COMMENTARY

September 22nd, 2010

Dear clients and colleagues,

Last week was a busy week for us at Global Alpha. Qing attended two conferences in San Francisco, one on clean technology by Wedbush, the other one multi-sector by Bank of America; David attended a few conferences in the UK and Portugal; and I attended a real estate conference in Chicago.

While attending the 5th annual BMO North American Real Estate Conference in Chicago (over 60 US and Canadian real estate companies participated) I also did a property tour in downtown Chicago focusing on four top-tier office and mall properties.

Here are some takeaways:

Easy financing for quality properties

Post credit crisis, the survivors, i.e. all companies that we met at the conference, told us it was easy to obtain financing at all-time low rates. For example, one REIT recently refinanced an office building with a 5%, 10-year nonrecourse loan; interest-only for the first five years. An apartment REIT recently refinanced many properties for 7 years at 3.56% fixed. So no sign of credit tightness for well-capitalized REITs. Loan-to-value criteria are generally slightly lower than before the crisis and interest coverage ratios somewhat higher, but most companies have raised equity in the last 18 months, giving them lots of financial flexibility.

Too much money chasing too few quality assets

With easy financing, strong financials and few new developments, all the REITs we met had a similar growth strategy: Acquisitions.

They are not the only ones looking for high-quality assets, however. Pension funds looking for long duration assets and yield have increased their allocation to real estate and are bidding up prices.

Some companies have explained to us how those institutional investors (pension funds) are distorting the markets with a different investment rationale. With a longer time horizon and a lower expectation of returns, they are ready to pay higher prices for properties.

As a result, valuations are approaching all-time highs, cap rates are at historically low levels and there is a bubble forming.

Distressed assets are not on the market

Unlike previous real estate downturns when banks would force the sale of an asset and realize their loss if they thought that the market value would not recover to loan value over the foreseeable future, this time it is different. Banks are sitting tight, as long as loan payments are current. With interest rates so low, their carry cost is almost nil. With strong demand for real estate assets, they are hoping that the economic situation will improve and help them avoid losses.

So, despite the idea and the fact that the US commercial and office real estate market is depressed and full of opportunities, prices remain very high and few undervalued opportunities exist.

A piece of good news, little new construction

Vacancy rates for downtown office buildings in larger cities are above 10% and higher than that for lower quality and suburban office space. For retail space, vacancy is also above 10%, especially in strip and suburban malls. The good news is that there is very little supply available and current rents do not justify new construction. As an example, Chicago would need rates higher that $40 to justify new construction and current renewals are closer to $30.

Apartment REIT fundamentals are good

In our opinion, many fundamental forces are helping apartment REITs.

Home ownership, which peaked at 69% in 2006, is now down to 67% and should continue to trend down. The long-term average before the bubble was 62%.

Demographics are very favorable, with both the over-65 and the 18-25 age groups growing significantly in the next 10 years. Both these groups have tended to rent versus own.

Immigration continues to be a positive factor as new immigrants are renters.

Job growth could be an additional positive catalyst.

Financing costs for multi-family units continue to be favorable and eligible for government guarantees.

Finally, there is very little new construction of multi-family dwellings.

Our only US REIT in the portfolio is Mid American Apartment (www.maac.net). MAA owns 42,252 apartments across the southeast and south central US. Despite being up 33% in the last 12 months, we still like it as the company is trading at an implied 6.6% cap rate and $77,000 per apartment unit, compared to 5.6% and $173,000 for its peers. MAA also has better rent growth, NOI growth and occupancy growth.

In conclusion, we found the conference to be very useful. However, we did not come away with many new investment ideas that meet our criteria of expected return. We remain happy with owning MAA as well as our two Real Estate services firms, Jones Lang Lasalle (www.joneslanglasalle.com) and Savills PLC (www.savills.co.uk) and Hong Kong and Shanghai Hotels (www.hshgroup.com) in Asia.

In our EAFE small cap portfolio, we have a few additional holdings such as Keppel Land (www.keppelland.com.sg) in Singapore and Advance Residence (www.adr-reit.com) in Japan. These are two companies we find attractive and that could be added to the Global portfolio in the future.

Have a good week.

The Global Alpha team.