

From: Levin, Scott A [scott.levin@lehman.com]
Sent: Monday, January 21, 2008 9:30 PM (GMT)
To: Hash, Steven R [shash@lehman.com]; Lazarus, David S [david.lazarus@lehman.com]; Schaevitz, Scott [scott.schaevitz@lehman.com]; Beeson, Lisa E [lisa.beeson@lehman.com]
Cc: Bishop, Michael (GREG Banking) [michael.bishop@lehman.com]
Subject: RE:

Over the weekend, we met with Tishman, Barclays and Bank of America to discuss the Barron's article published on Saturday morning. While we are not planning to formally respond to the report, we created a lot of materials in order to update our respective teams. We analyzed public company information, compiled data on recent ASN asset sales and comparable asset sales, reviewed ASN's business plan and discussed the revised model and pro forma capitalization.

As I am sure you are aware, the article is incorrect in stating that there is no equity value in the company. When Andrew Bary is calculating the value of the company, it does not appear that he is including Archstone's assets held for sale, development pipeline, German platform, ground leases and other assets, which have significant value. He is also not attributing any value to the company's asset management / development platform. Andrew is simply applying a cap rate on the company's core operating portfolio NOI. Most of all, that cap rate is significantly higher than the cap rate that ASN's assets have recently traded and is not representative of the company's portfolio. That being said, if we actually thought the appropriate cap rate for the company's assets was 6.0%, there would not be much equity value in the company (please do not share that information).

We have also created materials that illustrate 1) applying an implied cap rate based on the share price of a public company is misleading because there is a significant disconnect between public REIT share prices and private market real estate values and 2) cap rates for institutional quality apartment buildings in high barrier-to-entry markets have moved relatively little. Below please find a summary of the information we compiled and please let us know if you want any of the back-up data. Thanks.

HUGE DISCONNECT BETWEEN PRIVATE AND PUBLIC MARKETS:

The article claims that if you "assume a 6% cap rate, the company would be valued at \$14 billion, based on an optimistic \$850 million of net operating income for this year."

Public companies are trading at a significant discount to NAV (Archstone's comps are trading at a 34.4% discount to consensus NAV estimates) and their implied cap rate (based on share price)

substantially exceeds private market cap rates. For example, AvalonBay's current implied cap rate is 7.3%, but according to Green Street, it's nominal cap rate is only 4.9%. The nominal cap rate is the assumed cap rate for the company's primary property type. In addition, as we mentioned above, the \$14 billion number excludes the company's other business lines.

CAP RATES REMAIN LOW:

We also did work around recent property transactions to demonstrate that cap rates for well-located, institutional-quality assets have moved very little, if at all. Of the 10 most recent transactions of apartment properties in ASN's core markets (Boston, New York, Washington, DC, Southern California, San Francisco and Seattle) the weighted average cap rate was 4.17%. We specifically highlighted a \$726 million JV on 12/21/07 between AIMCO and JPMorgan in West LA at a 4.2% cap rate, and ASN's two most recent sales and the Orange County / San Diego JV completed at close (3.75% weighted average cap rate).

Compared to other sectors, cap rates have remained relatively stable for apartments in spite of the current credit turmoil, given the "back-stop" provided by Fannie Mae and Freddie Mac.

RESEARCH EXCERPTS:

Listed below are a few excerpts from various research reports.

"We favor the company's (referring to AVB) high-quality assets, which appear to be holding their value better than B/C product. A strong presence in high-barrier-to-entry markets is also helping support NAV, while allowing for above average earnings growth." - Bear Stearns AVB Report (1-10-2008)

"We expect AVB's assets to continue to hold their value better than lesser-quality product in less desirable locations. AVB sold three communities through the third quarter of 2007 at a weighted average cap rate of 4.6%, below the 4.9% nominal cap rate used in our NAV calculation and in line with the average cap rate on four 2006 asset sales." - Bear Stearns AVB Report (1-10-2008)

"Amidst an extremely illiquid transactions market, property values are currently very hard to peg. The fact that a major institutional player (JP Morgan) was willing to pay a price that approximates the values utilized in our estimate of NAV sends a reassuring signal that apartment values have yet to move down much from their mid-'07 highs." - Green Street AIMCO JV Report (1-4-2008)

"Many observers point to the wall of capital and the seemingly insatiable appetite of advisors and others looking to invest committed capital, as well as historically strong property-level fundamentals that still exist in apartment-land as support for sticky cap rates. Additionally, the dislocation in the debt markets has not had as profound of an impact on borrowing rates and cap rates for apartments as for other sectors, given the "back-stop" provided by apartment lenders Fannie Mae and Freddie Mac." - Green Street Apartment Outlook (11-30-2007)

"Despite the debt market turmoil leading to widening spreads, treasury rates have come down and Fannie Mae and Freddie Mac remain active lenders in the space, thus diminishing the negative effects of the credit market tumult. That said, there remains the potential for higher debt costs based on the continued uncertainty in the market. Nonetheless, cap rates on A quality assets in top markets have yet to increase, although cap rates in secondary markets are up slightly. Cap rates remain in the 4% range in California and the West Coast more generally, and in the mid-to-high 4% range in its East Coast markets, with Boston averaging about 5.0% for AVB's assets." - Bear Stearns AVB Report (11-2-2007)

"The greatest issue facing REIT investors generally, and apartment REIT investors specifically, is the ever-increasing discount to NAV at which REITs are trading. Apartment REITs now trade at a 25% discount to NAV and a 14% discount to unleveraged asset value. The public market is clearly expecting an increase in cap rates driven by slowing NOI growth, historically small equity risk premiums, and dislocation in the debt markets. While expectations of higher cap rates are justified, there has been no change in private-market apartment cap rates thus far." - Green Street Apartment Update (8-10-2007)

-----Original Message-----

From: Levin, Scott A

Sent: Monday, January 21, 2008 4:18 PM

To: Hash, Steven R; Lazarus, David S; Schaevitz, Scott; Beeson, Lisa E

Cc: Bishop, Michael (GREG Banking)

Subject: RE:

Below please find the article. Bishop and I will send you an overview of our analysis shortly. Thanks.

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.

-----Original Message-----

From: Hash, Steven R
Sent: Monday, January 21, 2008 4:14 PM
To: Lazarus, David S; Schaevitz, Scott; Beeson, Lisa E
Cc: Levin, Scott A; Bishop, Michael (GREG Banking)
Subject: Re:

Is it possible to have someone send me the text of the article

----- Original Message -----

From: Lazarus, David S
To: Schaevitz, Scott; Beeson, Lisa E; Hash, Steven R
Cc: Levin, Scott A; Bishop, Michael (GREG Banking)
Sent: Mon Jan 21 13:40:23 2008
Subject: RE:

Guys have been working all weekend to deal with this as it obviously creates issues both externally and internally. Scott and Mike Bishop can get some bullet points.

-----Original Message-----

From: Schaevitz, Scott
Sent: Monday, January 21, 2008 11:44 AM
To: Lazarus, David S; Beeson, Lisa E; Hash, Steven R
Subject:

Do we have a standard response to questions regarding this weekend's Barron's article on ASN?

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