

Real Estate Investments – October 4, 2007

NEW YORK – Oct. 4, 2007 – When the music stopped in the residential-real-estate market, speculators who got caught with unsold houses and condos began putting them on the market as rentals. This “shadow market” has made investors jittery about price-destroying competition for the real-estate investment trusts that own big apartment complexes.

For most of the country, though, it is a landlords' market, with vacancy rates falling and rents rising in many major cities. Despite a sell off in apartment REITs, the shadow market is really confined to real-estate disaster areas such as Florida, Las Vegas and Phoenix. That presents a buying opportunity for stock-market investors.

Figures released Wednesday by New York-based research firm Reis Inc. show that the nation's apartment-vacancy rate dropped 0.2 percentage point in the third quarter, while rents increased a healthy 1.4 percent.

Apartment owners in high-price cities such as San Francisco and New York seem to be benefiting from renters who are getting locked out of the for-sale market because of the lack of so-called jumbo mortgages, which are more than \$417,000, says Sam Chandan, Reis chief economist. Rents in New York jumped 3.6 percent in the third quarter. In San Francisco, they were up 3.4 percent.

That is all good news for publicly traded REITs that specialize in apartments.

REITs are real-estate companies that pay no corporate income tax and distribute at least 90 percent of their earnings in dividends. Apartment-company stocks have suffered compared with their real-estate rivals. The Dow Jones Apartment REIT sub index is down 8.6 percent year-to-date, though the stocks have rallied in the past month. The overall Dow Jones Equity REIT index, which includes hotels, retail, self-storage and office properties, is down just 2.8 percent.

The stocks of apartment-owning REITs have a lot going for them. Nearly two million rental households have entered the market in the past two years, including buyers who have shied away from the for-sale housing market and those who defaulted on home mortgages.

“That’s equivalent to filling up New York City,” says Raymond Torto, principal of CBRE Torto Wheaton Research, a real-estate research firm.

Some companies say investors haven’t recognized that apartments, in some cases, behave in opposition to single-family homes, absorbing the decline in homeownership and lack of affordability. “They clump it all together,” says Richard Campo, chief executive of Camden Property Trust, a Houston-based apartment REIT. Camden’s stock is down 11.5 percent this year, closing Tuesday’s session on the New York Stock Exchange at \$65.35, up \$1.55, or 2.4 percent.

The supply of apartment buildings has been constrained by below-average construction of units, less than 100,000 units a year in the past few years in the top markets, according to Reis. And the echo boom – the demographic bulge made up of baby-boomer offspring – is entering prime renting age.

“In our view, we will have more additional demand for renters than additional supply of rental property,” says James Corl, chief investment officer at Cohen & Steers, a New York investment firm specializing in REITs. It has about \$35 billion under management.

It is easy to understand why investors have been nervous about apartment REITs. For one, it is difficult to assess the impact of the shadow market because there isn’t an accurate measure of the number of individual homes and condominiums that are on the rental market.

“It’s my greatest frustration,” says apartment analyst Craig Leupold of Green Street Advisors Inc., a Newport Beach, Calif., real-estate research firm. “I’d love to get better data on how many vacant single-family homes are for rent.”

James Kammert, portfolio manager at Transwestern Securities Management, a Chicago-based asset manager with about \$250 million in the REIT sector, says the discounts are “quite attractive in the apartment space.” He says the value of apartment buildings may hold up because apartment REITs can access commercial-mortgage loans from Fannie Mae and Freddie Mac. Property owners in other sectors can’t, and are thus more exposed to the recent credit crunch. Still, there clearly are risks for apartment REITs, the biggest being an economic slowdown that could reduce demand for apartments.

The most attractive REITs are trading below the total value of the apartment buildings they own and are cheaper than their competitors based on their projected funds from operations, which is essentially their profit excluding depreciation expenses.

For example, the share price of the largest apartment company, Denver-based Apartment Investment & Management Co., with 1,200 apartment complexes and 209,000 units, is down 15 percent this year and has been sold off to the point that it looks cheap. Aimco is trading at a 24 percent discount to its net asset value. What's more, it trades at 13.5 times its 2007 estimated funds from operations, compared with 21.2 times for the apartment sector. In 4 p.m. trading Tuesday on the Big Board, Aimco's shares were up \$1.05, or 2.3 percent, to \$43.74.

Another to consider: AvalonBay Communities Inc., based in Alexandria, Va. With a high-end portfolio of buildings in hard-to-build urban markets, AvalonBay is trading at a 7.4 percent discount to net asset value, though its funds-from-operations multiple is an above-average 25.2. Its shares closed Tuesday on the NYSE at \$122.09, up \$2.60, or 2.2 percent.

There are bargains throughout the sector. According to BMO Capital Markets, apartment REITs overall are trading at a 10 percent discount to net asset value. That discount would be even more but for the takeover of one of the largest apartment REITs, Archstone-Smith Operating Trust, whose stock price has stayed relatively high since it agreed to a buyout in May and closed Tuesday at \$59.95, down 23 cents on the Big Board. That deal is scheduled to close Friday.

Camden's Mr. Campo says the shadow market has had a sizable effect on his company's apartments. But there also is a flip side: Camden is recruiting failed homeowners to rent its apartments.

"They're pretty good renters," he says of foreclosed-upon homeowners. "But they didn't realize what the total cost of ownership really meant. We are marketing to those people as long as they have reasonable credit minus the foreclosure," he says.

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