
MEMORANDUM

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FROM: David Augarten, Kevin Siebers

SUBJECT: Archstone Update

DATE: March 24, 2008

Current Status of the Plan

Since October we have sold approximately \$653 million of assets and closed on \$199M of new financings, which has led to the pay down of \$553 million of Term Loan and \$92M of the Development Loan. While it has certainly been an uphill battle to get deals closed, it looks like we will achieve the debt pay down targets through Q1 that we outlined in the original Plan. Assuming the NY seconds financing closes next week, we will have paid down approximately \$964 million of bank debt (Development Loan and Term Loan) through Q1 as compared to \$958 million in the original Plan.

Despite the successes earlier this year, selling assets has proven to be very difficult in general and market participants have become decidedly more cautious in the last several weeks. All of the large deals that we were trying to put together earlier this year have been unsuccessful to date (although Irvine is now engaged in discussions about direct purchases of California assets). In addition, few of the deals that we have taken to market and awarded to buyers have led to actual closed transactions, and re-trades have been common.

Last week alone, in the wake of the Bear Stearns meltdown, three transactions that appeared to be moving forward (Crystal City portfolio, Thousand Oaks, Canyon Creek / Redmond Hill) were abruptly dropped by the buyers. Together these deals represented over \$1 billion of potential real estate sales. On the Crystal City deal specifically, the buyer, SJ Ross, was able to find a new equity partner after dropping the deal, but then asked for a \$98 million re-trade (representing a 13% discount to the previously negotiated contract price), which we declined.

Until market conditions stabilize it will continue to be challenging to sell assets. Nevertheless, we will continue to do everything we can to close deals at reasonable prices without appearing desperate, and we are in the midst of discussions with several potential buyers that appear to be promising.

The “Revised Plan”

To adjust to changing market conditions, we have retooled our disposition strategy. There is a lot of competition today for JV capital, so we are focusing our efforts on selling assets outright, and are proactively reaching out to well-financed buyers like Douglas Emmett, Irvine, Essex, EQR, etc. We will consider selling a broader range of assets (including assets in Northern California) and are prepared to



accept slightly lower prices if necessary, in the near term, to free up some liquidity. We are also preparing to bring some trophy quality assets to market (Studio City, Del Mar Station) which will hopefully attract better demand, but we are also cautious about not flooding the market with too much product. Above all, Archstone must continue to position itself as a disciplined seller of assets, or prices will decline significantly.

The Revised Plan assumes roughly \$3.7 billion of asset sales in 2008 (as compared to \$3.9 billion in the original Plan) at a 13.4% discount to appraised value for the core portfolio sales (as compared to a 10.4% discount to appraised value for the core portfolio sales in the original Plan). All of the pricing and timing assumptions are based on feedback from Archstone, which reflects their continued dialogue with active participants in the market.

Specifically, the Revised Plan assumes that we will be able to sell the Werner assets, the Crystal City portfolio, the DC portfolio currently being marketed for sale, Newport Village, Gaithersburg, Studio City, San Jose, Clinton and several other deals. Most of the sales are projected to occur in Q3 or Q4 given current market conditions. In addition, the Revised Plan also assumes \$816 million of refinancing proceeds in 2008. \$319 million is being provided by Fannie for the New York seconds and is expected to close by the end of the month. The balance is projected to come from the unencumbered Fannie asset financing that closed two weeks ago and from new construction loans, land loans and a new mezz loan on the Calabasas asset.

A detailed summary of the Revised Plan is attached hereto. A summary of the gross and net proceeds by quarter is shown below.

	Original Plan Gross Sales Proceeds	Revised Plan Gross Sales Proceeds	Original Plan Debt Pay Down and Cash for Revolver	Revised Plan Debt Pay Down and Cash for Revolver
Q1 - 2008	275,257,080	278,395,977	693,092,120	725,597,342
Q2 - 2008	1,269,128,722	221,758,879	727,238,775	599,978,063
Q3 - 2008	1,728,941,250	1,346,949,446	769,043,438	552,694,019
Q4 - 2008	605,225,000	1,857,444,281	244,532,069	630,919,366
TOTAL	3,878,552,051	3,704,548,583	2,433,906,403	2,509,188,789

If we are able to successfully execute the Revised Plan, it should allow us to repay most of the Development Loan by year end and provide \$2.1 billion of cash in 2008 to pay down the Term Loan and refresh Revolver capacity. However, if market conditions continue to deteriorate, we will not be able to meet the sales goals outlined above, and could face a liquidity problem. In recognition of the near term challenges, we have assumed very few sales in Q2 as compared to the original Plan.

Liquidity Analysis

By the end of March, the Company is projected to have \$377 million drawn on the Revolver and another \$167 million of capacity used up by letters of credit. In total \$544 million of capacity on the \$750 million Revolver will be used. Based on the current Base Case liquidity analysis, which assumes normal capex spending, funding of the development pipeline and an expansion of the mezzanine loan business, we will run out of liquidity by the end of July if we are unable to execute sales of assets.

Because of the way that the Term Loan sweeps work, we are unable to refresh Revolver capacity on an on-going basis except from asset sales.¹ We are required to sweep 100% of the first \$500 million of net

¹ We have also incurred transaction costs in the amount of \$93 million that have been paid with Revolver borrowings and were incurred as part of the initial acquisition of the Company. These costs are reimbursable from the Incremental Term Loan. We are likely to draw on the Incremental Term Loan in the near term to repay \$93 million of Revolver borrowings. The Base Case liquidity analysis assumes this happens in May. This is a one-time event.

sales proceeds to repay the Term Loan and at this point we have only generated net sales proceeds of \$390 million, and therefore need to generate another \$110 million of net sale proceeds before we can get into the 50% Term Loan sweep.

The Base Case liquidity analysis assumes that we get through the 100% term loan sweep in June after the mezz fund is raised and several existing mezz investments are recapitalized. This leads to peak Revolver usage of \$693 million at the end of June.² Thereafter, the Revised Plan assumes we are successful selling assets in Q3 and Q4 such that the Revolver usage is down to \$373 million by the end of the year. A detailed summary of the base case liquidity analysis and the underlying assumptions is attached hereto.

Release Prices

As previously noted, if market conditions continue to deteriorate and we are unsuccessful selling assets, we will run out of liquidity in July, if we continue to operate the business as-is. The near term liquidity concern is further exaggerated by the release prices required to be paid in order to refinance development assets. As an example, the Prudential financing will require a \$36 million letter of credit and a \$58 million Revolver draw to pay the Development Loan release price. Given how the Development Loan is structured, it actually creates a disincentive to refinance assets during a liquidity crisis because the Prudential loan alone uses up \$94 million of near term Revolver capacity in order to avoid an \$8 million development equity draw each month.³ There are three additional loans that we are negotiating which also have the similar potential to create near term liquidity issues.

	Project	Revolver Draw to Pay Release Price	Letter of Credit	Total Reduction in Liquidity	Debt Repaid from Financing Before Revolver Draws	Debt Repaid from Financing With Revolver Draws
Prudential	Multiple	58,232,112	36,000,000	94,232,112	154,336,078	212,568,190
Teachers	Multiple	22,218,696	-	22,218,696	70,470,508	92,689,204
Sovereign	Avenir	10,806,129	-	10,806,129	313,871	11,120,000
State Farm	Multiple Land	5,277,994	1,350,000	6,627,994	33,475,000	38,752,994
TOTAL		96,534,930	37,350,000	133,884,930	258,595,457	355,130,387

Putting the liquidity issues aside, the right answer for the Company is to refinance these assets, use the Revolver draws to pay down debt and have the new loans as a source of funds for all future development expenditures. However, if we were to delay these four refinancings, it would create additional near term liquidity for the Company if needed, but would also delay the repayment of \$258 million of Development Loan and Term Loan (before Revolver draws).

If the lenders were willing to consider leaving some of the Development Loan and/or Term Loan in place rather than requiring a draw on the Revolver to pay release prices, it would significantly help the Company's liquidity position without requiring anyone to put additional cash into the system, and it would give the Company an incentive to push forward with these financings ASAP without worrying about the potential liquidity issues of doing so.

Worse Case Liquidity Analysis

In a theoretical worse case analysis, we will be unable to sell any assets for some period of time and will need to find ways to reduce our monthly cash burn. Given current market conditions, the Company is carefully evaluating all options including the deferral of capex, and other potential options. They are also in the process of reviewing all of their development projects with closings in 2008 and 2009 to determine, which projects have attractive enough returns that we should proceed forward, which projects should and

² The Revolver usage actually gets to \$716 million in April, but this is a temporary issue until the Incremental Term Loan can be drawn upon

³ Based on the current forecasted construction draws per month for the four assets financed by Prudential: Gateway, Santan, Genesis Park II (Esplanade II) and North Point Place.



can be delayed due to liquidity concerns, which projects should be dropped and/or renegotiated, etc. We expect this comprehensive plan to be ready in a few weeks.

With some simplifying assumptions in the meantime, we looked at how long the Company could continue to operate before it ran out of liquidity, if it were able to reduce development and capex expenditures until sales begin to materialize. Specifically, the analysis assumes that the Company stops all “elective” development expenditures for the balance of 2008. This includes gross expenditures of \$22 million for projects that are currently owned but not currently under construction, and \$168 million for land acquisitions and related development costs for projects from the existing development pipeline that are not yet owned. Since these expenditures would be offset by \$85 million of financing proceeds, the net equity savings from delaying these projects is \$105 million in 2008.

Similarly, the analysis assumes that the Company can reduce capex expenditures by \$30 million in 2008, roughly a 17% reduction. The Company is currently in the process of identifying what specific projects can be removed or delayed from 2008 and which expenditures provide a return on investment (revenue enhancing or expense reducing) and therefore help us meet our NOI targets for the year.

If we are able to achieve both the development and capex savings above, it would reduce our cash uses by approximately \$135 million over the course of 2008 and potentially allow us to operate through November despite the fact that we would be unable to complete any additional sales. At November 30, 2008, the Revolver balance would be \$743 million after a monthly cash burn of \$15 - 20 million.

While it is helpful to understand how much time we have if we cut back on our capex and development expenditures, there are several negative consequences of doing so. First, if we are not making any new investments because of liquidity issues it will have a negative impact on the platform value. It will also have a negative impact on the overall equity returns of the deal and make it harder to syndicate equity at some future date. Finally, a decision to defer all new development expenditures in 2008 would lead to an exodus of the Company’s top development talent, which would impact our ability to successfully complete projects already underway and would diminish the value of the Company’s platform.

We certainly understand that times have changed and most developers are scaling back their development plans in the short term. We believe that we need to strike a careful balance between not doing any incremental development in 2008 and proceeding with everything currently budgeted. If we can focus our efforts on those deals with the most attractive returns, we should be able to maintain some near term liquidity while also preserving our platform value and retaining our development talent. We will also always put construction financing in-place prior to the start of any new ground-up development in order to minimize the potential equity commitment to each project. In these tough times, we will be most successful if we can find the right balance between managing for liquidity and maximizing the long term return on invested capital.

Interest Reserve

The Interest Reserve can be utilized to pay operating shortfalls (essentially NOI less overhead less interest expense). Each analysis presented here assumes that we fully draw on the Interest Reserve to cover operating shortfalls. In the base case this leaves us with only \$147 million of Interest Reserve at the end of the year. This is much less than in the original underwriting where we assumed excess Interest Reserve capacity would be maintained to help us meet the DSCR covenant in future years. This is a consequence of the liquidity crunch today that could be mitigated at some future date if we were allowed to refill the Interest Reserve to help us meet the DSCR covenant.⁴

⁴ The Term Loan currently allows us to add funds to the Interest Reserve, but the amount is capped at \$100 million.



Alternatively, if the Interest Reserve could be swept today to repay the Revolver, it might allow the Company to delay a liquidity issue through Q3, assuming we continue to invest in elective development projects and do not significantly cut back on capex as in the base case above, or even longer if we cut back on development and capex expenditures. Beyond providing additional liquidity, using the Interest Reserve to pay down the Revolver would also eliminate the negative arbitrage between the interest rate we pay on the Revolver and our return on cash in the Interest Reserve. This is a simple change that we should all consider as a way to provide more liquidity for the Company with cash that has already been committed.

Financing Unencumbered Assets

Another potential problem in the existing Term Loan sweeps is the way that refinancing proceeds are treated as compared to net sale proceeds. Refinancing proceeds are 100% swept as compared to net sales proceeds which are 100% swept for the first \$500 million of proceeds and 50% swept thereafter. In a situation where liquidity is tight, this creates an incentive for the Company to not refinance assets that are unleveraged or underleveraged because every dollar of refinancing proceeds will reduce the amount of cash potentially available to pay down the Revolver by 50 cents (once you get through the initial 100% net sale proceeds sweep). As an example, we could generate net sale proceeds of approximately \$300 million if we are able to sell the Werner assets at a reasonable price today, but if a sale is delayed because of market conditions and we decide to finance the assets (with a 50% LTV loan) in the interim, the net sale proceeds potentially available to repay the Revolver would decrease (by approximately \$75 million). This is another case where it should be in everyone's best interest to get cash back from these assets today as long as the Company's liquidity is not negatively impacted in the process.

Liquidity Summary

The Company is doing everything that it can to operate with the cash available to it today and recognizes that it needs to closely manage its near term liquidity. That being said, none of us can predict how long it will be until the market stabilizes and we are able to sell assets. In the interim, we will identify ways to scale back capex and development expenditures where possible. However, in order to ensure that we are also making the right long term decisions for the business, we should also consider revisiting the Development Loan release price mechanism, the uses for the cash in the Interest Reserve and the treatment of financing proceeds to ensure that the Company has enough liquidity available to it to weather the storm as long as possible while continuing to take advantage of attractive investment opportunities that may come along, so that we can continue to protect the long term value of the Company and its platform. In this regard, we think there will be attractive buying opportunities in late 2008 and want to position ourselves to be able to take advantage of those opportunities.

Other Credit Issues

Our ability to source new construction financing today has been impeded by the tightness of the Term Loan covenants and an overleveraged balance sheet. In general it has been very difficult for us to get new construction financing closed. Our two biggest loans, Prudential and TIAA, have been in process for months and we are still waiting to get credit signoff in both cases. For Prudential specifically, it appears that we will have to pull several assets out of the Archstone structure in order to get them financed. We risk further delays in paying back the existing Development Loan and providing more liquidity for the Company if the situation continues as is with tight Term Loan covenants and an overleveraged balance sheet. Nevertheless, we are pushing forward with the lenders that are in the market and trying to make the best deals that we can.

Similarly, the Term Loan covenants are also impacting our audited financials statements and we may struggle to get a clean audit in the near term if the covenants are not waived or loosened. The potential implications of this are serious. It would put the Company into default of several debt agreements and



would also need to be disclosed in an SEC filing if the issue is not resolved by March 31st. Given the seriousness of this issue, we are hopeful that we can reach a resolution with KPMG and the lending group soon to solve the problem.

Finally, the Company will soon be drawing upon the Incremental Term Loan to reimburse itself for transaction costs that have been funded on the Revolver since closing. If ASOT's leverage ratio is above 85% at the time of the borrowing, it will trigger a 200 bps increase (6.0% to 8.0%) in the coupon rate of the Series O preferred units and also require a notice to be sent to unitholders. We are still working through the specific leverage analysis, but believe there is a reasonable chance that the analysis will show ASOT's leverage above 85%. If this does occur, we could agree to sweep \$93 million of proceeds from the next refinancing to pay down the Revolver, rather than sweeping it to pay down Term Loan A. This would allow us to avoid the increased interest rate and save potentially \$4.5 million per year. There may be other ways to structure this which yield the same result. We believe it would be in everyone's best interest to do something here, if needed, to avoid the increased interest expense and notice requirement to the extent we can with simple changes to the debt agreements.

Summary

While we have largely met the goals outlined in the original Plan through Q1, it will continue to be challenging for us to sell assets until market conditions stabilize. Nevertheless, we will continue to do everything we can to close deals at reasonable prices without appearing desperate. We are also acutely focused on providing liquidity for the Company and continuing to operate with the cash available to us today, and in that regard we are taking a fresh look at the budgeted capex and development expenditures for 2008 to see where prudent cuts can be made.

At the same time, we would ask this group to consider several changes to the existing credit agreements including:

1. A restructuring of the Development Loan release price mechanism, to avoid draws on the Revolver for the sole purpose of repaying the Development loan,
2. A sweep of the Interest Reserve to pay down the Revolver, which would eliminate the negative arbitrage between our return on cash and borrowing costs,
3. A change to the Term Loan sweep for financing proceeds to eliminate any disincentive to refinance assets, and
4. Waiving specific covenant defaults for the balance of 2008, at a minimum, or providing additional cure periods in order to enable a clean audit opinion.

While we believe each of these changes is in the best interest of all parties involved, we are also open to other suggestions to solve the near term liquidity and balance sheet issues.

