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Apartment-House Blues

By ANDREW BARY

A TOP-OF-THE-MARKET LEVERAGED BUYOUT of Archstone Smith, a leading real-estate investment trust, could prove disastrous for Wall Street firms and other equity investors in the \$22 billion transaction, which closed three months ago.

What differentiates Archstone from other potentially troubled LBOs, including Chrysler, Linens 'n Things, Swift Transportation and Claire's Stores, is that Street firms could be stuck with a good chunk of the equity in the deal. In most LBOs, private-equity firms like Apollo and Blackstone provide the equity while banks and investment banks offer financing guarantees.

The Archstone situation is murky because key participants, including Tishman Speyer and Lehman Brothers (ticker: LEH), are saying little about the transaction other than that the company had 5%-plus rent growth in 2007 and that two property sales were completed recently at high prices. When Archstone, a leading REIT focused on the apartment market, went private, Lehman, Banc of America Strategic Ventures and Barclays Capital provided a \$4.6 billion bridge-equity loan to get the deal done. Real-estate funds operated by Tishman Speyer, a prominent New York property firm, and Lehman Brothers each put up \$250 million for control of the private Archstone.

It's unclear now how much of the bridge-equity loan has been sold to institutional investors. Prior to the closing of the deal, Lehman and Tishman Speyer said on a conference call that only \$500 million of the bridge-equity loan was likely to be sold at closing. The duo looks to sell all the equity within a year.

Heavy Load: Privately held Archstone has five times the debt of AvalonBay, a comparable publicly traded real-estate investment trust. As a result, it faces a tougher challenge in a rocky real-estate market.

Soon after the deal got done, prices of apartment REITs, including AvalonBay Communities (AVB) and Equity Residential (EQR), fell. With apartment REITs down 30% since October, it may have proven difficult for Lehman and Tishman Speyer to sell the equity, leaving Lehman, Banc of America Strategic Ventures and Barclays stuck holding much of the bridge loan. AvalonBay, a comparable REIT, has seen its shares drop to 83 from 125 in October.

Archstone has an attractive portfolio of apartments in good markets, including Washington, Manhattan, southern California and the San Francisco Bay area. It owns a mix of desirable garden apartments and high rises.

Wall Street is concerned, however, that rent increases will slow, even in relatively strong markets. Apartment REITs also face pressure as large numbers of unsold single-family homes get rented out. Several Street analysts have cooled on apartment REITs, cutting stock-price targets and financial projections for the group.

Archstone has staying power because it raised a substantial amount of money when it went private, including \$9 billion of secured loans from Fannie Mae (FNM) and Freddie Mac (FRE). Yet, based on current REIT prices, the value of the Archstone equity could be zero.

Archstone is a classic example of a good company with a bad balance sheet. It has more than \$16 billion of debt, and its interest expense is running at more than \$1 billion annually. Cash flow from its properties was running at just a \$700 million rate in the second quarter of 2007, meaning the company is burning cash. The LBO sponsors told potential lenders in September that Archstone actually was covering its interest expense -- but that was only because of a pre-funded \$500 million interest reserve.

The Bottom Line:

Archstone is burning cash and could face slowing rent increases. It may also feel pressure as unsold single-family homes are rented out. Its equity may now be zero.

In the real-estate world, properties and companies often are valued based on a capitalization rate, which essentially is the return that an all-cash buyer would get. The cap rate is calculated by taking annual net operating income and dividing it by the purchase price. Archstone's buyers accepted a low capitalization rate of about 4.3%, below the 6% interest cost on its debt.

With the selloff in REIT shares, cap rates on apartment REITs have risen to an average of 7%. The highly-regarded AvalonBay has a cap rate of around 6.3%. The lower the cap rate, the higher the value of a company.

With rising cap rates, Archstone's value probably is going down, imperiling the equity in the deal. Assume a 6% cap rate and the company would be valued at \$14 billion, based on an optimistic \$850 million of net operating income for this year. This would imply a wipe-out of the \$5 billion of equity since the company has that \$16 billion-plus in debt that takes precedence. Even the use of an aggressive cap rate of 5.5% results in no equity value.

Things could break right for Archstone if the economy recovers and apartment-REIT shares come back into favor. But those are big ifs. Archstone may end up being one of the biggest casualties of the LBO mania.

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