

Company Flash

26 July 2007 | 9 pages

Archstone-Smith Trust (ASN)

Could the Buyer Cut Their Losses and Walk Away?

- **Cutting Their Losses?** — If the Tishman/Lehman partnership that is acquiring Archstone had to finance the transaction at today's interest rates or if they had to sell the Archstone portfolio, the losses would likely be greater than the \$1.5 billion breakup fee, as outlined below.
- **Reputation and Spillover Risk** — While paying the break-up fee could be attractive given the potential losses, the parties' reputations would be at risk, and the spillover effects could be large, making it an inferior long-term decision.
- **Debt Details Unclear** — The degree to which Lehman has hedged the debt and equity commitment they made to the transaction is unclear, but Lehman is not likely fully hedged, in our view. The debt commitment is through 12/31/07, so one option would be to delay the deal closer to year-end when liquidity will likely be better. However, it is unclear why Archstone would agree to a delay.
- **Battle over Fee Could Occur** — The cap on the break-up fee (limited to "up to" \$1.5 billion in damages), the likelihood of a legal debate in determining damages, and the fact that the break-up fee exists could minimize the damages.
- **Downside Risk** — If ASN were to trade at the same implied cap rate as AVB today (5.1%), ASN would be at \$51, \$10 below the deal price. Up to \$6 could be recovered in the break-up fee, putting ASN at \$57. However, ASN would likely trade lower than AVB, as the deal has not sat well with investors and ASN has historically traded lower, making it likely the stock could trade even lower. If the deal goes through as planned, there is 4% upside potential.

Hold/High Risk	2H
Price (26 Jul 07)	US\$58.35
Target price	US\$60.75
Expected share price return	4.1%
Expected dividend yield	0.0%
Expected total return	4.1%
Market Cap	US\$13,007M

Jonathan Litt
 +1-212-816-0231 | 1-203-975-5026
 jonathan.litt@citigroup.com

Craig Melcher, CFA
 +1-212-816-1909
 craig.melcher@citigroup.com

Skyler Cho
 skyler.cho@citigroup.com

See Appendix A-1 for Analyst Certification and important disclosures.

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- **REITs Down 10%** — REITs have fallen 10% since the deal to purchase Archstone for \$60.75 was announced on May 29th. While several aspects of the deal were disappointing, including CEO Scot Sellers signing of an employment agreement and re-trading of lower bids from \$64 to \$60.75, getting a higher price has moved to the back burner and concerns over whether the deal will close have risen.
- **Break-Up Fee Lopsided** — The break-up fee of up to \$1.5 billion would consist of \$250 million from Tishman and \$1.25 billion from Lehman, meaning all of Tishman's equity commitment in the deal is at risk and only one-quarter of Lehman's and Banc of America's equity commitments of \$4.6 billion are at risk if they walk. Tishman is less likely to want to walk given the quick payback of its equity from fees it can earn going forward in the deal. However, the reputation risk for Lehman and Banc of America would be great if they walked.
- **Arb Spread Wide, But Not With Risks** — ASN screens as a good arb opportunity trading 3.9% below the takeout price, representing an annualized return of 50% if the deal closed end the end of August, which could occur given the shareholder vote scheduled for August 21st. However, the deal could be delayed or fall through.
- **Spreads Widened** — The all in rate on the \$17.1 billion in debt is at least 100 bps higher than when the deal was announced. AAA spreads have widened 25 bps, and BBB spreads have widened by over 400 bps (now over 800 bps above the index, causing the all in cost to be in the low double digits), while the junk piece is likely in the low to mid-teens.
- **Lower IRR** — On the equity side, the transaction was tight at the outset, with a targeted IRR of around 10% on the sale of the \$4 billion in equity. The increase in debt costs have likely lowered that IRR to the 6%-7% level at the same time that equity investors will likely be demanding higher returns.
- **Likely to Wait** — If the deal proceeds, we would expect the debt and equity to be re-sold at a later date, some time in the fall after the backlog of LBO financings have cleared the market and likely after the current extreme sell-off has settled down. If it had to be done today, the loss would likely be in excess of the break up fee of \$1.5 billion. The Lehman/Tishman team seems likely to take the chance that loss will be less in several months, rather than taking the loss now, in our view, based on the current state of the credit market. Lehman and Banc of America have posted the debt commitment, with Lehman expected to syndicate the equity.
- **Lehman in Both Chairs** — Lehman's position is atypical, as it is in both chairs, acting as the PE player and the bank. Typically, the debt is being funded by a bank and a PE firm is the buyer, creating a situation where the bank has not option to make good on their commitment. We thought it instructive to walk investors through the thinking of the buyers, given the sufficiently unusual nature of this type of transaction in the REIT space.

Levered IRR Falls by 3% Assuming 100 bp Rise in Debt Costs

We estimate the levered IRR on the deal has dropped by 300 bps, assuming a 100 bp rise in all-in debt costs. A 9%-10% levered IRR could have been achieved, but we estimate this fell by roughly 300 bps assuming a 100 bp rise in debt costs. Arguably, exit cap rates may also have to be tweaked higher. Our assumptions include:

- 4% initial yield (including closing costs, tax protection payments and higher property taxes);
- 6% annual NOI growth;
- 4.5% exit cap rate;
- an increase in all-in borrowing costs on total debt from 5.75% to 6.75%;
- debt representing 78% of total deal price, with equity the remainder; and
- 5-year hold period.

Details from the proxy on the break-up fee highlight uncertainty of amount (this was an item discussed and changed during the process):

In connection with the merger agreement, Lehman Brothers and TS Fund VII have agreed to unconditionally and irrevocably guarantee the payment obligations of the buyer parties and any obligations to pay losses or damages under the merger agreement in an amount up to an aggregate of \$1.5 billion, consisting of a \$1.25 billion guarantee from Lehman Brothers and a \$250.0 million guarantee from TS Fund VII.

Archstone-Smith Trust

Company description

Archstone-Smith (ASN) is a large-cap multifamily REIT based in Denver, Colorado that owns an interest in approximately 77,700 apartment units throughout the United States and 8,300 units in Germany. In addition, the company has an interest in 6,700 units under construction in 17 communities. Archstone-Smith was formed through the June 1998 merger of its predecessor company, Security Capital Pacific, and sister company, Security Capital Atlantic. Archstone-Smith focuses on acquiring, developing, and operating multifamily units in high-barrier-to-entry markets, primarily Washington, D.C., Southern California, northern California, and New York. The company is a member of the S&P 500 Index.

Investment thesis

We rate ASN shares Hold/High Risk (2H). Archstone owns a portfolio of high quality properties, located in high-barrier-to-entry markets, run by a sophisticated management team. Archstone is focused in the Northeast and California and has the largest Manhattan presence of any publicly traded multifamily REIT. Archstone has a \$4-billion development pipeline that should drive value creation. Our enthusiasm for the shares is tempered by premium valuations across the multifamily sector and FFO contribution from Ameriton.

Valuation

We use a dividend plus growth model to forecast total returns, which generally assumes the current-year multiple is applied to next year's earnings. For example, if a company's normalized AFFO (adjusted funds from operations) is expected to grow by 8%, our target price is 8% above the current level. We then add the dividend yield to arrive at a 12-month forward expected total return. We currently believe that REITs will deliver a +/- 10% total return in the next 12 months. We consider a result falling within a range of +/- 10% of the company's current multiple as typically within the margin of error. ASN's \$60.75 target price is within this margin.

Risks

We rate ASN shares High Risk, reflecting our increased concern over REIT sector valuations. We have High Risk or Speculative ratings on all of the REITs in our coverage universe. While we do not see an imminent catalyst to derail the sector's prolonged rally, several factors could cause the group to retreat, including higher interest rates, a broad equity market rally, or a shock to the credit markets. Our higher risk ratings across the sector suggest the group is more susceptible to a downdraft, should a catalyst emerge.

Other factors contributing to our High risk rating on shares of ASN include an above-average 2006 AFFO payout ratio and the volatility of the earnings stream from Ameriton, the company's speculative development subsidiary. These factors are balanced by ASN's long-term stability of core earnings, below-average leverage, and relatively large market capitalization.

Risks we see to the stock's ability to achieve our target price include:

- 1) ASN has a large development pipeline, which may be a drag on earnings if ASN is unable to lease up completed developments;
- 2) a potential repeal or modification to Proposition 13 in California poses a risk of a sharp increase in real estate taxes.

If the impact of any of these factors proves to be greater/less than we anticipate, it could prevent the stock from achieving our target price or it could cause the shares to meaningfully exceed our target price. Also, if the 10-year Treasury remains at historically low levels, the REIT universe could continue to rally, and shares of ASN could outperform our target price.

AvalonBay Communities, Inc (AVB.N - US\$109.18; 2H)

Valuation

We use a dividend plus growth model to forecast total returns, which generally assumes the current-year multiple is applied to next year's earnings. For example, if a company's normalized AFFO (adjusted funds from operations) is expected to grow by 8%, our target price is 8% above the current level. We then add the dividend yield to arrive at a 12-month forward expected total return. We currently believe that REITs will deliver a +/- 10% total return in the next 12 months. We consider a result falling within a range of +/- 10% of the company's current multiple as typically within the margin of error. AVB's \$125 target price is within this margin.

Risks

We rate shares of AVB High Risk, reflecting our increased concern over REIT sector valuations. We now rate all of the REITs in our coverage universe High Risk or Speculative. While we do not see an imminent catalyst to derail the sector's prolonged rally, several factors could cause the group to retreat,

including higher interest rates, a broad equity market rally or a shock to the credit markets. Our higher risk ratings across the sector suggest the group is more susceptible to a downdraft, should a catalyst emerge.

Other factors contributing to our High Risk rating on shares of AVB include a high level of earnings volatility and the dependence on development where yields are difficult to predict. These factors are balanced by AVB's high quality assets, exposure to supply-constrained markets, and below-average 2007 AFFO payout ratio.

Risks to the stock achieving our target price include: Increased costs and slower lease-ups have resulted in lower stabilized yield expectations on new development (down 200-plus bps). The potential for a repeal or modification of Proposition 13 – which has suppressed real estate taxes for many of AVB's properties in California — poses a risk of sharp expense growth.

If the impact on AVB from any of these factors proves to be greater/less than we anticipate, it may prevent the stock from achieving our target price or could cause our target price to be materially outperformed. For example, if the 10-year Treasury rate stays low, the REIT universe could continue to perform strongly and AVB could further exceed our target price.

Appendix A-1

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Archstone-Smith Trust (ASN)

Ratings and Target Price History - Fundamental Research

Analyst: Jonathan Litt



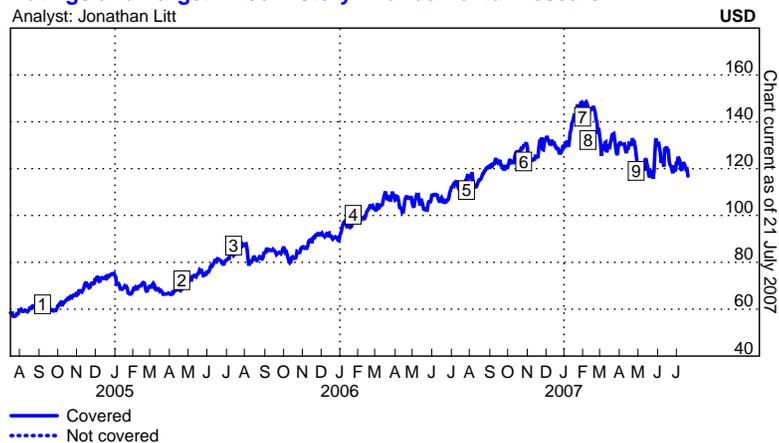
#	Date	Rating	Target Price	Closing Price
1:	3 Nov 04	2M	*33.00	34.81
2:	1 Mar 05	2M	*35.00	34.30
3:	14 Jul 05	*2H	*43.00	40.19
4:	2 Feb 06	2H	*46.00	46.46
5:	25 Jul 06	2H	*52.00	51.99
6:	24 Oct 06	2H	*60.00	58.63
7:	1 Feb 07	2H	*64.00	61.75
8:	9 Feb 07	2H	*66.00	60.58
9:	9 May 07	2H	*56.00	52.14
10:	29 May 07	2H	*60.75	61.42

*Indicates change.

Avalon Bay Communities (AVB)

Ratings and Target Price History - Fundamental Research

Analyst: Jonathan Litt



#	Date	Rating	Target Price	Closing Price
1:	8 Sep 04	*3M	*58.00	62.10
2:	21 Apr 05	*2M	*72.00	68.52
3:	14 Jul 05	*2H	*89.00	82.92
4:	25 Jan 06	2H	*100.00	98.30
5:	27 Jul 06	2H	*115.00	115.53
6:	26 Oct 06	2H	*136.00	130.20
7:	1 Feb 07	2H	*152.00	146.88
8:	9 Feb 07	2H	*159.00	145.99
9:	27 Apr 07	2H	*145.00	125.95

*Indicates change.

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Data current as of 19 July 2007

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