIT Chartbook January 2007, SNL

According to NAREIT, nearly \$120 billion in merger and acquisition deals were announced or closed in 2006, trumping the more than \$25 billion in 2005. A desire by well-capitalized public REITs to take out old rivals and expand into new markets fueled about half the deals, with private equity take-outs of public REITs accounting for the other half. With so much capital sloshing around, private equity firms such as Blackstone Group made profits buying high, and selling higher; the firm bought REITs outright at high premiums, broke them up, and sold their properties piecemeal at even higher premiums. The Blackstone Group swallowed four REITs last year, and added office REIT **Equity Office Properties** EOP to its roster this year following a hotly contested bidding war with **Vornado Realty Trust** VNO. We doubt the tailwinds provided by M&A activity will last forever, and dividends will likely resume their role as the anchor for total REIT returns.

Average Monthly Price-FFO Multiples



Data source: SNL

10-Year Average Equity REIT Returns (%)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Avg.
Average Dividend Yield (%)	7.1	5.9	6.4	7.9	7.8	7.3	6.7	6.4	5.2	4.7	4.0	6.2
Dividend Per Share Growth (%)	4.9	7.4	8.0	7.7	6.8	3.8	1.9	5.2	5.8	5.0	6.0	5.7
Income Return (%)	8.9	6.9	4.8	7.6	9.9	9.5	6.9	8.7	7.2	5.5	5.6	7.1
Price Return (%)	26.4	13.3	-22.3	-12.2	16.5	4.4	-3.1	28.5	24.4	6.7	29.5	7.4
Total Return (Comp. Ann. %)	35.3	20.3	-17.5	-4.6	26.4	13.9	3.8	37.1	31.6	12.2	35.1	14.5
FFO Per Share Growth (%)	10.4	12.5	18.6	10.9	8.2	-2.4	2.5	3.3	2.3	-3.9	1.5	5.4
Beginning of Period P/FFO [X]	12	13	14	10	9	10	10	10	13	18	18	NA
End of Period P/FFO [X]	13	14	10	9	10	10	10	13	18	18	20	NA

Data source: NAREIT Chartbook January 2007, SNL

Our Outlook for the REIT Market

In the long run, we believe the underlying performance of REIT property holdings drives investment returns. REITs generate cash flows from rental income based largely on long-term leases. In the last 10 years, such cash flows—measured by FFO per share—grew at an average annual rate of 5.4%, ranging from negative 4% to nearly 20% per year as shown in the table above. After steadily declining since 2003, cash flow growth is back on track, driven by rising occupancies and rents, and lower tenant improvement and leasing commissions. With current dividend yields of less than 4% and assuming cash flow growth tracks the long-term average of 5.4%, an average, fairly valued REIT should deliver about 10% long-term investment returns. But today, as a result of their runup, by our estimates the average REIT is more than 30% overvalued.

There are wide differences in valuation between the sectors: Apartments, as a group, are trading 67% above our estimates of fair value, while health-care REITs seem fairly valued to us. There are even wider differences within each sector. For instance, although hotels on average trade more than 20% above our fair value estimates, **Lodgian** LGN trades almost 25% below our fair value estimate and **Orient-Express Hotel** OEH trades for more than twice our DCF-based estimate of its intrinsic value per share.

Overall, we think investors should consider trimming the REIT portion of their stock portfolios. And, within the REIT portfolio, they should consider selling or underweighting overvalued stocks.

Sector by Sector Valuation

Name	% Above Fair Value	P/FFO [X]		Dividend Yield TTM (%)		Weight in REIT Index (%)
		Recent	5-Yrs Prior	Recent	5-Yrs Prior	
Apartments	67	25	11	3.5	6.9	17
Self Storage	40	31	12	2.5	5.5	5
Retail	37	18	9	3.3	7.4	28
Hotel	23	15	14	4.4	7.2	8
Diversified	20	21	11	3.9	6.9	11
Industrial/Mixed	18	15	11	3.7	6.7	10
Office	17	21	13	3.5	7.3	14
Manufactured Homes	12	21	12	3.2	4.1	1
Health Care	0	17	10	5.3	8.7	6
Equity REIT Average	36	20	11	3.7	7.1	NA

Data source: Morningstar SNL

Major Themes by Sector [Data from Morningstar, SNL as of 03-04-07]

The Morningstar REIT analyst team covers 78 REITs and REOCs (real estate operating companies, which are not required by law to pay dividends) in all the major property sectors. We've compiled our thoughts about each sector below.

Apartment REITs

With all the rosy news about renters coming back into the market, apartment REITs are the most richly priced in our coverage universe: The slowdown in the housing market has been great news for these firms. With housing prices still high and first-time buyers finding it increasingly difficult to get nontraditional financing, the demand for rental apartments has been rising, especially in urban areas with the highest home prices. Owning a home is still too expensive for millions in supply-constrained markets such as New York City, Los Angeles, and San Francisco—according to the Census Bureau, the homeownership rate is about 55% in these markets compared with 69% nationwide, which should favor REITs, like **AvalonBay** AVB and **Archstone-Smith** ASN, with a heavy presence in these markets.

Apartments

Name	% Above Fair Value	P/FFO Est. [X]	Dividend Yield TTM (%)
Apartment Investment AIV	83	18	4.4
Archstone-Smith Trust ASN	70	24	3.3
AvalonBay Communities AVB	96	28	2.5
BRE Properties BRE	80	25	3.4
Camden Property Trust CPT	36	19	3.9
Equity Residential EQR	33	22	3.8
Essex Property Trust ESS	43	25	2.7
Home Properties HME	62	18	4.8
Post Properties PPS	82	24	4.0
United Dominion Real UDR	91	18	4.1
Apartment REITs Overall	67	25	3.4

During the height of the housing boom, nearly all new apartment projects were built for sale, and many rental apartments were converted into condominiums. The U.S. Census Bureau reported a 2.5% net decline in rental units from 2000 to 2005. Taking a lesson in economics 101, apartment owners viewed surging demand and dwindling supply as a sign to aggressively raise rents and eliminate incentives and concessions. We think this momentum should continue into 2007.

Even in this rosy environment, several factors could cause apartment REIT valuations to come down from last year's lofty levels. First, unsold condominiums will likely come into the market as rental units; we think developers would rather take a steady stream of rental income than sit on an empty unit for years hoping for a buyer. This problem will likely be most pronounced in markets that have seen large amounts of new condo construction over the past few years—Miami and San Diego come to mind. Second, rents can be pushed only so far before people start taking on more roommates or moving in with relatives. As a result, we would jump at the chance to pick up narrow-moat firms AvalonBay, Archstone-Smith, and **Equity Residential** EQR if they traded lower. By contrast, we believe firms with lower-end suburban properties—such as **Home Properties** HME, **United Dominion Realty** UDR, and **AIMCO** AIV—would be unattractive long-term investments even at cheaper valuations.

Retail REITs

Retail REIT fundamentals remain strong with high overall occupancy and strong demand for space translating into high rent renewal rates. Additionally, retail REITs were spared a major retailer bankruptcy in 2006. In addition to the overarching trend among REITs of incredible amounts of capital waiting to be deployed, we think retail REITs will continue expanding internationally, and the lines between traditional mall and lifestyle center owners will continue to blur.

Simon Property Group SPG, **General Growth Properties** GGP, **Taubman** TCO, **Developers Diversified Realty** DDR, and **Kimco** KIM have sought growth through joint ventures in international markets. We like the joint-venture approach to international markets because REITs get to team up with operators with local market knowledge, minimizing risk. REITs with an international footprint also provide a conduit for U.S. retail tenants seeking to expand internationally, and international retailers seeking to enter the U.S.

Another trend is the shift away from large-scale mall developments toward the “lifestyle center” concept. Lifestyle centers are open air, and contain a smaller footprint than malls but with traditional inline mall tenants. Lifestyle centers create a pleasant ambiance for shoppers by including elements of the outdoors. Their smaller size allows developers to locate the centers closer to areas with strong demographics. The developments have been well received and have strong operating performance.

Retail

Name	% Above Fair Value	P/FFO Est. [X]	Dividend Yield TTM(%)
CBL & Associates CBL	4	13	4.3
Cedar Shopping Centers CDR	0	13	5.6
Developers Diversified DDR	37	17	3.8
Equity One EQY	16	19	4.7
Federal Realty FRT	55	25	2.8
General Growth GGP	42	19	3.0
Getty Realty GTY	-4	14	6.5
Kimco Realty KIM	52	20	2.9
Kite Realty Group KRG	42	16	3.9
Macerich MAC	50	20	3.1
New Plan Excel Realty NXL	58	17	3.8
Realty Income O	4	15	5.6
Regency Centers REG	57	21	3.1
Tanger Factory Outlets SKT	35	16	3.6
Simon Property Group SPG	39	19	3.0
Taubman Centers TCO	57	21	2.4
Weingarten Realty WRI	19	17	4.0
Retail REITs Overall	37	18	3.5

Though the concept is relatively new, we think lifestyle centers will continue chipping away at the dominance of traditional malls. But mall REITs are responding by developing their own lifestyle centers. We think that the blurring between the two formats may open up possible consolidation between mall REITs and community centers.

Office REITs

About half the dollar value of announced or closed mergers and acquisitions (M&A) in 2006 involved office REITs; the buyout of Equity Office Properties by the Blackstone Group (a private equity player) alone accounted for one third of the \$120 billion transaction volume; we think office REITs in general rode this Blackstone wave in 2006. A clear line separates large office landlords in top markets such as Manhattan, Washington, D.C., and San Francisco, and smaller regional players with predominantly suburban assets. Among the former are **Brookfield BPO**, **Boston Properties BXP**, and **SL Green SLG**, all of which are overvalued, in our view. Even though we think markets like Manhattan remain among the strongest in the country—hiring is robust, new office supply remains constrained, and rents are growing at double-digit rates—we doubt rents can keep rising at such rates forever. Opportunities to increase rents are shrinking as space nears full occupancy and fewer leases come up for renewal each year. Besides, rapidly rising rents may already be forcing businesses to relocate more staff to surrounding suburbs, which favors suburban landlords like **Mack-Cali CLI**.

Industrial REITs

It's taken six years, but industrial REITs are finally back on top of their game. Surging global trade and a strengthening economy are driving improvements in occupancy and rents; net absorption of new space—meaning the amount of additional space that has become occupied during a year—has been consistently positive, and vacancy finished below 10% in 2006. Additionally, rents on new leases rose for the first time in several years. Inspired by these numbers, investors plunked down more than \$35 billion on industrial properties last year alone.

We think 2007 should offer more of the same as industrial REITs continue reaping the benefits of a growing logistics industry. Developers have been cautious about adding new space, which is a change from past trends; although development lead times are short in the industrial sector, we think high building costs are acting as a deterrent to new construction. We believe strong demand should support another year of solid growth. Corporations' emphasis on efficient supply-chain solutions and structural changes throughout the rest of the world—such as the European Union's role in transforming Europe into a boundary-less market and China's move to relax foreign

Office

Name	% Above Fair Value	P/FFO Est. [X]	Dividend Yield TTM(%)
Alexandria Real Estate ARE	17	19	2.8
Brandywine Realty Trust BDN	-12	14	5.2
Brookfield BPO	25	21	1.8
Boston Properties BXP	75	26	2.4
Crescent Real Estate CEI	-1	18	8.0
Mack-Cali Realty CLI	-7	15	5.2
Duke Realty DRE	21	16	4.5
HRPT Properties Trust HRP	2	11	6.9
Kilroy Realty KRC	55	27	2.7
Maguire Properties MPG	6	23	3.2
Corporate Office Properties OFC	3	23	2.5
SL Green Realty SLG	96	27	1.8
Office REITs Overall	17	21	2.8

Industrial

Name	% Above Fair Value	P/FFO Est. [X]	Dividend Yield TTM(%)
AMB Property AMB	12	17	3.2
EastGroup Properties EGP	18	18	3.7
First Potomac Realty FPO	12	16	4.4
First Industrial Realty FR	19	11	6.1
Liberty Property Trust LRY	2	16	4.9
ProLogis Trust PLD	36	17	2.6
Industrial REITs Overall	18	15	4.0

investment restrictions—should keep occupancies high in distribution facilities.

ProLogis' PLD and **AMB**'s AMB decision to become the "go-to" companies for multinational firms should enable them to retain their position as the top performers in the sector.

With the frothy valuations of top companies, we'd place our money on more under-the-radar players in the industry. **First Potomac FPO** and **EastGroup Properties EGP** both cater to strong local economies—the mid-Atlantic and the Southeast, respectively. At a slight discount to our fair value estimates, we would pounce on our favorite industrial REITs, ProLogis and AMB. They have second-to-none management teams, highly profitable property fund businesses, and smart development strategies.

Hotels

The hotel industry had a tumultuous start to the decade. Travel plummeted after the 9/11 attacks, leaving hotels half empty. The industry's woes were compounded by high fixed costs on unoccupied rooms. There were concerns that fears of terrorism and greater use of video conferencing would permanently depress travel.

However, the doom and gloom scenario did not come to pass. Starting in 2004, travelers rushed back as fat corporate profits led to more business travel, convention goers re-established their importance, and more confident consumers took longer and more expensive vacations. According to Smith Travel Research, revenue per available room (RevPAR), a key indicator of the strength of the hotel market, rose by more than 8% in 2005 and 2006—the fastest rate in 20 years.

At the same time, few new hotels have been built since 2000. Smith Travel reports that supply grew an average of 0.5% annually over the last three years, well below the previous years' 1.5% average rate. With so much fear and uncertainty surrounding the travel market, developers shied away from new construction, and the brave ones that tried to build faced several barriers. First, there was a limited amount of land in major business centers where demand for hotel rooms is highest. Second, construction and permitting costs rose dramatically as residential construction and international development sucked up scarce resources. This is beginning to change, though, especially in low-barrier-to-entry suburban markets. But even with new supply, we think the outlook for hotels is bright. According to Smith Travel, average nightly rates have surged 17% since 2002 as demand outpaces supply.

There are a few picks in the hotel sector. Until rumors of a takeover started, **Strategic Hotels & Resorts BEE** was trading below our fair value estimate. So, too, was **Sunstone Hotel Investors SHO**. Both firms focus on upscale and luxury properties in major urban and resort locations, which we believe will outperform suburban properties in the coming years. **Ashford Hospitality Trust AHT** has become cheaper since the announcement of a \$2.4 billion hotel portfolio purchase in January.

Hotels

Name	% Above Fair Value	P/FFO Est. (X)	Dividend Yield TTM(%)
Ashford Hospitality AHT	-18	11	7.1
Strategic Hotel & Resorts BEE	-13	13	4.6
Diamondrock Hospital DRH	9	11	4.3
Equity Inns ENN	0	11	5.8
Felcor Lodging Trust FCH	47	10	3.5
Hilton Hotels HLT	20	NA	0.5
Starwood Hotels & Rsrts HOT	12	23	1.0
Hospitality Properties HPT	1	10	7.1
Host Hotels & Resort HST	17	14	2.9
Interstate Hotels & Rsrts IHR	36	NA	0.0
Lodgian LGN	-24	NA	0.0
Marriott International MAR	27	NA	0.5
Morgans Hotel Group MHGC	16	NA	0.0
Orient-Express Hotel OEH	105	NA	0.2
Sunstone Hotel Investors SHO	-18	10	4.6
Wyndham Worldwide WYN	-18	NA	0.0
Hotel REITs Overall	23	15	2.5

Although we increased our risk rating to above average since the firm will be forced to take on a substantial new debt burden, we think Ashford could make a compelling investment at a deep enough discount to our fair value estimate. Two non-REITs, owner and manager **Lodgian** LGN and franchisor **Wyndham Worldwide** WYN, are also attractively priced right now.

Niche Sectors

It's no surprise that sectors such as self-storage, health-care, and student housing have turned in their best performances in recent years. Turned off by sub-5% capitalization rates (expected initial yields from acquisitions) in mainstream sectors, investors have opted for niche property sectors offering higher yields. We think this desire to buy less-expensive properties and diversify real estate holdings sent self-storage and health-care REIT stocks through the roof in 2006—both sectors surged more than 40%. Student housing fell behind—on account of one company, **GMH Communities** GCT, which saw its stock nosedive 33% following earnings restatements and management departures.

Self-Storage Sector

The stars have truly aligned for self-storage; strong job creation, steady population growth, and low construction starts have combined to drive exceptional growth in net operating income. Companies took advantage of low interest rates to acquire more properties, or, in the case of **Public Storage** PSA, to take out old rivals. The world's largest owner of storage space gained a foothold in Europe by buying Shurgard in one of the largest REIT mergers of the year.

While we expect the operating environment to remain favorable in 2007, we can't justify buying any of these stocks at current levels. Fundamentals can change on a dime in self-storage, where barriers to entry are low and pricing power is negligible. **U-Store-It** YSI is our best value in the sector. We believe the company is out of favor with Wall Street following management resignations and operational missteps. However, we think the company's operational problems are fixable, and are encouraged by the hiring of former Storage USA CEO Dean Jernigan as U-Store-It's new CEO.

Self-Storage

Name	% Above Fair Value	P/FFO Est. (X)	Dividend Yield TTM(%)
Extra Space Storage EXR	16	18	5.0
Public Storage PSA	45	22	2.1
U-Store-It trust YSI	6	24	5.9
Self-Storage REITs Overall	40	31	2.6

Health-Care Sector

Health care is the mirror image of self-storage in terms of industry economics. All the health-care REITs we cover have narrow economic moats thanks to long-term leases, high returns on capital, and protected portfolios courtesy of certificate of need (CON) laws that regulate new construction of hospitals and skilled nursing facilities. As a result, we're much more optimistic that the current good times will last, particularly with a wave of baby boomers approaching their 60th birthdays. The U.S. Census Bureau predicts that the number of 65- to 85-year-olds will increase nearly 40% from 2010 to 2020. We think the current share prices of most health-care REITs do not fully reflect this factor. We believe as health-care REITs become savvier portfolio managers, more investors will recognize this increasingly sophisticated and attractive sector. **Health Care Property HCP** is a shining example of this sophistication; by focusing on private pay facilities and selling noncore properties for large profits, we believe the company has assembled the best health-care real estate portfolio in REIT-land.

Student Housing Sector

Student housing is also benefiting from steady demand for its facilities. The Department of Education projects a 16% increase in college enrollment from 2002 to 2014, and we expect this growing (and more affluent) demographic to favor the on-site suites and resort-style amenities offered at student housing REITs. Eager to unload their landlord duties, more colleges are turning their student housing management and development needs over to these companies, which should drive growth. The only question in our minds is supply. The student housing market is incredibly fragmented, and not much prevents a private developer from putting up a new apartment complex. For this reason, we prefer REITs such as **American Campus Communities ACC** that own more than 90% of their properties within one mile of campus. A strategy such as this allows American Campus to consistently raise rents and compete with the latest off-campus property to go up down the street.

GMH Communities GCT is currently the only 5-star stock in our REIT universe, for good reason. The stock has suffered one misstep after another, from accounting investigations to poor property performance. However, we think the market has overlooked its quality student housing properties and the value of its management contracts with the military. It may take awhile for the market to come around, but we think GMH represents a compelling buy for patient investors.

Health Care

Name	% Above Fair Value	P/FFO Est. [X]	Dividend Yield TTM(%)
Health Care Property HCP	10	17	4.9
Nationwide Health Prop NHP	8	16	5.3
Senior Housing Prop SNH	-9	14	6.1
Universal Health Realty UHT	-7	14	6.5
Ventas VTR	-7	17	2.8
Health-Care REITs Overall	0	17	4.9

Student Housing

Name	% Above Fair Value	P/FFO Est. [X]	Dividend Yield TTM(%)
American Campus Comm ACC	14	21	5.9
GMH Communities Trust GCT	-28	22	8.4
Student Housing REITs Overall	4	21	6.5

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