13TH ANNUAL
SEEVAK RESEARCH COMPETITION

# REAL ESTATE INVESTMENT TRUSTS
# RETAIL SECTOR

JOHN RANDALL
ALEXANDER VIRTUE
IRA WEIDHORN
VERA WIDJAJA

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## INTRODUCTION

The subject of the 13th annual Seevak Research Competition is to answer the question of what a REIT is to do in the current capital constrained environment. This report will specifically analyze the retail (shopping center) sector of the REIT industry and the major challenges that this sector will most likely face in the future. To that end, we first present an analysis of the current real estate market trends in the sector, including supply and demand factors. Next, the impact of new potential ancillary revenues due to the REIT Modernization Act is examined. In the third section of the report, the effects of the Internet and e-commerce on shopping center REITs and some possible responses are analyzed. Lastly, we evaluate a number of the strategies of two of the leading shopping center REITs, Developers Diversified Realty Corporation and Kimco Realty Corporation. The report concludes with recommendations for the retail (shopping center) REIT sector as a whole.

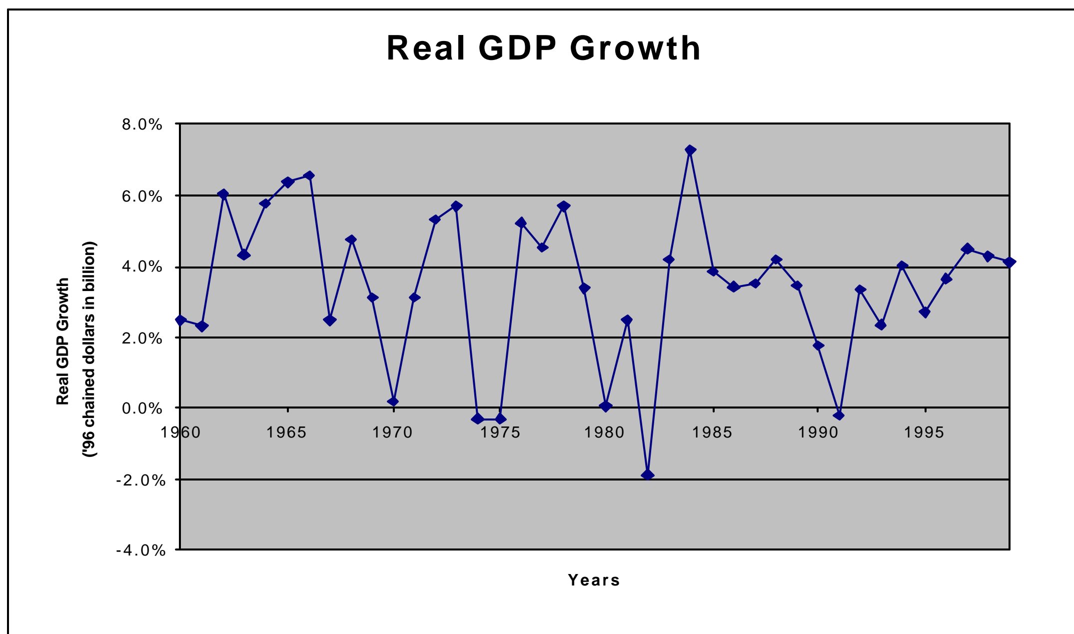
## Importance of Public Markets

The public markets (both equity and debt) are currently a source of governance for the real estate industry, checking capital flows into the industry, hence, restraining future supply and demand imbalances. Therefore, the real estate community will have to manage short-term stock price volatility as a by-product of the public markets.

## Demand

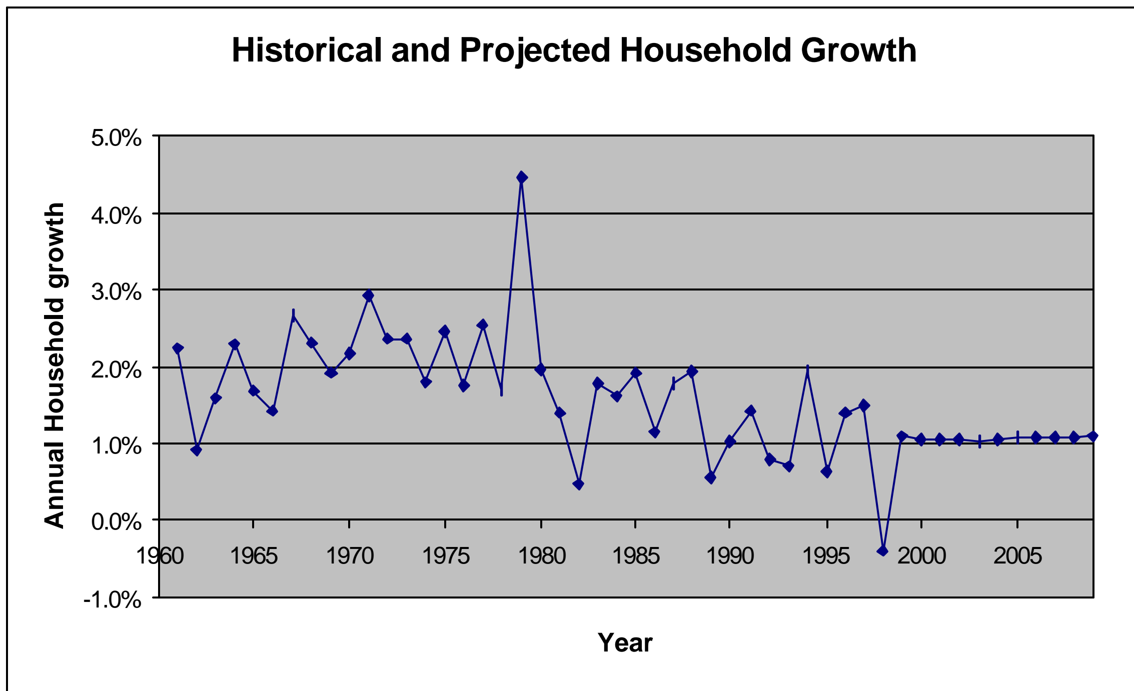
*GDP:*

The gross domestic product (GDP) of the U.S. has been growing since the recession in 1990. However, the annual real GDP growth has been slowing down since 1997, and has maintained a level of about 4% (see chart below). This is a major factor in the demand side of the equation. A slow down in the U.S. economy can easily topple the current near equilibrium real estate market. With the rise in February jobless rate and a substantial reduction in the number of jobs created in the month, along with the declining durable good orders and falling home sales, it can be a sign, as speculated by many, that the U.S. economy may be losing its steam. Clearly, there is also the flip side of the argument that says the Federal Reserve has a good record over the past years of maintaining the economic boom and may still be able to sustain the current growth rate.



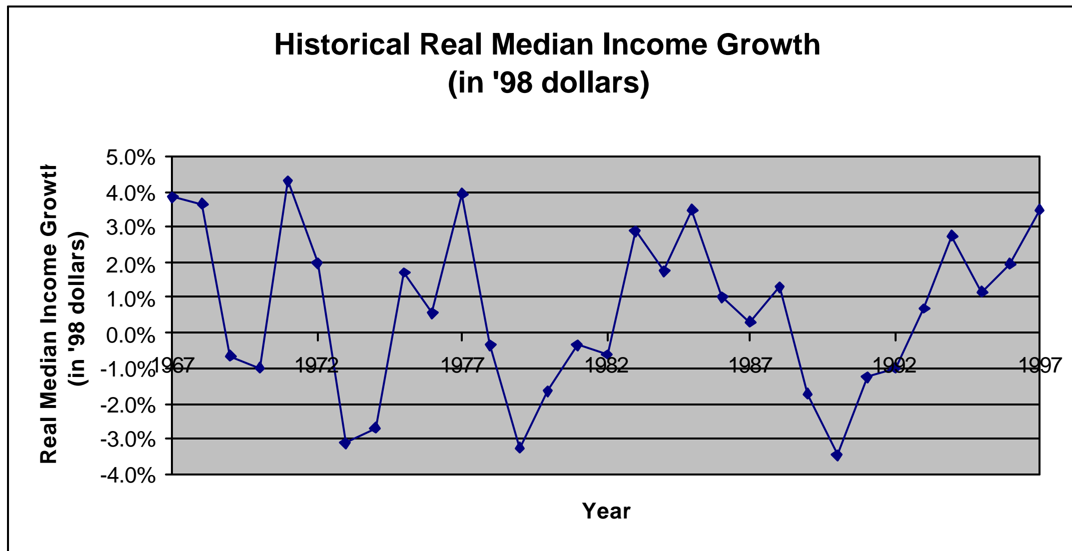
*Household Formation:*

Similarly, household formation had been growing steadily at a rate of 1% to 2% every year throughout the 1990s. The U.S. Census Bureau projects a steady growth of 1% every year from 2000 to 2010 (see chart below). Therefore, household formation does not seem to be a potential factor of disruption for the current growth in the retail industry.




*Median Income:*

Median household income has been increasingly growing from 1% in 1996 to 3% in 1998 (see chart below). With the steady growth in household formation, the growth of household income will be highly dependent upon the economic growth of the country. Households that consist of one person have been increasing tremendously over the past years and households ranging from age 45 to 54 and 75 and above have been on the rise since 1990 due to the aging baby boomers. Last, but not least, median income of households consisting of three to five people have been rising more rapidly that that of the other household types over the same period of time. Therefore, there may be a greater trend in the retail industry to provide for these increasingly important groups in the population.



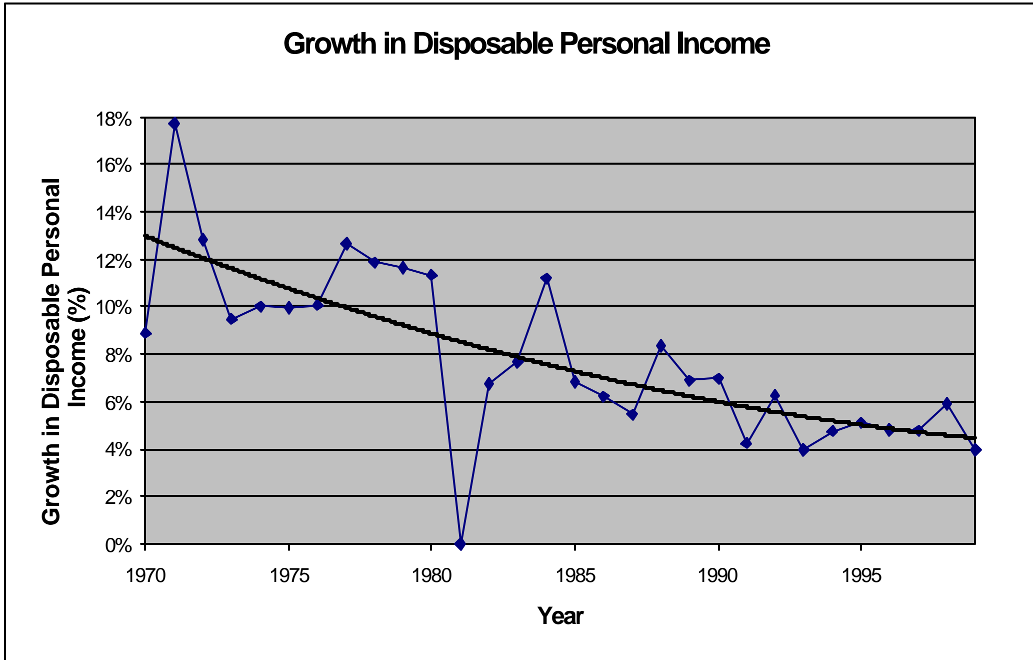

*Disposable Income and Buying Power:*

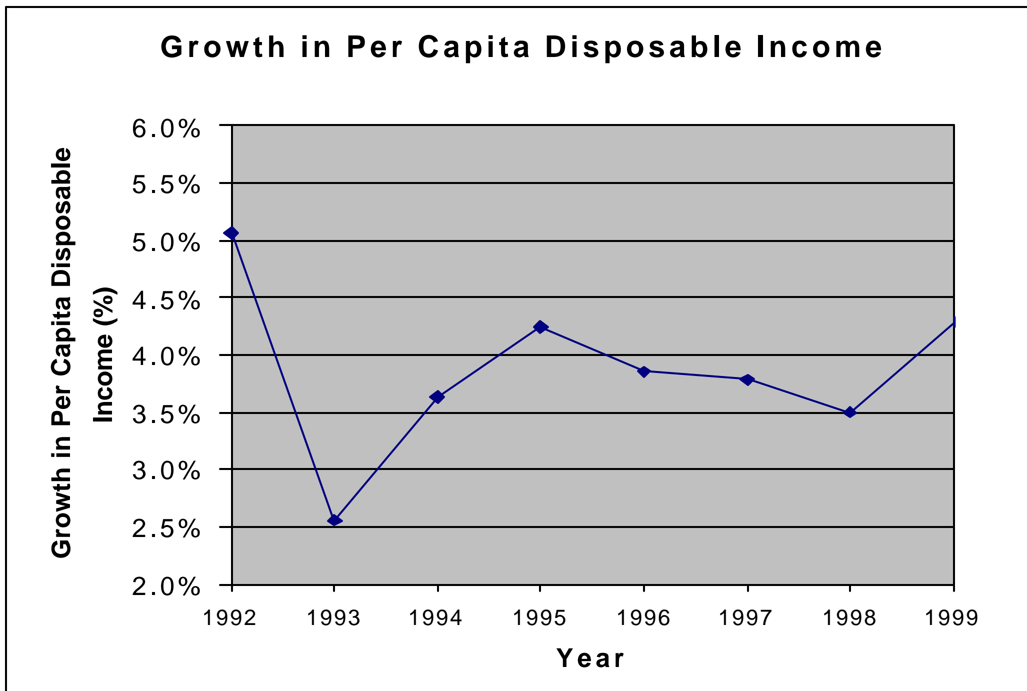
Although the growth of annual disposable personal income has been in a general decline since the 1980s, it has stabilized throughout the 1990s (see chart below). Over the past ten years, total disposable income has been growing at a rate between 4% to 6%. Regardless of the dip last year to 4% from 6%, the growth of per capita disposable income has increased by about 1% (see chart below). The consumption level of the population has generally stabilized over the past ten years at about 94% of total disposable income. Therefore, the spending power of the population appears to be as powerful as that since the mid-1990s, even though the growth of total disposable income of the population has declined over the past year. According to the *Survey of Buying Power* by Sales & Marketing Management, the North Central, South Central and the Mountain[1] regions of the United States will be the areas of high EBI growth over the next 5 years.

[1] North Central: Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North/South Dakota, Ohio, Wisconsin.

South Central: Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, Tennessee, Texas.

Mountain: Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming.


Growth in Disposable Personal Income
Growth in Disposable Personal Income (%)
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
1970
1975
1980
1985
1990
1995
Year


Growth in Per Capita Disposable Income
Growth in Per Capita Disposable Income (%)
6.0%
5.5%
5.0%
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
1992
1993
1994
1995
1996
1997
1998
1999
Year

*Retail Sales:*

Retail sales have been growing steadily between 5% and 10% over the past five years and approached the $3 trillion mark last year. Per capita retail sales growth has stabilized at a level of 3% to 5%. Therefore, if the economy is maintained at the current level, retail sales per capita may be maintained at this level.

*Investors:*

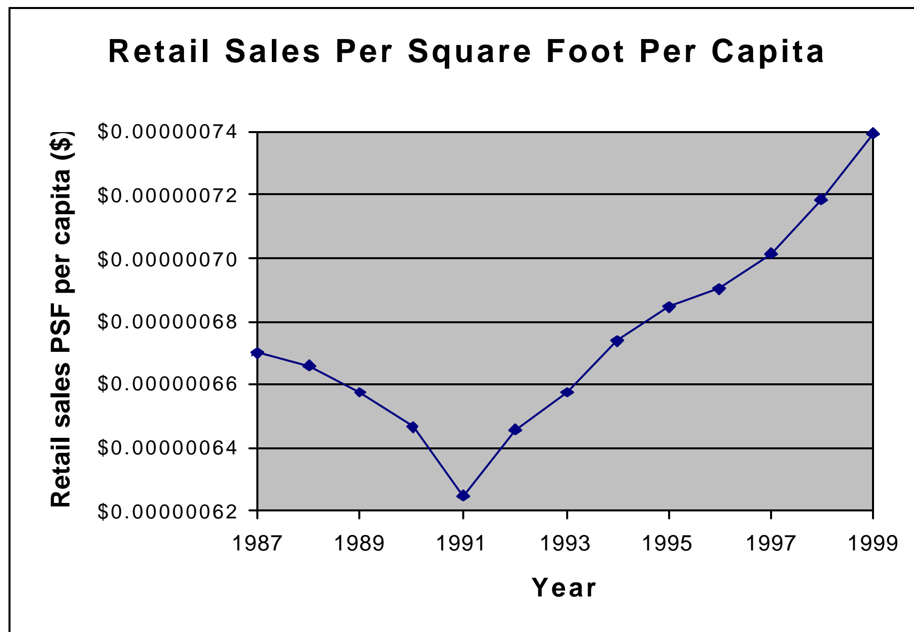
The fourth quarter of 1999 saw outflows from the dedicated mutual funds in the retail sector. While the strength of the sector is highly affected by the strength of the U.S. economy, absorption is expected to be slower as the economy reaches its maximum capacity (that is, slower growth). Ultimately, demand will be restrained by the replacement cost barriers that are imposed by investors.

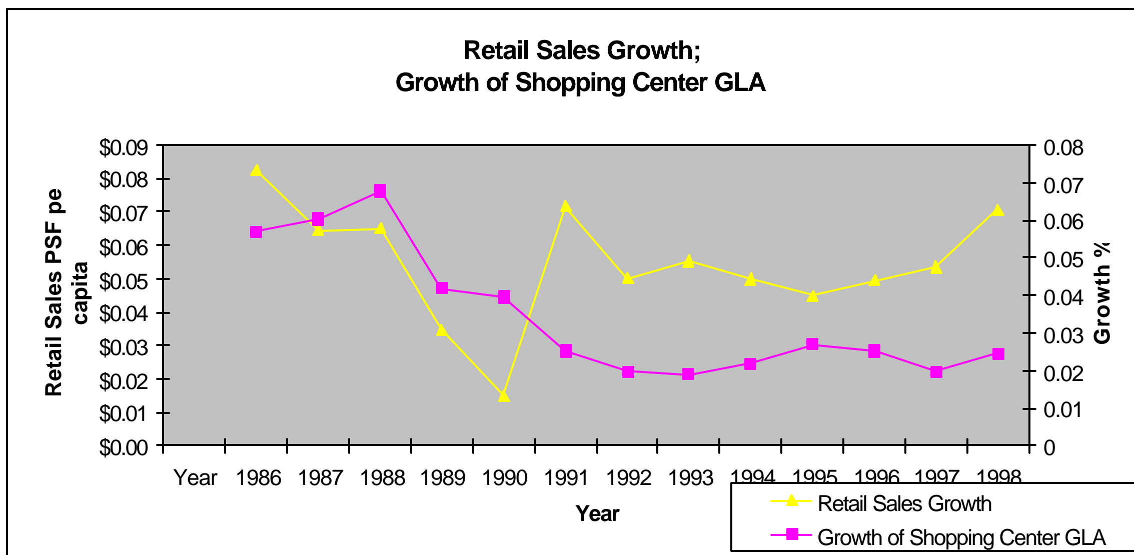
**Supply**

*GLA:*

According to the National Research Bureau, the number of shopping centers in the U.S. has been growing at a declining rate from 2.2% to 1.8% from 1996 to 1999. Shopping center GLA has stabilized at about 2%-3% over the past 8 years (see chart below). According to the National Association of Real Estate Investment Trusts (NAREIT), the estimated new supply is 78 million square feet of GLA, as opposed to the 131 million SF in 1999. This results in a 1% projected growth in GLA for this year.

At the same time, retail sales in shopping centers have been growing steadily at a rate of 5% since the early 1990s. With the stabilizing growth in GLA and population, retail sales has been the main variable in generating growing retail sales PSF per capita (see charts below). Therefore, if retail sales continue growing at the current rate and the total leaseable area for shopping centers in the country continues to slow down, the sales PSF at shopping centers should continue to rise accordingly.



*Vacancy Rate:*

The vacancy rate of the retail sector has been declining since the 9.2% level in 1996. NAREIT has projected the rate to be a relatively low 7.6% for this year, indicating a tightening of the supply-demand gap.

Currently, the supply-demand conditions in the retail sector are in equilibrium. In the event that demand slows down (due to a weakening in the economy or some other trigger), an oversupply situation will develop due to continuing construction until 2001. Therefore, Kimco and DDR should be cautious in their geographical focus. Currently, both companies have a concentration in the North Central, one of the highest areas of EBI growth. However, about 40% of their portfolio is currently located in regions where the GLA per capita is higher and the sales PSF is lower than the national average. Although it is difficult to determine whether some of these regions are growing, Kimco and DDR should move some of their South Atlantic property allocation (22%-23% of their portfolios) to states that have GLA per capita that is lower and sales PSF that is higher than the national average[2].

[2] Alabama, Arkansas, Kentucky, Louisiana, Oklahoma, Minnesota, Montana, New Mexico, North Dakota, Texas, Wisconsin, Wyoming.

## ANCILLARY REVENUE IMPLICATIONS

Recent tax law changes that resulted from the signing of the REIT Modernization Act will help all REITs to add additional ancillary revenue to their bottom line. To summarize, effective in 2001, REITs will be allowed to own up to 100% of the stock of a taxable REIT subsidiary (TRS) that can provide services to REIT tenants without disqualifying normal tenant rents. These TRS securities can not exceed 20% of a REIT's assets, and the dividends from a TRS will not qualify under the REIT's 75% income test. This law change will invariably accrue additional benefits to REITs that aggressively exploit this, especially as it becomes increasingly difficult to grow rental revenues and cut operating expenses.

The critical question is in what form will these ancillary revenues take place. It is easy to see a large regional mall owner with a subsidiary company that provides cleaning or security services. In this case, common area maintenance is a higher level of cost for tenants. For smaller neighborhood and community shopping centers, potential services are less expensive. Many community centers have CAM costs that encompass only security and landscaping/snow removal. Other costs, including water and utilities, not to mention trash removal and repairs and maintenance are directly incurred by the tenants or are reimbursable. Out-sourcing services like administrative assistance and back office support may make sense to office users. However, there are a variety of companies that provide these out-sourcing services and the needs of tenants in a typical shopping center are small.

Ancillary services should have a number of characteristics:

- Use the combined purchasing power of the tenants; this economy of scale as well as centralized coordination costs would make this most viable;
- Use the combined purchasing power of the customers; in so far as this assists tenants and can be a reimbursable service;
- Be non-geographical so as to leverage the dispersed assets;
- Leverage off the existing core competency of the company.

The area with the greatest potential opportunity could be the Internet and providing services that combine the retail buying needs across tenants. This could be using goods and services to

resell to tenants. Similar models exist in office (Broadband) as these REITs are focusing on the fact that they provide control point or a portal to a large number of tenants. The Internet section will describe the efforts of Eversave.Com, a firm in which Kimco has invested. Further, both Kimco and DDR have been creatively thinking about ancillary revenue implications. We believe that their efforts, to be addressed later, present a good model for other REITs in this capital constrained environment.

**Growth in On-Line Sales**

All reports indicate that the Internet is going to continue to have a profound impact on how people shop which may impact the use of shopping centers. Estimated on-line retail revenues is projected to be $40 billion in 2000 and will grow to approximately $184 billion by 2004 according to Forrester Research Inc.[3] Although significant in gross sales, these sales will remain a small portion of total retail sales (from 2% in 2000 to 7% in 2004). This is highlighted by the fact that in 1999 online sales still only accounted for one-tenth of total catalog sales.[4] Still, this sales percentage can be significantly higher for certain retail items. For example, according to a January 2000 study by Deloitte & Touche, Internet sales could total 10% to 15% of total GAF (general merchandise, apparel and furniture) sales by 2004. Further, Goldman Sachs suggest that the rise of e-commence will cause average growth in offline retail sales over the next decade to slow down from 5%to 3% per year.[5]

Despite this rapid growth and wide media coverage, it is less clear how these on-line retail sales will ultimately impact retailers and hence landlords. The media has often indicated that the impact will be very powerful, but in fact there are a number of reasons why this may not be the case. A Merrill Lynch study projects that 40% of on-line sales currently come at the expense of mail-order catalogs.[6] Thus, off the bat, we can reduce the cannibalization of bricks & mortar retailers by almost a half. Secondly, Todd Sinai of Wharton indicates that many of the current sales have been induced sales; i.e. reaching people that would not otherwise buy given the lack of available retailers in their area for that good. This further reduces the direct effect on-line sales may perceive to have on shopping centers. Thirdly, according to the Merrill study, currently 62% of Internet sales are accounted for by traditional brick & mortar and catalog retailers. Thus, on-line sales can just be viewed as another distribution channel for bricks & mortar retailers. One analyst expects this to grow to 85% by 2005 as traditional retailers figure out how to leverage their existing distribution system and relationships to their advantage over "e-tailers." Given that these are tenants of shopping centers anyway, this growing percentage of brick & mortar's sales means that landlord's biggest customers are getting richer and hence

[3] *The New York Times*, October 10, 1999
[4] The Economist, February 26, 2000, p. 1 of Survey of E-commerce
[5] The Economist, February 26, 2000, p. 6 of Survey of E-commerce
[6] "Shopping Center Real Estate Investment Trusts: Internet's Potential Impact on Retail Real Estate", Merrill Lynch, 4 March 1999.

their tenant quality is increasing. These trends and statistics suggest that Internet is more hype than hurt affecting the bottom line of shopping center based retailers. For example, even in the supposedly first Christmas on-line shopping season in 1999, according to the ICSC, mall sales increased 7.7% with over 1.2 billion people shopping in enclosed malls.[7]

A fourth reason to cast a discerning eye on the advent of on-line retailing is that there is large volatility in these projections that could result in a downward revision of some of the more optimistic forecasts. A recent study by Wharton Virtual Test Market (WVTM) indicates that there have been drop-offs among some on-line shoppers. In 1998, 15 percent of the consumers who bought on-line in 1997 did not buy online in 1998.[8] These "drop-outs" are concerned with: 1) e-mail spam following on-line purchases, 2) low level of trust with online retailers, and 3) concern about third party monitoring. In addition to drop-outs, there are those segments called "never-buys" who cite the following concerns about online shopping: 1) online security, 2) want touch and feel of traditional shopping, 3) delays in shipping, and 4) bad online shopping experiences in the past. Todd Sinai indicates that true dot.com retailers continue to have problems especially with the shipping component, the most likely Achilles heel of the virtual retailer.

**Retailers That Will Be Impacted**

Although current Internet retail sales have not had measurable impacts on most retailers, it is important to think of the type of retailer who may ultimately be impacted the most by the Internet. In general, most experts think that it is the low volume, high price items, with low experiential qualities, that generally sell better through the Internet. In contrast, high volume and convenience oriented goods like groceries may be less suited to the Internet given the logistical issues of immediacy (although some firms are trying). Unlike regional malls, shopping centers are oriented for convenience or for your "to do" list items. Typical centers will include a laundry, video store, haircut, grocery or pharmacy, not the type that can be easily replaced through Internet services.

[7] *The Wall Street Journal*, January 3, 2000

[8] Knowledge@Wharton on-line magazine, March 5, 2000

In their report on the Internet, Merrill Lynch REIT analysts Eric Hemel and Craig Schmidt reported that those product categories which are better insulated against eroding in-store sales include fashion, accessories, jewelry and home furnishing.[9] Schmidt added, "Any purchase that has a greater focus on ego or self-definition may still heavily favor in-store purchases. The need to see color, feel the material, try on the fit, test the function, are all items where the Internet will be less effective in generating sales." Noting those projections, Hemel reports that community centers and power centers will feel a "moderate impact" from Internet sales, while neighborhood centers will feel the fewest effects, and malls and outlet centers only slight effects. Community centers' reliance on hard goods, and power center's focus on price and "pull marketing" make those categories most vulnerable to Internet retailers. Hemel defines pull marketing as promotions featuring particular manufacturers generating shopping visits. This is especially the model employed by big box retailers. Outlet centers, whose changing inventory and product quality often require "firsthand" visits, should face little competition from the Internet.

**Portfolio Type of Kimco and DDR**

Given this report, it would appear that both DDR and Kimco, particularly with their discount department store and category killer retailers, should feel an on-line sale impact before mall or neighborhood centers should. In general, Hemel projects that the overall impact on all retail REITs will likely be minimal. This attitude is demonstrated in the continued real estate-based expansion plans of major retail REITs. This follows the demand from retail tenants who are signing 10-year leases, committing real dollars in anticipation that store-based volume will grow significantly. In general, we note that these on-line retailing trends have not harmed either Kimco or DDR in terms of the ability to sign or retain tenants. Both report that their tenant exposure (by GLA) to those types of tenants that have been most impacted - books, computer goods, music and office supplies - is under eight percent. In fact, the only limit to either firm's and indeed most retail REIT's ability to expand has been the constraint of the capital markets and not the lack of demand.

[9] "Shopping Center Real Estate Investment Trusts: Internet's Potential Impact on Retail Real Estate", Merrill Lynch, 4 March 1999.

**How Could Landlords Get Hurt**

Clearly on-line shopping, if it truly eliminates a trip to a center, reduces the possibility for either an in-store sale or additional pedestrian traffic which leads to an "impulse buy." On the first, an in-store sale, it has been hypothesized that tenants will encourage sales through on-line kiosks to their websites at the stores. The tenant retailer can then capture the sale but not technically report this as an in-store sale subject to percentage rent. This theory is what prompted the St. Louis Galleria to briefly ban signs and other display devices encouraging Internet use at its mall. However, we note that at Kimco and DDR's percentage rent accounts for a negligible amount of their revenue. We assume that for many shopping center REITs this is similarly the case. Even if they were impacted, landlords can address this by increasing face rental rate at the expense of percentage rates to reduce this potential loss. We note that at least Kimco has been resigning leases with strong clauses concerning on-line sales.

Addressing the other point, community centers do not live on impulse buying and browsing pedestrian traffic as much as regional malls. We believe that people go to community centers, like those owned by Kimco and DDR, for convenience items and specific goods. In other words, the tenants tend to be destination shopping oriented and hence less reliant on browsing. This is especially true with centers with strong regional and national retailers. Thus, the impact of impulse shopping is not deemed a major issue when considering the impact of Internet sales.

**Competitive Responses**

There have been a number of competitive responses to the Internet by several landlords, particularly the large mall REITs. For example, Simon Properties is testing "FastFrog" a small hand held computer that is loaned to shoppers to help them scan items for purchase. Simon is also thinking about how to leverage their MallPERKs program which provides discounts and frequent shoppers promotions to customers. General Growth Properties started Mallibu.com to encourage a virtual connection with the Internet and their properties. Also, another competitive response found in malls has been to move towards improved access with clustering of stores to make shopping convenient. This is going against the traditional "planned inconvenience" found in malls to encourage impulse shopping.

In terms of community and strip shopping centers, strategies have been less well-publicized. One competitive response has been found with Eversave.com. Kimco has recently invested (along with Pan Pacific Properties) in this concern which is a Boston-based startup Internet firm that intends to serve neighborhood shopping centers by allowing consumers to search for discounts and promotions before they go shopping. DDR has also made a small investment in an Internet operation to look for ways to exploit this channel. We believe this is an appropriate response: a small-scale investment to allow informational gathering and testing of different strategies.

The trend that several recent articles suggest is that traditional retailers – no longer victims of e-commerce – are looking to have their stores, catalogs, and web sites work in concert with each other. They are different but potentially synergistic channels. They include CVS's acquisition of Soma.com, eBay's purchase of Butterfield & Butterfield and, of course, the proposed AOL/Time Warner merger. Other trends include partnering as exemplified with AOL with Wal-Mart and Yahoo! with Kmart. Japan's Seven-Eleven retail chain has released plans to allow consumers to order over the Internet and collect them on the way home from work. Thus, we challenge landlords like DDR and Kimco to think about creative opportunities in partnerships with both on-line retailers and their existing tenants, bricks & mortar retailers. Kimco has reportedly had discussions with Wal-Mart, Kmart's Bluelight.com, and Costco on their Internet strategies.

A final area that we feel that landlords should look to is thinking creatively about their stores as distribution points along a value chain. As mentioned earlier, Todd Sinai of Wharton believes that distribution and delivery concerns and costs could be the biggest impediment for an on-line e-tailer's success. REITs like Kimco and DDR have well located real estate that are within several miles of millions of consumers. Using this knowledge in conjunction with their tenants could be a competitive advantage if e-tailing continues to have distribution problems.

**Recommendation**

In general, we believe there is an option value to waiting as long as by waiting, one can gain information. One reasonable recommendation is for REITs like DDR and Kimco to continue to monitor the development of the Internet and its effect on its tenants and consumer shopping

habits. This means not exercising the option by large-scale investments in one strategy or another. Rather, action steps that we recommend include:

- Look to develop partnerships with net firms like Eversave.Com that creatively blend the virtual with the tangible;
- Look to have closer relationships with major anchor tenants both virtually and in their stores. Help address their needs proactively to respond to any perceived attrition of shoppers;
- Consider the location as a central point of distribution to consumers and how a retailer may be able to harness it; and,
- In the immediate term, structure rental agreements to those tenants with major Internet sites with higher base rent in lieu of percentage rents.

In general, we believe just as catalog retailing did not obviate the need for locational based retailing, the Internet will not do so as well. At the margin, the Internet will only effect poorly located and badly managed real estate. Kimco, DDR and other superior retail REITs do not suffer from either of these attributes and should be able to competitively respond and take advantage of the advent of Internet retailing.

Developers Diversified Realty Corporation ("DDR") is one of the largest owners and developers of shopping centers in the United States. The company owns a geographically diverse portfolio of over 200 shopping centers in 39 states totaling over 47 million square feet. DDR's current enterprise value is over $2.4 billion:

| | Value (in millions) | Percentage |
|---|---|---|
| Common Shares | $827 | 34.6% |
| Preferred Partnership Units | 110 | 4.6 |
| Perpetual Preferred Stock | 304 | 12.7 |
| Total Equity | $1,241 | 51.8% |
| | | |
| Fixed Rate Senior Unsecured Debt | $592 | 24.8% |
| Variable Rate Construction Debt | 38 | 1.6 |
| Revolving Credit Debt | 291 | 12.2 |
| Fixed Rate Debt | 231 | 9.7 |
| Total Debt | $1,152 | 48.2% |
| | | |
| Total Enterprise Value | $2,393 | 100.0% |

Over the last year, DDR's stock price has fallen significantly although the shares have bounced back recently. Despite it's recent stock price appreciation, DDR is still trading at approximately 85% of net asset value.

**DDR's Stock Price for the Last Year**

DDR focuses on larger centers (100,000 to 600,000 square feet) and its largest tenants are national big box retailers such as Wal-Mart, Kmart and Home Place. The company's exposure to major tenants can be seen in the following table:

| Tenant | Number of Stores | Total Base Rent | Percent of Total | Credit Ratings |
|---|---|---|---|---|
| Wal-Mart | 28 | $16.9 | 5.6% | Aa2/AA |
| Kmart | 29 | 11.2 | 3.7 | Ba2/B+ |
| Home Place | 12 | 7.3 | 2.4 | NR |
| Office Max | 28 | 6.8 | 2.2 | NR |
| T.J. Maxx/Marshall's | 25 | 6.7 | 2.2 | Aa3/BBB+ |
| Kohl's | 11 | 6.7 | 2.2 | Baa1/BBB+ |
| Barnes & Noble | 18 | 5.7 | 1.9 | NR/BB |
| Best Buy | 7 | 4.7 | 1.6 | Ba2 |
| AMC Theater | 6 | 4.3 | 1.4 | B2 |
| Lowes Home Centers | 6 | 4.1 | 1.4 | A2/A |
| Bed Bath & Beyond | 9 | 3.9 | 1.3 | NR |
| Toys "R" Us | 17 | 3.7 | 1.3 | A1 |
| Michael's | 15 | 3.4 | 1.2 | Ba2 |

Source: Developer's Diversified Realty Corporation
NR= not rated
As of December 31, 1999.

We have identified four strategic items that we believe are key to DDR's success in the future: (i) joint ventures, (ii) the Internet (iii) investor relations and (iv) capital structure and the funding of future growth.

**Joint Ventures**

DDR has used the off balance sheet joint venture more than any other publicly traded REIT. The joint venture structure is one that is touted by many REITs but used extensively by only a few. DDR has been criticized for their aggressive use of joint ventures, mainly because it has made it more complex for analysts and investors to understand the performance of the company. In our view, DDR has used this strategy extremely well as DDR has achieved impressive FFO per share growth, even in the current capital constrained environment.

Even before today's challenging environment, joint ventures had always been a core strategy for DDR. DDR likes this structure for many reasons. First, the joint ventures allow them to

expand their development activity while minimizing overhead costs. Additionally, DDR receives a disproportionate share of the upside in these deals once the money partner and DDR reach certain minimum return levels. On top of this "promote", DDR usually receives some sort of managing or leasing fee from the venture that also serves to increase the return to DDR. Since projects are typically aggressively financed at the venture level, no additional capital is required. Furthermore, the joint venture debt is typically non-recourse to DDR. Overall, this structure greatly lowers DDR's capital requirements given the current state of the capital markets and also enhances returns. For instance, using 50% leverage at the venture level, an investment with a pro forma yield of 10.5% will generate more than a 14% leveraged return to DDR after fees.

DDR also retains significant control on the exit. Usually, DDR has a call option on the property or can buy the property from the venture at some fixed pricing formula in the event the money partner wishes to sell. In this capital constrained environment, if the money partner wants to sell and DDR does not have the capital to buy, then DDR will either find another institution to step into the money partner's position or will sell the venture and re-deploy the capital.

DDR currently has ventures with numerous institutional partners. The company has made agreements with short-term opportunistic institutional investors as well as local development sharpshooters. The large list of institutions that DDR has successfully done ventures with is impressive. Thus, DDR enjoys a strong reputation in the institutional community that should result in continued financial flexibility by having access to an additional pool of capital.

While the benefits of the joint venture structure are numerous, some drawbacks do exist. The main drawback to the joint ventures is that it makes it much more difficult for the average investor in DDR's common stock to analyze the company's financial health since these are mainly off balance sheet ventures. Additionally, many of these ventures are funded heavily with debt, thus increasing DDR's overall risk. It should be noted however, that while DDR has a higher debt to total enterprise value, their debt service coverage ratio is at a very strong level as evidenced by their investment grade rating.

We believe that DDR has developed a great core competency with respect to their joint ventures and they have generally achieved stellar returns on these projects. DDR has rightly chosen not to let Wall Street, and their dislike of the complexity associated with the joint ventures structure, govern their investment philosophy. If DDR continually achieves greater returns with the joint venture strategy, it will be reflected in their financial results and eventually in their stock price.

**The Internet**

The threat of e-commerce and its potential negative impact on tenant sales and base rents has been one of the most cited fears of investors in retail REITs. However, the reality of the situation is that DDR has seen no negative impact from the Internet on its tenants or its customers. For example, DDR's average annualized base rental rates have grown over 5% annually for the last three years and portfolio wide occupancy stands at a strong 95.7%. Moreover, power center anchors enjoyed the strongest same store sales growth of any category type this past holiday season. In fact, DDR's major tenants have enjoyed considerable same store sales growth as shown by the following table:

| Tenant | Total Sales (January) | Comparable Stores (January) |
|---|---|---|
| Wal-Mart [1] | +22.8% | +4.1% |
| Kmart | +5.4% | +3.6% |
| Target | +11.4% | +5.7% |
| Sears [2] | +0.7% | +1.7% |
| J.C. Penney [3] | +8.8% | +6.1% |
| Saks | +3.0% | +3.0% |
| Gap | +36.0% | +11.0% |

Source: Developers Diversified Realty Corporation
(1) Includes Sam's Club
(2) Domestic stores
(3) Department store only

The proponents of the Internet threat argue that e-commerce will most directly affect the sales of commodity type retailers. However, less than 10% of DDR's tenants sell books, music, computer equipment and office supplies – collectively, the strongest of the commodity items available on the Internet.

Conversely, the Internet can be seen as a large opportunity for DDR. As mentioned earlier, there are actually potential synergies between bricks and mortar and e-commerce and the "winning" strategy will require having a local destination to return goods purchased on the Internet. This opens up a whole new universe of potential e-tailing tenants to DDR such as Gateway and even Amazon.com. In fact, DDR has an internal initiative to contact these potential tenants and tell them about the real estate solutions that DDR can offer them. Lastly, even if some of DDR's traditional tenants do become obsolete, this is not a new phenomenon to the retail industry. Historically, obsolete retail concepts have been quickly replaced by new retail concepts.

DDR has also made a very small investment in an Internet retail aggregator, PIIQ.com. DDR's main impetus for the investment was to gain information on e-commerce and the happenings in this particular space. Currently, it is too early to say whether or not the start-up will be successful. Either way, DDR has improved its knowledge base and as a result will be able to make more informed decisions relating to the Internet in the future.

Overall, we feel DDR has made an appropriate response to the Internet and e-commerce. As stated earlier, there is tremendous option value here to wait and see how the Internet will affect the retailing world. In the mean time, DDR has developed internal initiatives to contact potential e-tailing tenants, monitored the effect of the Internet on its properties, and attempted to gain valuable information through its investment in a start up as well as other sources. This will enable DDR to make the appropriate response to the Internet in the future.

**Investor Relations**

For a long time REITs have suffered from a negative perception by the institutional investing community. Unfortunately, this is due to the long history of REITs taking advantage of public shareholders through misaligned fee structures, conflicted deals and accounting irregularities. While some of these problems have been eliminated, others still linger. For example, there is still cynicism towards REIT accounting standards, a perception that REIT boards are stacked with friendly directors and an overall lack of interest from non-dedicated real estate funds. Combine this with the recent kickback scandal at JDN Realty and the fact that the average REIT

is still very illiquid, and it is understandable why some institutional investors have stayed away.

In DDR's case, they have the additional "complexity" burden from their numerous joint ventures. DDR addresses this problem by being a leader in public disclosure for the REIT industry. They make available to any investor a supplemental financial/operational package every quarter. Included in this package is disclosure on every property and joint venture they own and exactly how properties are financed. Despite their large efforts in public disclosure, many analysts still believe that DDR suffers from a complexity discount. Said another way, despite the many positive aspects of DDR's joint ventures, many investors are worried that the joint ventures somehow obscure the underlying operating trends of the properties and that the off-balance sheet financings disguise DDR's "true" leverage.

Despite their high level of disclosure and frequent communications with analysts and investors, DDR has been a victim of external market forces. For example, two of DDR's largest shareholders are two of the largest REIT mutual funds. When these funds got hit with redemptions, the fund managers often chose to sell DDR's stock, not because of unhappiness with the company but because DDR is one of the most liquid REITs. Thus, DDR's stock price would not plummet significantly as would other REIT stocks as a result of this selling pressure.

It has also been hypothesized that REITs could improve their investor relations by having management purchase more shares and thus increasing their ownership in the company. In DDR's case, management already owns a significant percentage of stock (over 10%) and it is unlikely that DDR would get any benefit from insiders purchasing more. On the flip side, if management at DDR (or any other REIT) sold one share of stock for any reason, there is a high likelihood that the company's stock price would suffer significantly.

There is also investor resentment due to the large amount of REIT unit investment trusts issued two to three years ago. As a result, there is now a large overhang in stocks of companies who participated in these programs. As these unit investment trusts get liquidated, there will be additional price pressure on the already thinly traded REIT stocks, a negative to institutional

investors. For example, DDR has over 300,000 shares of its stock in unit investment trusts while its average daily volume is only approximately 120,000 shares.

We believe that DDR has the correct approach to investor relations. They are a leader in public disclosure, they frequently communicate with investors and analysts, and management owns a large percentage of stock. Unfortunately the market places little value on these items. In terms of investor relations, companies do not seem to be rewarded for going above and beyond the call of duty. However, investors will quickly punish REITs for straying from what they consider to be the proper path.

**Capital Structure and the Funding of Future Growth**

DDR's total enterprise value is approximately $2.4 billion. The capital structure is comprised of approximately 48% debt, 17% preferred equity and 35% common equity. DDR has an investment grade rating and generally enjoys good access to capital. Additionally, DDR's stock is owned 60% by institutional investors. DDR has also raised capital in a more creative fashion through selling non-core assets, private placements and the use of "down-REIT" partnership units.

DDR's dividend policy is to grow its FFO faster than it grows its dividend. As a result, DDR's dividend payout ratio is currently a very low 61%. Thus, they are moving closer every year to paying out the minimum dividend required and recycling more of their cheapest form of capital, their retained cash. With plenty of investment projects in their pipeline and facing the current capital constrained environment, DDR has wisely chosen not to payout a larger percentage to shareholders.

There are also new sources of capital available to DDR from ancillary revenues. Providing various services to tenants and customers is a high growing revenue stream for DDR, but still small in magnitude. For example, DDR has recently signed an agreement with Praeses to enhance and expand the public telephone service at DDR's shopping centers. Additionally, DDR also signed an agreement with Tower Resource Management that covers wireless telecommunication access rights (such as constructing towers). Furthermore, the REIT

Modernization Act will also let DDR develop projects that they would not have chosen to develop in the past. For instance, DDR can build such a project with the intent of "flipping" it to an investor who wants to own this type of product and pay the capital gains tax. Thus, DDR can increase their cash flow and not have to worry about jeopardizing their REIT status

DDR currently has a $200 million stock buy back program in place to repurchase what it believes is a significantly undervalued stock. The rationale is that by selling some assets at net asset value and buying back stock, DDR is essentially buying shopping centers at a 14%+ yield. However, as DDR's share price recovers (as it has done in the last month), their stock becomes less attractive use of their scarce capital. It is worth mentioning that there is an increasing beliefs among credit analysts that stock purchase programs can hurt credit statistics depending on the size and source of the funding for the program. Additionally, DDR may be indirectly signaling to the market that it does not have many investment opportunities outside of its own common stock.

Capital structure and funding future growth goes straight to the heart of what a REIT is to do in this environment. DDR utilizes a wide range of capital sources that have enabled them to fund growth while not limiting their financial flexibility. Ancillary revenues will play a larger role in the future as will the increased retention of DDR's own cash. Furthermore, DDR should not become overleveraged and run the risk of ruining their investment grade rating and access to cheaper public debt.

## Introduction

Kimco Realty has been an operator, developer and manager of shopping center and retail strip malls since 1966 when the company was co-founded in Florida by its current Chairman, Milton Cooper. The Company literally kicked off the public REIT boom of the 1990's, with their initial public offering in November 1991. Today, with 445 properties and 58 million square feet of GLA, Kimco is the nation's largest owner of neighborhood and community shopping centers and is the dominant and most liquid REIT in the shopping center sector. Kimco pursues a strategy of geographic diversification and owns properties in 41 states, with large concentrations in Florida, Illinois, Ohio, Missouri and Pennsylvania:

| State | Number of Properties | # Properties as % of Total | GLA (000s) sf | GLA as % of Total |
|---|---|---|---|---|
| Arizona | 8 | 2.2 % | 1,848 | 3.7 % |
| California | 10 | 2.7 | 2,227 | 4.4 |
| Colorado | 7 | 1.9 | 590 | 1.2 |
| Connecticut | 4 | 1.1 | 989 | 2.0 |
| Delaware | 1 | 0.3 | 112 | 0.2 |
| **Florida** | **52** | **14.1** | **6,385** | **12.7** |
| Georgia | 7 | 1.9 | 931 | 1.9 |
| **Ilinois** | **51** | **13.8** | **6,014** | **12.0** |
| Indiana | 15 | 4.1 | 1,837 | 3.7 |
| Iowa | 6 | 1.6 | 615 | 1.2 |
| Kansas | 6 | 1.6 | 787 | 1.6 |
| Kentucky | 3 | 0.8 | 398 | 0.8 |
| Louisiana | 3 | 0.8 | 603 | 1.2 |
| Maryland | 4 | 1.1 | 462 | 0.9 |
| Massachusetts | 1 | 0.3 | 135 | 0.3 |
| Michigan | 8 | 2.2 | 1,043 | 2.1 |
| Minesota | 1 | 0.3 | 120 | 0.2 |
| **Missouri** | **25** | **6.8** | **3,435** | **6.8** |
| New Hampshire | 1 | 0.3 | 341 | 0.7 |
| New Jersey | 9 | 2.4 | 1,372 | 2.7 |
| New Mexico | 3 | 0.8 | 278 | 0.6 |
| New York | 17 | 4.6 | 2,672 | 5.3 |
| North Carolina | 9 | 2.4 | 1,482 | 2.9 |
| **Ohio** | **32** | **8.6** | **4,531** | **9.0** |
| Oklahoma | 4 | 1.1 | 527 | 1.0 |
| **Pennsylvania** | **33** | **8.9** | **3,423** | **6.8** |
| Rhode Island | 1 | 0.3 | 130 | 0.3 |
| South Carolina | 6 | 1.6 | 953 | 1.9 |
| Tennessee | 5 | 1.4 | 674 | 1.3 |
| Texas | 27 | 7.3 | 3,337 | 6.6 |
| Utah | 1 | 0.3 | 121 | 0.2 |
| Virginia | 5 | 1.4 | 1,224 | 2.4 |
| Washington | 1 | 0.3 | 175 | 0.3 |
| Wisconsin | 1 | 0.3 | 156 | 0.3 |
| West Virginia | 3 | 0.8 | 383 | 0.8 |
| **Total** | **370** | **100.0 %** | **50,310** | **100.0 %** |

*Source: Company Financial Statements, Deutsche Banc Alex.Brown*

**Summary Financial Statistics and Recent Performance**

Kimco's total market capitalization is $3.7 billion and the Company currently has 60.7 million shares outstanding, of which approximately 14% are held by Kimco insiders. With reasonable leverage of 37% debt to total market capitalization and a strong fixed charge coverage ratio (approximately 3.0x), Kimco has enjoyed consistent access to capital, unlike some of its smaller competitors in the retail sector. According to Merrill Lynch's *Comparative Valuation REIT Weekly (1/14/00)*, Kimco also had a 1999 FFO multiple of 9.9x - the second highest reported multiple in its sector and significantly stronger than the 8.0x sector average.

From an operating performance perspective, Kimco investors have historically had little to complain about. Since the 1991 IPO, Kimco has averaged a 20% annual increase in FFO. Despite the capital-constrained environment for all publicly-held real estate companies, Kimco has managed to consistently increase earnings and posted over a 19% FFO increase in 4Q, 1999. The same property NOI growth during this same period was over 5%. From a valuation standpoint, Merrill Lynch figures indicates that Kimco trades at a modest 2%-3% discount to its net asset value (NAV), which is in sharp contrast to the 15%-30% price/NAV discount of other public retail REITs.

Despite the Company's admirable performance, the stock market's reaction has been less than favorable over the past two years. However, as the price performance graph below indicates, it appears that recent buying by large institutional investors may have reversed the negative trend as Kimco's stock price has rallied in March and April, 2000. On April 11, 2000 Kimco closed at $38.56 - very near its 52-week high of $40.75. (see chart on next page)

**Kimco's Stock Price for the Last Year**

## Property and Tenant Characteristics

Kimco's tenant roster largely rests on a base of prominent "big-box" retailers as represented in the table below. The 1998 merger with Price REIT further established Kimco as a player in the power-center niche and the 1997/98 acquisition of the Venture Stores portfolio added a significant number of Kmart leased properties to the company's portfolio. Overall, Kimco's real estate portfolio is 91.4% occupied. (see table on next page)

**Statistics on Kimco's Top-10 Tenants:**

| Tenant | Number of Stores | % of Leased GLA | Annualized Base Rental Revenues | % of Annualized Base Rents Revenues |
|---|---|---|---|---|
| Kmart | 72 | 13.2% | $53,487,000 | 13.4% |
| Home Depot | 13 | 2.6% | 11,072,000 | 2.8% |
| Kohl's | 18 | 2.9% | 10,275,000 | 2.6% |
| Toys R Us | 25 | 1.8% | 6,966,000 | 1.7% |
| TJX Companies | 36 | 1.9% | 6,534,000 | 1.6% |
| A & P | 10 | 0.9% | 5,947,000 | 1.5% |
| Costco | 9 | 1.9% | 5,863,000 | 1.5% |
| Wal-Mart | 11 | 2.2% | 5,829,000 | 1.5% |
| Shopko | 12 | 1.9% | 5,672,000 | 1.4% |
| Office Max | 23 | 1.0% | 5,331,000 | 1.3% |
| **Total** | **229** | **30.3%** | **$116,976,000** | **29.3%** |

*Source: Company Financial Statements, Deutsche Banc Alex.Brown*

**Primary Issues of Analysis**

In addressing the question at hand, and in researching the history and composition of Kimco, our team has identified four salient issues which will significantly affect the future of Kimco. First, we will examine Kimco's approach to investor relations, and specifically its attitude towards dividend policy and share repurchase plans. Second, we will look at how Kimco uniquely approaches joint-ventures by examining the 1998 spinoff of what Wall Street analysts have termed the "baby-Kimco" - Kimco Income Realty (KIR). Kimco's growth strategy, including the Company's traditional strengths in development and opportunistic acquisition, as well as its approach to the newly-liberalized world of ancillary revenues will be our third area of scrutiny. Finally, the fourth area that we will explore is perhaps the most often talked-about issue these days, especially in retail circles - the Internet. Specifically, we'll look at how Kimco plans on dealing with not only the threats, but the myriad of opportunities offered by this new technology and the "new economy".

**Investor Relations: Dividend Policy and Share Repurchases**

Kimco's approach to dividend policy is to pay the minimum amount allowable while still maintaining its legal REIT status. According to Merrill Lynch, Kimco has a 73% payout ratio, calculated as a proportion of the current dividend per share to the current estimated FFO per share. Management's strategy for this policy is one of capital conservation; a low dividend payout ratio allows Kimco to conserve its retained earnings for use in high-yielding growth initiatives including development, acquisition and investments in ancillary ventures.

It's worth noting however that Kimco's approach to dividend policy is not necessarily detrimental to its investors that hold and view KIM as an income stock. While Kimco's 7.4% dividend yield is 25% below the 9.9% sector average, the Company's estimated 1999-2003 dividend growth rate is 7.0% as compared with the 5.5% average for the sector. Therefore, Kimco is able to provide very competitive dividend returns despite its conservative dividend payout policy as the dividend grows in direct proportion to Kimco's historically-robust growth in FFO.

While Kimco has instituted share repurchases in the past (including 160,000 shares from an institutional investor at $31.75/share last year), management's sentiment on this issue mirrors its take on dividend policy. The Company is of the view that any excess cash is better utilized in external opportunistic investments rather than in buying back stock. This approach is rather controversial as many REITs both in the retail sector and in other groups, have found share repurchases a good way to buy back their stock at a discount when the market is punishing the price. This argument is predicated, of course, on the assumption that the true underlying value of the real estate assets (the "NAV") is worth significantly more than the trading price of the company. However, as noted in the introductory remarks of this section, even in the current capital environment, Kimco's stock has traded at a negligible discount to NAV. As such, management believes that open market share repurchases are not nearly as "cheap" for Kimco as they are for other companies that have significant price/NAV discounts of over 15%.

**Diversification and Joint Ventures - Kimco Income REIT**

Kimco's approach to joint-ventures with institutional partners is unique and significantly different than the approach taken by Developers Diversified. A spin-off created by the parent Kimco Realty, Kimco Income REIT ("KIR") was formed in 1998 through a joint venture with Kimco and the NY State Common Retirement Fund (NYSCRF). Capitalized at just under $600 million at year-end 1999, KIR was designed to achieve strong returns through the use of high non-recourse leverage at the individual asset level. The increased risk of the higher leverage is mitigated by the non-recourse/non-cross-collateralized mortgage structure. Thus, if one tenant or property presents a financial burden, the other properties in the KIR portfolio are not affected. The Company has plans to continue to grow KIR's portfolio through acquisitions in 2000 and has targeted an asset base of approximately $1 billion by year-end.

By contributing 23 of its more mature, cash-flow generating assets, KIR is aimed at attracting investors who seek to the higher levered returns and the correspondingly higher yields that this vehicle offers. KIR's investment strategy can be summarized as follows:

- investment in neighborhood and community shopping centers, power centers, and single tenant retail properties;
- the properties must be financed with non-recourse mortgages at (generally) 70-75% LTV;
- 70% of tenants will be under long-term leases (greater or equal to 10 years) with an emphasis on high-credit-quality national or regional tenants;
- the properties will be at least 96% occupied;
- the properties will have less than 2% expected internal growth due to the long-term leases, and;
- the properties should be relatively new and require minimal tenant improvements.

According to a recent Deutsche Bank Alex Brown report, KIR has been able to achieve a 165-170 basis point spread between its average cost of mortgage financing and the typical property yield. Consistent with management's objectives, the average occupancy of the KIR portfolio is 98% versus 91.4% for Kimco's primary portfolio.

Given the depressed state of the public real estate equity market, Kimco has shelved any plans to bring KIR public as a separate company. Additionally, Kimco's management disclosed to our team that their partner in the venture (NYSCRF) is loath to pursue any public offering of KIR as all assets would be marked-to-market in the public arena. Additionally, NYSCRF would rather invest in a pure real estate play rather than in the stock of a publicly-traded real estate vehicle.

In creating Kimco Income REIT, Kimco's management has seized on an innovative method of addressing some of the growth limitations of the REIT vehicle by pursuing a higher growth, although slightly-riskier strategy for their mature assets. Despite the current position of their institutional partner, the Company still retains the option of bringing KIR public in the future, a move that could create significant value for the Company's shareholders in the appropriate capital environment.

**Growth Strategy - Development, Acquisitions & Ancillary Revenues**

As a dominant player in the retail strip-center sector, Kimco's traditional strengths have been in the areas of development and acquisition. While the dampened capital markets have forced many growth-oriented REITs to curtail their acquisitive and development-oriented growth strategies, Kimco had over $400 million in acquisitions in 1999 ($229.4 million for KIM and $193.3 million for KIR) and plans $300 - 400 million in 2000. Development activity in 1999 totaled $80 million and plans for 2000 amount to over $120 million. Relevant developments and acquisitions are outlined below.

*Acquisitions:*

- **Hechinger Stores:** In December, 1999 Kimco announced that it was awarded the right to broker 54 locations of the bankrupt home-improvement chain, Hechinger Stores. The $118 deal allows Kimco the right to step into Hechinger's existing leases and to re-let the vacant properties or sell its sublease rights. The upside in this transaction comes from Kimco's ability to identify underpriced assets and to re-lease the locations at higher market rents. Kimco's ability to react quickly is further enhanced by its nationwide and long-standing large big-box retailers. Morgan Stanley Dean Witter (March 3, 2000 report) indicates that the spread gained from brokering these deals may be as high as $3 per square foot.

Additionally, Kimco purchased seven fee simple and one leasehold property from the bankrupt Hechinger portfolio that it will release and hold for investment (anticipated yield on these properties is 10%).

- **Venture Stores**: The 1997/1998 acquisition of the Venture Stores portfolio is another example of Kimco's opportunistic investment approach. This transaction resulted in the $400 million acquisition of 94 former Venture locations totaling almost 9 million square feet. At the time of acquisition the average base rent was $4.00 per square foot. Approximately one year later (June 30, 1999), the average rent per square foot was greater than $7.00, an increase of more than 75%.

*Development:*

- KIR presently has seven projects in the development stage consisting of approximately 2.6 million square feet and a total of $200 million in cost (when completed). Estimated unleveraged returns from these developments ranges from 11.4% to 13.7%. As of July, 1999 KIR had expended approximately $30 million in construction costs for its new development projects and significantly increased its development capital expenditures during the latter half of the year. Management anticipates that KIR will open at least one new project per quarter through the end of 2000. The table below summarizes the major development and redevelopment projects of Kimco as of November, 1999.

**Major Developments/Redevelopments:**

| Project | Description | Est.Total Cost (mil.) | Cost as of 11/99 (mil.) |
|---|---|---|---|
| Chandler, AZ | 130,000 sq.ft. center to include GAP, Banana Republic and AJ Foods | $22.5 | $9.9 |
| San Antonio, TX | 1.0 million sq.ft. ground-up development (1st Phase $300K) | $65.0 | $13.4 |
| Skokie, IL | Redevelopment of existing Venture location for Marshall & others | $8.6 | $0.0 |
| Houston, TX (JV) | Phase II expansion for Linen N' Things and Ross Stores | $15.0 | $1.2 |
| Cedar Hill, TX | 220,000 sq.ft. development to include Kohl's | $16.7 | $9.2 |
| **Total** | | **$127.8** | **$33.8** |

*Source: Merrill Lynch & Kimco Company Reports (expected unleveraged return: 11.5%)*

*Ancillary Revenues:*

The third significant growth area that Kimco is targeting is the area of ancillary revenues. The REIT Modernization Act ("RMA") will go into full effect in January, 2001 and Kimco is poised to take advantage of the growth potential via its 100% taxable subsidiary. Areas of additional revenues that can be channeled through the "taxable-sub" include brokerage services, service contracting, management services as well as the rapidly expanding area for real-estate-related e-commerce.

**The Internet**

Much has been written about the threat of the Internet to real estate owners and particularly, owners of retail-oriented real estate. Cynics argue that consumers will embrace Internet shopping and business will streamline via B2B exchanges to such an extent that much of the nation's retail stock will eventually be rendered obsolete. Our team takes a more optimistic view and believes that the synergies created by "clicks and bricks" will allow retailers with strong tenants and well-located real estate to benefit from the advances in online transactions.

Kimco's most notable foray into the online world is its $250,000 (plus warrants) equity investment in Eversave.com, an online retail shopping conduit that creates "virtual communities" for users who enter their profile into the system. Once Everlast.com has the user's geographical location and user profile, it accesses its search engine to direct customers to participating retailers in that user's area. Kimco's relationship with Eversave.com is currently being beta-tested in 25 New York metro area malls and is an example of how Kimco is assisting its smaller tenants who do not have direct access to the online resources that its larger tenants do.

According to management, Kimco is also discussing online initiatives and partnerships with some of its largest tenants including Costco, Wal-Mart and Kmart - all companies that have online catalogues that support their retail locations. Additionally, by developing initiatives in online leasing, property sales, vendor service contracting and information management, Kimco

can exploit the power of the Internet by setting up its online ventures with the taxable subsidiary discussed above.

**Summary**

During our discussion with Kimco's management, Joseph Kornwasser (Senior Executive Vice President) noted that there is a widening chasm in the REIT industry between the "haves and have-nots." Clearly, we view Kimco as one of the "haves" and see its initiatives in the areas of joint-ventures and the Internet to be indicative of the entrepreneurial and innovative nature the Company's management. While we believe that there is no single panacea that will cure the ills of all REITs, we view Kimco's actions as appropriate for many REITs, given the current rapidly-changing technological environment. Kimco maintains a healthy financial position and is taking prudent steps towards embracing the Internet while also relying on its traditional strengths in the areas of development and strategic acquisition.

## CONCLUSION

The stock prices of REITs in the retail (shopping center) sector have suffered over the last two years, as have the stock prices of all REITs generally. Despite strong real estate market fundamentals, investors have largely ignored retail REITs. It is worth noting that one of the main causes of the current environment has not been the poor decision making of REIT management teams, but rather the explosive growth of technology companies. As a result, money has flown out of REIT mutual funds and into technology funds in the hope of riding this wave. Nonetheless, there are many strategies that retail REITs can pursue in order to combat the current capital environment:

- **Ancillary Revenues**. Despite the recent capital constraints, retail REITs have large opportunities to expand future cash flow through the REIT Modernization Act. Both DDR and Kimco have taken steps to capture some of these new ancillary revenues. Likewise, we recommend that retail REITs should be creative in exploring any service they can provide their customers or their tenants as a future source of cash flow.

- **The Internet.** While many view the rise of the Internet as a threat to retail REITs, we feel that bricks and mortar will be critical to any successful e-tailing strategy. This puts large owners of retail real estate in a favorable position. We recommend that REITs should spend some of their capital, as both DDR and Kimco have done, to get educated on how e-tailers are formulating their current strategies and how REITs can help them achieve their goals. However, we also believe that there is a large option value for REITs to wait and not spend too much money until the impact of e-tailing is more definitive.

- **Joint Ventures.** In order to maintain financial flexibility, we believe that REITs must be able to access as many pools of capital as possible. One of these pools can be accessed through the use of joint ventures. While Kimco and DDR use joint ventures very differently, both have had success with the structure. While it takes years to develop the expertise of a DDR in the joint venture arena, we still recommend that

retail REITs use joint ventures as another alternative source of funds in this capital constrained environment.

- **Dividend Policy and Capital Structure.** Growing FFO faster than the dividends will also be another important source of capital for retail REITs in the future as retained cash is the cheapest form of capital available to REITs. It is also imperative that retail REITs do not become overleveraged and thus lose their access to the debt markets.

- **Growth Strategy.** Kimco and DDR both have various opportunities to grow. That is, both companies engage in a numerous types of real estate deals including acquisitions, development, re-development and joint ventures. We believe that the most successful retail REITs will be the ones that have core capabilities in all of these areas and do not have to rely on one type of real estate transaction in order to grow.

- **Investor Relations.** While both DDR and KIMCO seem to have above average relationships with their investors, this has done little to help them in the current capital constrained environment. While we believe investor relations are important to the long term success of all retail REITs, it appears that spending more time in this arena will not significantly help these companies to overcome the scarcity of capital.

The recent downturn in the NASDAQ has led to an increase in overall REIT prices over the last month. While still along way from their 1994 to 1998 glory days in which they enjoyed unprecedented access to capital, REITs may be looking at the end of the current capital constrained environment. Until that point in time, we believe that we have outlined a plan for retail REITs to be successful in this environment.