

***Developing the Right REIT Strategy:*
**Recommendations for Two Multifamily
Companies****

by

**Evan Henkin
Kelley Mast
Jacob Slosburg
Andrew Stewart**

**Seevak Real Estate Competition
Professor Gyourko
April 14, 2000**

Introduction

This paper provides strategic recommendations for two multifamily REITs, AvalonBay Communities and Gables Residential Trust in an effort to answer the question, “What is a REIT to do in today’s environment?” After providing a brief overview of the firms as well as a discussion on current supply and demand fundamentals, this paper describes how AvalonBay and Gables’s strategy must carefully consider each company’s existing operations, new opportunities and capital structure. The four major areas analyzed in existing operations are portfolio strategy, branding, ancillary services and human resources. Under new opportunities, strategies for optimal size, acquisition, development and consolidation are detailed. Finally, sources of capital and capital structure are discussed.

From the analysis, the following recommendations are presented:

AvalonBay Communities should:

- Become a leader in residential services
- Take advantage of its size and scope
- Utilize local market knowledge

Gables Residential Trust should:

- Strengthen its niche portfolio
- Grow to maximize economies of scale
- Expand third party management

Firm Overviews

AvalonBay Communities (NYSE: AVB) was formed by the fourth-quarter 1998 merger of Avalon Properties and Bay Apartment Communities. Based in Alexandria, VA, AvalonBay is a REIT focused on the development, acquisition and management of class-A apartment communities in high-barrier to entry markets. As of December 31, 1999, AvalonBay owned or held interest in 134 apartment communities containing nearly 40,000 apartment homes in twelve states and the District of Columbia covering the Northeast, West and Midwest regions of the United States. As of March 2000, AvalonBay's equity market capitalization was 2.3 billion dollars.

Gables Residential Trust (NYSE: GBP) was founded in 1982 and elected REIT status in 1994. Formed from the team that managed the southeastern region for Trammell Crow Residential, Gables is a vertically integrated developer, acquirer and manager of class-A apartment communities in Florida, Georgia, Tennessee and Texas. It currently operates 95 multifamily communities containing 28,000 units. Gables, based in Atlanta, GA, is dedicated to high quality assets and service and is committed to a strong local presence. As of March 2000, its equity market capitalization was 570 million dollars.

Existing Operations

National Demand

Demand for multifamily apartments has stemmed from a strong economy and demographic trends that have increased the number of apartment renting adults. These factors bode well for the future prospects of multifamily apartment owners.

The strong economy has led to healthy job growth, a direct correlation with apartment demand. In 1999, 2.5 million new jobs were created resulting in a 300,000-400,000 unit increase in apartment demand (6 new jobs = 1 new apartment). While continued growth is expected in the near term, the current buoyant growth may not be sustainable.

Should the economy weaken, however, demographic trends still support increased multifamily demand over the next 5-10 years. Census figures estimate that the number of apartment households should increase along with the total growth in households over the next decade at about 1.1% annually. Given that there are approximately 15 million apartment households in the United States, over the next decade, there will be an annual need for at least 150,000 new multifamily units.

The major groups contributing to this growth are baby-boomers, 20-29 year olds, singles and immigrants. Although it might seem odd that baby boomers are contributing to apartment household growth given that one's proclivity to rent diminishes in middle age, the sheer size of this demographic segment is contributing to apartment growth in the 45-64 year-old segment. Another key apartment renting segment, the 20-29 year olds, a segment that shrunk in the 1990s, also will see growth over the next decade. Adult singles, currently the source of nearly half of all apartment households, are also a growth segment as Census data has shown that US residents are increasingly living alone. The final major group contributing to apartment growth is immigrants.

It has been projected that 44% of the growth in the number of renter households from 1995 to 2010 will be attributed to this population group.

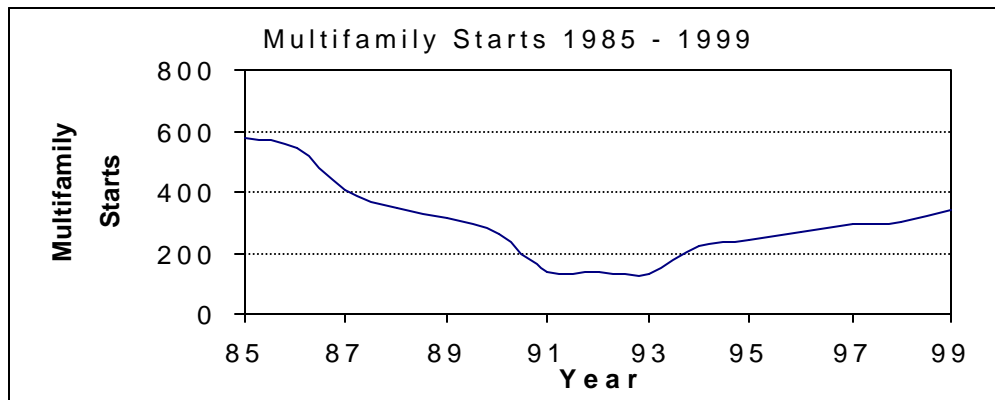
United States Apartment Household Growth 1995 - 2000

Source: Goodman, "The Changing Demography of Multifamily Rental Housing," p46.

	% US Households (1997)	Number 1995 (M)	Growth % 1995-2000	Growth % 2000-2005	Growth % 2005-2010
Total	14.8	14.2	0.9	1.1	1.2
Age					
Under 25	37.3	1.8	0.7	1.8	1.3
25-29	28.7	2.3	-1.1	0.6	2.0
30-34	18.5	2.0	-1.9	-1.0	0.7
35-44	12.8	2.9	1.6	-0.5	-1.2
45-54	9.6	1.6	4.1	2.9	1.6
55-64	9.0	1.1	3.0	4.7	4.0
65-74	9.7	1.1	-0.8	0.1	2.6
75 Over	14.8	1.4	2.1	1.2	0.3
Household type					
Married	6.2	3.3	-0.2	0.1	0.4
Other family, female head	20.4	2.2	1.1	1.1	1.2
Other family, male head	16.4	0.5	1.3	1.3	1.4
Nonfamily, female head	25.8	4.2	1.1	1.3	1.4
Nonfamily, male head	29.0	3.9	1.5	1.5	1.6

National Supply

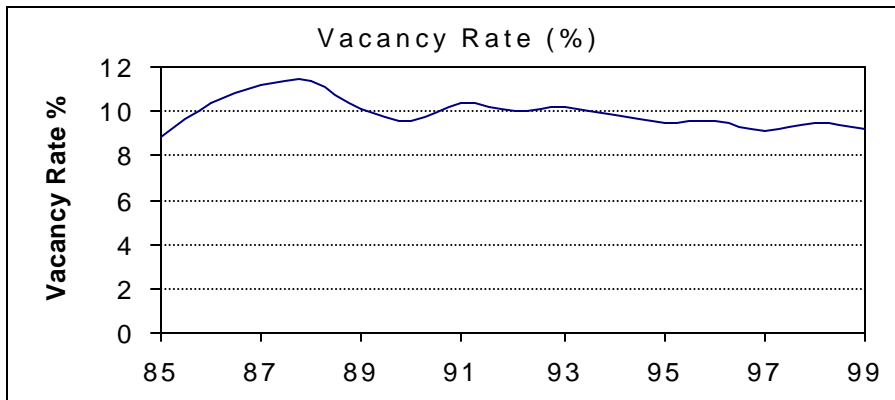
Multifamily supply since 1997 has been fairly steady at about 300,000 new units per year. New construction starts were higher in 1999 at 340,000 but this year should see starts fall back down to the 300,000 level. Actual completions in 1999 were between 325,000 and 350,000 units. With about 100,000 units lost to condo conversion and demolition, there is a net increase



of around 200,000 units per year. Overall, the steadiness of apartment supply can be attributed to stricter lending compared to the 1980s, less access to capital for developers due to the public disclosure associated with the increased influence of REITs on the multifamily industry.

Supply / Demand Summary

With the growing economy in the past decade, demand has exceeded the multifamily supply. This excess demand can be clearly seen by looking at multifamily vacancy rates over the last 12 years. In 1988, national vacancy in multifamily units was 11.4%. Last year this figure had declined to 9.5% and it is expected to fall further to 9.2% in 2000. This trend is indicative of the current health of the multifamily sector.



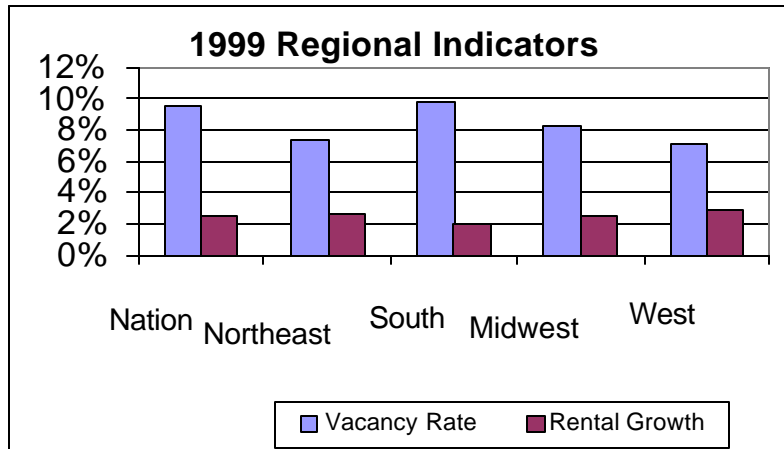
Regional Conditions

While the national macroeconomic trends are important to the overall fundamentals of the industry, apartment operators are more often concerned with the market conditions of the cities and regions in which they operate. These conditions happen to vary considerably.

Looking at the four major regions of the United States (Northeast, South, Midwest and West), the West is the top performer. Vacancy rates average 7.1% compared to 9.5% nationally

and rent growth stands at 2.9%. California is the strongest state containing 7 of the 20 MSAs with the lowest vacancy rates.

The Northeast has also been strong with solid rent growth of 2.6% and vacancy rates of 7.3%. The Northeast's performance has been aided by growth in the high barrier-to-entry



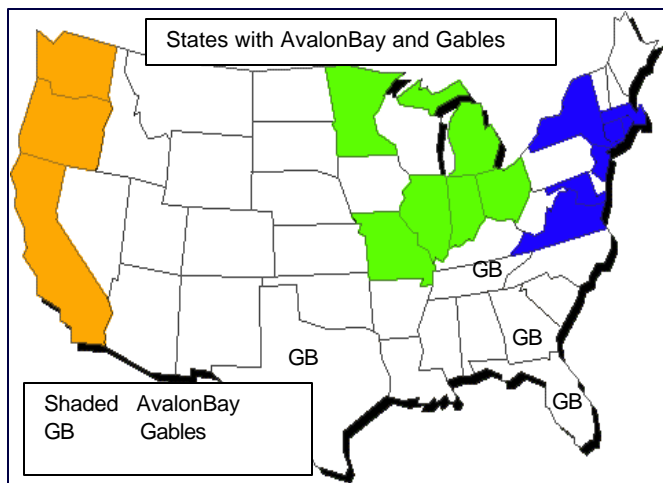
Washington to Boston corridor cities.

The Midwest, similar to the Northeast, has seen stable rent growth of 2.5% and a vacancy rate of 8.3%. Chicago and Minneapolis have been especially

strong in this region.

The weakest performing region has been the Southeast with rent growth of 2.0% and an average vacancy rate of 9.9%. Oversupply has hurt this region as construction has taken off in such high job growth cities as Orlando, Raleigh, Charlotte and Austin. One figure that illustrates

this oversupply is new construction permits in 1999. The Southeast region had 188,000 permits compared to 196,000 for the rest of the country.



The map at the left shows the states where AvalonBay and Gables operate communities. AvalonBay is primarily in the stronger Northeast and West regions

while Gables focuses on the weaker South and Southeastern states. While one could generally conclude that REITs operating in the stronger regions are better positioned than those with properties in the weaker regions, it is still extremely important to look at the local demand / supply fundamentals to understand how individual properties are doing. In fact, even though California is the strongest state, AvalonBay's properties in Santa Clara, California have struggled with dropping occupancy levels due to increased competition and a slowdown in job growth. At the same time, in the weaker South, there are strong growing markets such as New Orleans, LA, Greenville-Spartanburg, SC and Birmingham, AL.

Portfolio Strategy

Multifamily REITs must understand and utilize local market knowledge to develop their portfolio strategy and to minimize risk. Important portfolio characteristics for AvalonBay and Gables, as well as all multifamily REITs, are high barrier-to-entry markets, urban or urban in-fill locations and markets resilient to economic downturns. Multifamily REITs should focus on markets and submarkets with high barriers-to-entry to avoid the consequences of oversupply. Some characteristics REITs should look for in locations are entitlement barriers, strict zoning laws and limited land availability. REITs should also concentrate on urban or urban in-fill locations. Resident populations in city centers and their periphery are beginning to grow again as ex-suburbanites are seeking the lifestyle and cultural amenities as well as the neighborhood diversity found in cities. Multifamily operators can provide these relocaters with an entry into downtown without incurring the personal risk of purchasing a home in a transforming neighborhood. It is also important for REITs to operate in markets resilient to economic downturns. While the ups and downs of the previous cycle may be fresh on managers' minds,

REIT management should look back over two or three cycles and analyze how their markets performed in the downturns to gain a clearer picture of the future health of their properties.

In addition to following these strategies, AvalonBay and Gables should continue to concentrate on class-A properties. By focusing on class-A properties, AvalonBay can earn a premium in market upturns and protect itself in downturns. Class-A renters tend to have more disposable income than class-B renters so they will have a greater ability to continue to afford their apartments should the market turn sour. In a market downturn, class-A operators also have more flexibility as well as superiority over class-Bs. If necessary, class-A could lower their rents to class-B levels and effectively out-amenity class-B operators. In addition, class-A apartments tend to suffer less wear and tear than class-B apartments leading to less maintenance and repair costs and a longer time towards obsolescence.

The main difference in the portfolio strategies of AvalonBay and Gables is due to the size and geographic coverage of the respective companies. While geographic diversification is important to both companies in order to minimize risk due to pockets of overdevelopment, it is much easier for AvalonBay to do so. AvalonBay can utilize its current extensive market knowledge to evaluate and enter new markets and minimize its risk due to its broad geographic coverage. Gables, on the other hand, is concentrated in the Southeast region, and cannot as easily move into new markets, especially those outside the vulnerable Southeast region, due to its lack of market knowledge. However, Gables can stay in the familiar Southeast region where it is committed to a strong presence and can minimize its risk by looking for strong submarkets that meet the characteristics described above. It can also look to expand into new markets in the South such as New Orleans, LA and Birmingham, AL as well as those outside its southern sphere by utilizing third party management. In this capacity, Gables can strengthen its niche in

the South as well as gain the knowledge and experience to successfully enter new markets without taking on as much risk.

Branding

Branding is a major issue in product strategy and is being broadly implemented across the multifamily sector. Developing a branded product required a great deal of long-term investment, especially for advertising and promotion. Given the asset type and customer base in multifamily housing, branding does not appear to be a critical strategy for success.

Branding is considered to be “the art and cornerstone of marketing”. The American Marketing Association defines a brand as “a name, term, sign, symbol, or design, or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors.” In essence, a brand identifies the seller and represents a promise to deliver a specific set of features, benefits, and services consistently to the buyers – a warranty of quality.

The end goal of branding is to establish brand equity, the power and value that a brand carries in the marketplace. The benefits of brand equity are:

- Reduced marketing costs because of awareness and loyalty;
- More trade leverage in bargaining with distributors;
- Higher price than competition because of high perceived quality;
- Easier to launch extensions and/or enter new segments because the brand carries high credibility;
- Defense against price competition; and
- High switching costs – loyalty.

Within the multifamily REIT sector, the only successful branding strategy is currently being implemented by Post Properties. Post has found branding to be successful in local markets

where they have critical mass, defined as having more than 2,000 units. Although these efforts have been lucrative in such submarkets, they have not had much success rolling it out at the national level.

A branding strategy is very difficult to implement in the multifamily sector on a national basis. Since multifamily products are assets that are constantly aging and varying in appearance, it is difficult to produce a consistent product vis-à-vis quality, amenities, location, etc. The apartment homes have a useful life of more than 30 years and customer expectations going from product to product in an inventory would be inconsistent. Furthermore, customer profiles would vary significantly from market to market, thereby making it difficult to deliver a uniform product. Given the high costs to build a brand (advertising, etc.) and the non-conventional product offered in multifamily housing, a branding strategy is not recommended.

Both Gables Residential and AvalonBay Communities have adopted some form of branding. Gables is pursuing its branding strategies in a reaction to strong public interest. The company should continue to implement this strategy in its “critical mass” submarkets where the firm has enough units to build brand synergies. However, Gables should curtail any efforts to pursue branding at a national level.

AvalonBay is attempting to build a consistent corporate image across its asset portfolio. The company incorporates its "Avalon" name into each community it develops. It is recommended that AvalonBay pursue branding strategies in critical mass markets similar to Post Properties' strategy. Even though AvalonBay is diversified geographically across the country, any efforts to pursue branding at a national level is likely to be of marginal benefit.

REIT Modernization Act (“RMA”) and its Impact on Multifamily Companies

On December 17, 1999, President Clinton signed into the law the REIT Modernization Act (RMA) that contains many of the REIT modernization proposals supported by NAREIT, whose provisions will have a significant effect on the operation of many REITs. Specifically, in the multifamily sector, several opportunities now exist for REITs to pursue alternative revenue sources.

Under current law, taxable subsidiaries of a REIT generally are fully taxable corporations in which a REIT owns, directly or nondirectly, up to 99 percent of the value, but may not own more than 10 percent of the voting stock. Because of the 10 percent voting stock restriction, the voting stock of the taxable subsidiary typically is owned by a party that is “friendly” to the REIT. The value of the stock of each taxable subsidiary owned by a REIT may not exceed 5 percent of the value of the REIT’s assets. A taxable REIT subsidiary (“TRS”) generally cannot provide “non-customary” services to the REIT’s tenants without generating income for the REIT that is non-qualifying REIT income.

The recent Act allows a REIT to own up to 100 percent of the stock of a TRS and allows TRS's both to perform activities unrelated to the REIT’s tenants, such as third-party management, development, and other independent business activities, and to provide services to the REIT’s tenants. This provides greater operational flexibility to REITs and their TRS's and allows for greater revenue potential.

The RMA provides REITs with enhanced strategic flexibility to generate and diversify income. Under the Act, a TRS can provide both “customary” and “noncustomary” services to the REIT’s tenants without causing the rent that the REIT receives from its tenants to be treated

as bad income. The Act greatly expands the types of services that a REIT can offer its tenants, enabling the REIT to compete with non-REIT competitors, operate more efficiently, and have more control over the services provided to its tenants.

Because the multifamily REITs have an extremely captive audience with their tenant base, the RMA empowers them to offer new revenue-generating services to both tenants and third parties. These revenue sources are numerous, but can be broken down into Management and Services/Amenities.

The Management category of ancillary income opportunities includes:

- Property Management Systems
- Third-Party Management
- Development/Construction
- Corporate Housing

The Tenant Services/Amenities category of ancillary income opportunities includes:

- Telecommunications
- Broadband Access
- Brokerage
- Laundry
- Cleaning
- Mortgage
- Furniture sales/leasing
- Travel Agency

The revenue potential is far greater for the Management areas while the Tenant Services/Amenities relate more to the direction of the industry of becoming more service-driven. It is estimated that an aggressive Tenant Services package can comprise approximately 2-5% of NOI.

Multifamily REITs should focus on technology, as the “New Economy” has evolved to place significant value on those firms that can embrace the technology trends. Specifically, Property Management Systems and Technology Services are two key areas that should create the most value going forward.

Property Management Systems have been an area for innovation in this sector. These systems, in addition to improving a REIT’s ability to capture and retain tenants, can provide management with “real time information” such as tenant traffic, closing ratios, and daily/monthly vacancies. This will provide for a more yield-management-oriented approach to management, providing for significant revenue upside.

Technology Services include those focusing on Internet and telecommunications access.

Specific Strategies should include:

- Enhancing revenues and margins by attacking the internet space with large pools of properties and tenants;
- Improving tenant/landlord relationships through construction of portals;
- “Dis-intermediation” – the process of major corporations integrating vertically by eliminating B-to-B middlemen and taking full advantage of Internet strategies independently, and thus capitalizing on the captive audience of tenants under the firm's property umbrella (i.e. - PMS systems, purchasing, broadband access).

Several multifamily REIT’s have active technology strategies in place. Following are some multifamily companies' current strategies in this space.

AvalonBay/United Dominion: Javalon

Javalon, an internet-based PMS system, will lure and retain tenants through offering high-speed Internet access, e-commerce activities, and on-site virtual leasing kiosks.

BRE: Project Velocity and Lifestyle Solutions

Project Velocity will provide broadband access that will link renters up to the Internet at speeds up to fifty times faster. This service is coupled with an internet-based customer interface web portal.

AIMCO: Buyers Access

Buyers Access is an online purchasing cooperative representing over 500 owners allows for apartment equipment and furniture procurement.

Post Properties: 100% Internet Access

100% Internet Access is the first initiative in the industry to convert all existing units to provide Internet access.

Presently, Gables is lagging in its efforts to stay on the forefront of technological innovation, primarily because of its limited size and ability to bear the costs to develop such innovations. It is recommended that Gables seek to pursue joint ventures and utilize the company's third party management portfolio to support valuable technological innovations. Furthermore, Gables must focus on the increasing service needs of the industry and work to provide the vast array of services that tenants are beginning to demand.

Presently, AvalonBay has an active strategy with regard to technology and service. It is recommended that the company continue these efforts and strive to become the leader in technological innovation. AvalonBay must capitalize on its size and focus on vertical integration opportunities in addition to the company's Javalon project.

Human Resources Strategy

The operating intensity of these businesses creates a risk that must be acknowledged and confronted by the REITs in this sector. The increasing level of services that a multifamily operator is required to provide demands a greater responsibility to deliver them well. The cost of failure could be quite significant (tenant turnover, tenant ill will, etc.).

It is critical with the evolution of the multifamily sector into a service-driven business that REITs build the infrastructure to manage their properties well. With the shrinking labor force, it is extremely important to attract, develop and retain quality management from the

corporate level to the property level. This will inevitably become a source of competitive advantage in the industry.

Both AvalonBay and Gables have similar strategies in place at the corporate level. Gables University and AvalonBay University are strong training programs for management. It is recommended that these programs be implemented more aggressively at the property level. On-site training and corporate oversight will need to be provided on a regular basis. Furthermore, increased focus should be placed on retaining quality people through creative incentive programs and on creating a culture that caters to the needs of employees. Reduced turnover would have a significant effect on firm success. This will play a significant role in the future success of AvalonBay, the larger of the two REITs where size can lead to bureaucratic corporations. Human Resource departments should be strengthened.

New Opportunities

In order to evaluate new opportunities, REITs must first select an appropriate size to determine which opportunities fit with the company's strategy.

Optimal Size

Multifamily operators must include size as a decision factor when selecting the optimal strategy. Economies of scale are important but at a certain level become less significant, and at a certain size can even result in diseconomies of scale for particular functions. Still, the largest firms in the real estate market capitalize from various economies of scale creating a competitive advantage over the smaller, weaker firms. There are four major elements associated with economies of scale in production and operation in the multifamily market:

- Cost of capital;
- General and administrative and operating expenses;

- Management; and
- Marketing.

Cost of Capital

The cost of capital comprises 85 percent of a REIT's total costs. The large REITs are able to reduce their cost of capital increasing their advantage over the smaller REITs. However, the economies of cost of capital does diminish at a certain point. Kerry Vandell, Director of the Wisconsin Center for Urban Land Economics Research, argues that "the cost advantage of going from \$500 mm to \$1 billion in market capitalization appears to be significantly more than going from \$2.5 billion to \$3 billion"(CULER Report 4). The three components to the cost of capital include: the cost of debt, the cost of equity, and the costs associated with raising capital.

REITs with the best history of financial performance and the strongest balance sheets have relatively low debt costs. With a conservative balance sheet, large REITs can move to unsecured financing for their operating capital needs which can take approximately 50 basis points off the firm's cost of debt relative to traditional mortgage financing (CULER Report 4). Larger REITs can also access the public corporate bond markets, which provide even cheaper sources of capital. AvalonBay, the larger company in the analysis, has a 30 bps lower weighted average cost of debt capital than Gables Residential, 7.1 percent compared to 6.8 percent. While AvalonBay has a lower weighted average cost of debt, a significant portion of the savings that result from being large come in the costs associated with raising capital and having more sources to solicit both debt and equity capital.

The cost of equity is correlated with the price of risk – the lower the operator's risk, the lower the price of equity. Very large REITs also reduce investor risk via greater liquidity. Shareholders in the public markets are willing to accept lower expected total returns in exchange

for liquidity and the greater safety and stability that size provides which allows these companies to utilize their own "inflated currency" to make acquisitions or fund development.

Substantial economies of scale exist in the third component of capital costs - the costs associated with raising capital. Larger public REITs can utilize the economies of scale in capital raising as they have a substantial number of institutional investors. Many of the larger companies can seal better deals with their joint venture partners than that of the smaller, less liquid REIT simply because they have more clout with the investor. Better deals come in the form of larger amounts of funding, and a preferred return to the developer. For example, Gables Residential was able to secure enough funding to develop 2,400 units this year, which represents a large portion of its development pipeline.

Another way in which larger REITs realize benefits from cheaper capital is simply due to the structure of the REIT itself, and its requirement to pay out 90% of taxable income. AIMCO and Equity Residential, the largest companies in the sector, can use size to manipulate the REIT structure and save in capital costs. Because of these companies' large size, these REITs can partially overcome the disadvantage that comes with the lack of retained earnings, since 10% of taxable income from a large portfolio can be quite a significant amount of money to fund new opportunities. Big REITs add value by increasing retained earnings through their greater size, creating lower cash flow payout ratios, and retaining borrowing capacity via strong balance sheets. Conversely, small apartment REITs (\$150 million market capitalization or less) cannot grow or access capital as easily. The smaller REIT needs retained earnings to grow but the REIT structure prohibits it from retaining a significant amount of earnings, and therefore must access other capital sources. But, other sources of real estate capital are scarce for the small REIT because they are often viewed as a more risky investment, while large REITs are more stable and

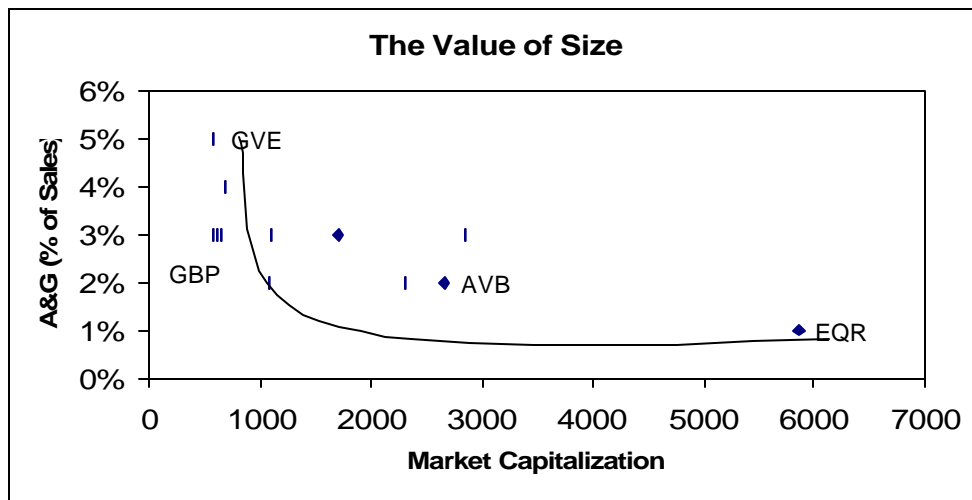
thus have the ability to utilize alternative capital sources such as private investors and pension funds to finance growth.

Also, REITs with low capital costs can use this cost advantage to reduce rents in order to attract and retain tenants. They can also make greater capital expenditures to keep the properties competitively positioned, pay more for managerial talent, and advertise more effectively.

General & Administrative and Operating Expenses

As a REIT's size increases, the allocation base for fixed overhead expands, thereby creating economies of scale in general and administrative expenses. The larger REITs take advantage of a cost basis whose marginal increase with size is insignificant. Other operating costs such as purchasing are also enhanced with size economies. The larger REITs have been successful in negotiating nationwide maintenance contracts and purchasing arrangements that further reduce costs.

As illustrated in the following chart, there is a correlation between G & A expenses and



market capitalization. The smaller REITs, like Grove Properties, have the highest general and administrative expenses while Equity Residential, the largest REIT in the sector has the lowest G&A expense as a percent of sales.

Management

Property management economies are displayed with increases in size. The larger firms are able to attract the top talent with their ability to offer the highest salaries, best professional challenges, and the most routes for advancement. Furthermore, asset management expenses are smaller with economies of scale.

Marketing

Economies of scale are also evident in marketing the asset base. Larger REITs can obtain better pricing with respect to advertising costs, which can take the form of apartment guides to web sites. Large REITs can even produce their own apartment guides since they can amortize the cost over a larger unit base. It is clear that the cost of building a web site for marketing purposes becomes much more affordable with each additional unit the site will market. For example, AvalonBay may have a bigger marketing budget than Gables Residential, but this is not the case on a per unit basis (Interviews with Company Management).

Other Benefits

Another benefit to being a large, national REIT is that an EQR or AvalonBay can diversify its portfolio to hedge risk. These REITs can diversify in terms of *geography* and *asset type*. AvalonBay has the advantage of balancing its portfolio geographically as they are located in the Northeast, West Coast and parts of the Midwest. If one region enters a recession, then AvalonBay can use its other geographic areas to absorb this shock. Conversely, Gables Residential is only located in the South/Southeast. If that part of the country enters an economic downturn, then Gables' entire portfolio suffers. (Gables does try to protect against this by holding assets in barrier-to-entry submarkets, but it is difficult to push rent increases when the market is underperforming.) Companies that have geographically diversified bases are less likely

to be hurt by the overbuilding in a single market. REITs such as Equity Residential, Archstone Communities and AIMCO have used their immense size to employ this strategy.

Also, the larger REITs can diversify across asset class and type. AvalonBay, for example, is not tied to class A garden apartments. They are starting to build high-rise towers (class A) and they also have student housing in their portfolio (they do not use the AvalonBay name on these properties). Gables is not big enough yet to vary its asset class and must stick to its core competence - garden style apartments.

It is clear that the optimal size comes into play when finding the appropriate strategy. While Gables Residential has realized some benefits from economies of scale, it still has a ways to go before it can reap the rewards due to size from that of AvalonBay. As such, Gables must grow its asset base and its third property management business to be able to fully realize the benefits of size and economies of scale. Since most research indicates that the advantages of increasing in size beyond a \$2 billion market capitalization are minimal, AvalonBay should build its infrastructure and not pursue growth for the sake of growth but must take advantage of true portfolio-enhancing opportunities.

Acquisition / Development

Today's market fundamentals support development over acquisitions for the following reasons:

- Acquisition cost exceeds replacement cost in most markets.
- The going-in capitalization rate is far greater than the exit capitalization rate even when accounting for development risk. With a 12 percent going-in capitalization rate and an 8.5 percent exit capitalization rate on development, it is better to develop than to acquire assuming a 2 percent risk premium on development.

However, the industry is at a critical point and REITs must proceed with caution. Housing starts have increased since 1991 and have flattened over the past two years, indicating that upside of the real estate cycle may be coming to a close. In addition, interest rates are increasing. An increase in interest rates will increase the cost of capital making expansion through development and acquisitions more expensive. REITs who cannot afford this, namely the smaller REITs, will not be able to expand through development or acquisitions as the cost will make it too expensive. Opportunities for acquisitions are diminishing. It is a competitive acquisition and development environment, with a strong presence from private players and institutional investors. With capitalization rates ranging from seven to nine percent (both AvalonBay and Gables have an 8.5 percent average capitalization rate) efficient and profitable acquisitions are increasingly hard to find. A REIT cannot spend its sparse time and capital looking for portfolio enhancing properties when it could be developing its own properties.

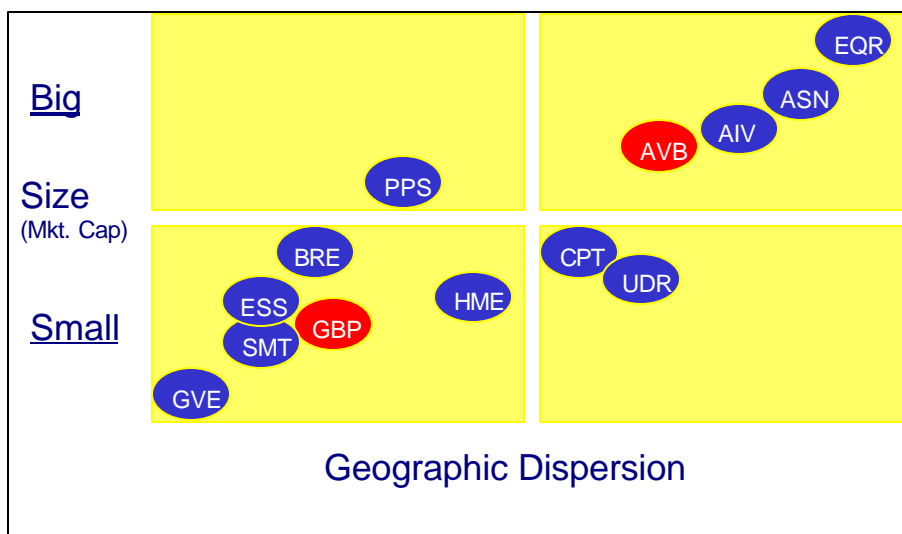
Both AvalonBay and Gables possess development as a core competency. It is clear that these companies should pursue development when the returns work, and must account for the end of the cycle, interest rate risk and construction cost increases in pro forma analysis. Gables, due to its smaller size, can be hit harder should some of its development projects go awry, and thus must truly pursue an insulated barrier-to-entry submarket strategy.

Consolidation

Three years ago, there were 29 apartment REITs, today there are 19 multifamily REITs. Consolidation activity slowed in 1999 as the REITs under-performed the S&P 500 and as such most acquisitions would have been dilutive to the company's value. Two transactions last year involved public companies going private. The Irvine Company, for example, paid \$32.50 for all

outstanding Irvine Apartment shares. Berkshire Realty went private at \$12.25 a share in October 1999. Finally, Equity Residential bought Lexford Residential for \$738 million in September.

Currently, there is not consolidation activity as the capital markets have denied REITs access to much needed capital to acquire and consolidate. It is clear that AvalonBay



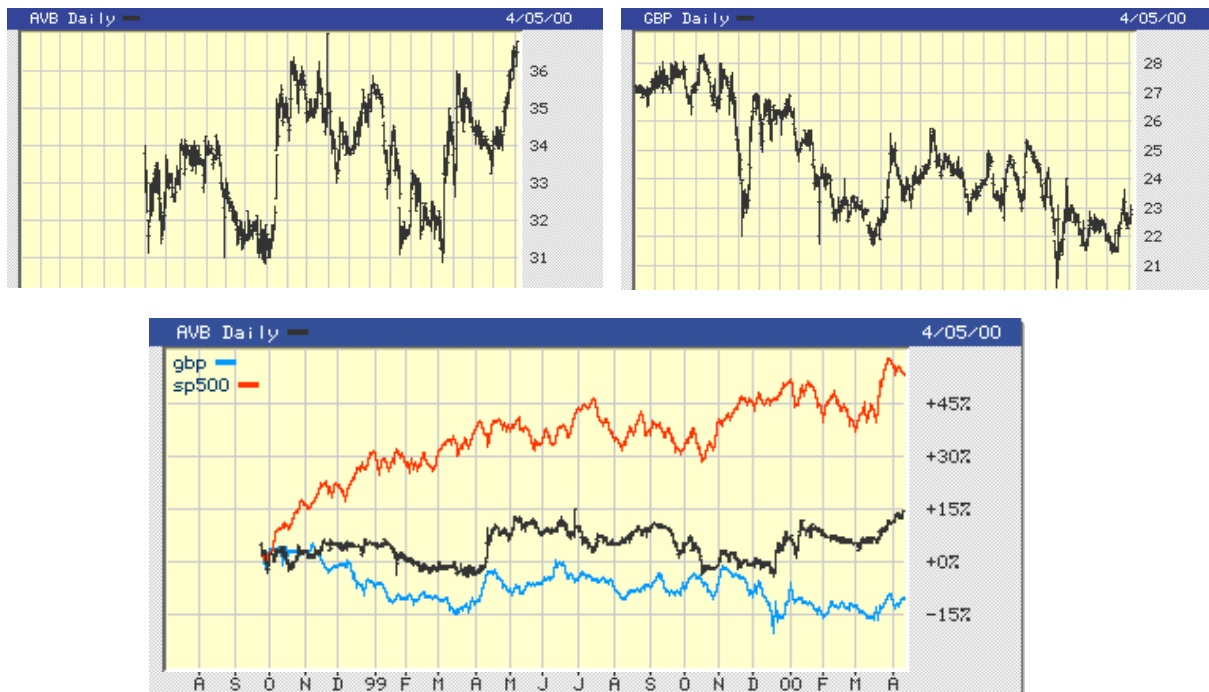
does not need to significantly enhance its size at this point in time given the end of the cycle approaching, its discounted share price, and diminishing economies of scale. Gables Residential could possibly benefit from a potential merger with the right multifamily operator, but the ideal candidates are also trading at a discount and it is likely that the partner would be adverse to any combination because the market would react negatively to any such transaction given the underperforming markets in which Gables operates. Essex Property Trust or BRE Properties, two California based multifamily REITs would make a good match from Gables' perspective. However, this is unlikely to happen for the reasons listed above combined with the fact that new management is in place at Gables and wants to communicate and build a successful strategy to raise its share price. Executing such a transaction would require Gables to merge at a substantial discount. Instead of selling to another public multifamily REIT at a large discount, management knows that it can receive a higher price for its portfolio on the private market. As such, a merger is not appropriate for Gables at this time.

Capital Structure

To determine the right capital structure for both AvalonBay Communities and Gables Residential, one must analyze each company's existing capital structure and then examine potential alternatives. Following is a summary of both companies' financial structure as well as their entity choice, along with some critical financial ratios:

Company	<i>AvalonBay Communities</i>	<i>Gables Residential</i>
Entity	UPREIT	UPREIT
Debt	\$1.6 Billion	\$755 Million
Preferred Stock	\$458 Million	\$170 Million
Common Shares and OP Units	\$2.4 Billion	\$723 Million
Debt-to-Market Capitalization	36%	46%
Debt + Pref-to-Market Capitalization	46%	56%
Weighted Average Interest Rate	6.8%	7.1%

It is clear that both of these companies have strong conservative balance sheets. In fact, AvalonBay has one of the most conservative balance sheets in the entire REIT universe. With these conservative financials, one might wonder if capital really is constrained in today's environment.

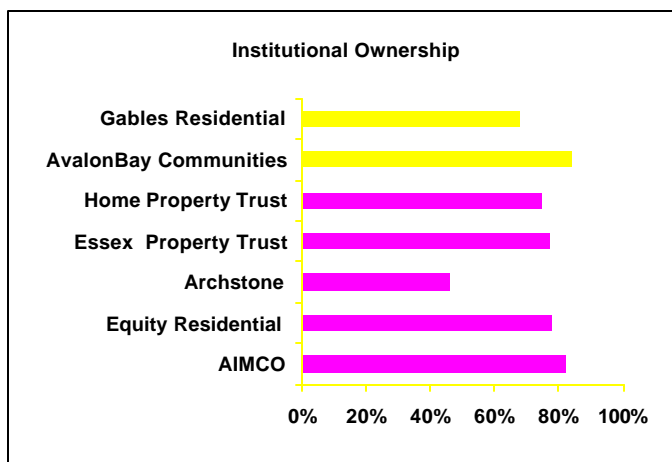


After speaking with management at both companies, and analyzing other companies in the sector, it is clear that most companies can locate funds to execute transactions and close deals. The cost of this funding is currently at a higher price since the ability to raise additional equity is not an option given the weak stock prices of both of these companies (see Stock Charts).

However, the companies have significant capacity under their unsecured credit facilities. AvalonBay Communities currently has only \$160 mm outstanding on its line of \$600 mm, while Gables has a balance of \$70 mm on its \$250 mm facility. Granted, this debt is variable rate debt and is subject to interest rate increases,

but nonetheless the availability of financing is evident.

This is not a long-term solution, however, to finding adequate financing because of the variable rate nature of this kind of debt.



As such, multifamily REITs are turning to their current institutional investors for funding. Many multifamily REITs have strong institutional ownership, so partnering with these investors is logical. Several multifamily operators have structured joint ventures with institutional capital, and this source of financing appears to be significant. While it was difficult to find any concrete research on the average deal that was taking place with equity partners, AvalonBay's recent deal with MEDP Investors seems like a win-win situation for the company. The deal structure is such that AvalonBay puts up only 25% of the equity and receives a 9% cumulative preferred cash-on-cash return, followed by 40% of the excess proceeds until the IRR to the investor reaches 12%,

and after this hurdle, the proceeds are distributed equally. AvalonBay's strong deal may be due to the fact that the company has the largest institutional ownership of any multifamily REIT. The one caveat with taking on joint venture partners is that many times the partners want to sell the asset before the owner/developer. However, this conflict can be and is currently being avoided through careful negotiating allowing for the developer to buy out the investor's interest at a specified multiple or price measure. Because the joint venture structure allows REITs to access capital efficiently, this is an acceptable and recommended approach to obtaining funds when the public equity markets are soft. It requires the REIT to be more selective in the deals it pursues because the cost of the capital is pricier, but allows it to hedge its exposure by sharing the risk with a partner that it can typically buy out at a later date when capital is less pricey, and the asset has stabilized. As mentioned, AvalonBay has executed its first joint venture structure, and Gables Residential is also receiving joint venture funding. Gables Residential recently signed a \$238 mm deal with JP Morgan Asset Management to develop 2,471 units across eight communities. It is likely that this deal was not too difficult for Gables to close given that JP Morgan Investment Management is the 15th largest institutional owner of the company (CIBC World Markets 7). The structure of this deal was not disclosed. Joint venture capital is a viable intermediate-term source of funding, but is not as inexpensive as straight equity issuance in a strong market.

Another source of equity for many of the REITs in this weak market stems from management of its own portfolio. By pruning the non-core assets and selling these to other yield investors, the REITs can obtain more capital for new opportunities. The REITs are effectively playing the spread that currently exists between acquisition and development. While arbitraging this spread makes sense given the state of the markets and current return on development, if

interest rates rise, the REITs practicing this should curtail their disposition-to-fund-development activity unless the overall risk level for the entire portfolio is reduced. For example, assume that AvalonBay wants to build a \$100 mm project, that will be 50 percent leveraged. To fund this project, AvalonBay will sell an asset in its existing portfolio. The typical capitalization rate upon sale of one of AvalonBay's properties is 8.5 percent. AvalonBay is currently building to an 11 percent yield. Also, it is important to note that AvalonBay assumes that the additional risk required to develop as opposed to straight acquisition is 200 bps, or 2 percent. Therefore, the company is creating an additional 50 bps of value ($11\% - 8.5\% = 2.5\% - 2\% = 0.5\%$). If interest rates were to rise by 100 bps, or 1 percent, the development project would incur an additional \$500,000 of interest expense (assuming an interest only loan), and this reduces the \$11 mm NOI to approximately \$10.5 mm, equating to a lower yield, 10.5 percent. With an increase in rates, the disposition/development strategy just meets the risk premium on development and therefore does not enhance AvalonBay's risk-adjusted return although it does improve its nominal return ($10.5\% - 8.5\% = 2.0\% = 2.0\%$ risk premium for development). Furthermore, the impact is likely to be even more severe given that the 8.5% cap rate on sale is also likely to increase with the rise in interest rates as real estate investors will demand a higher return. Therefore, disposition of non-core assets makes sense to fund development in the near-term, but this may change if interest rates rise, or construction costs increase. Disposition of non-core assets to buy back stock is a more viable strategy when the company's stock is trading at a discount, as this allows a company to invest in its current deals without any development risk. This strategy effectively reduces a REIT's overall basis in its asset portfolio by benefiting from the huge discrepancy that currently exists between the public and private market valuations of multifamily assets. Gables Residential has bought back approximately \$55.8 mm of its stock, representing approximately

2.13 mm shares, all of which was funded from 1999 dispositions of \$96.4 mm. Moreover, the market has also supported this strategy and Gables Residential recently increased its stock repurchase plan to \$100 mm. Analysts project that by the middle of this year, the Company may have bought back approximately 12% of the outstanding shares.

Another source of generating funds for new opportunities could result from converting to another company structure that allows for higher retention of earnings. In the private market, entities such as the S-Corporation or Limited Partnership allow for higher retention of earnings, and generate no taxes at the corporate level due to these entities' pass-through status. While this is not an option for a public company, a C-Corporation is another form for public ownership. Under the RMA, a REIT can now retain an additional 5 percent of its Taxable Income, so each REIT must payout 90 percent of its Taxable Income. This is in addition to the non-cash expense items such as Depreciation and Amortization. Not accounting for tax at the shareholder level, and thereby implicitly assuming that the shareholder is tax-exempt, which is not too far-fetched given the high institutional ownership in the REIT sector, the C-Corporation entity costs an additional \$.64 for each added dollar of retained earnings (this analysis assumed typical ratios of line items to NOI for the industry, and then compared these line items under the different structures). This is a high price to pay and therefore conversion to a C-Corporation is not a wise choice for AvalonBay or Gables Residential. It is important to note that in instances when this was done, i.e. Starwood Hotels, the REIT was kept in its corporate structure but converted to a private entity owned by the C-Corporation and other parties. This complex structure requires careful drafting to ensure the Company meets all of the REIT rules and can have a negative impact of confusing the analysts and members of the investment community, leading to the decline of one's share price because of the lack of transparency.

Given that the C-Corporation structure does not serve the firm's capital goals, one must consider the benefits of increased retention of earnings and value creation by taking a company private. Privatization has tremendous ramifications beyond just the ability to increase the company's retention of earnings to re-deploy capital into new opportunities.

Privatization is further complicated with the REIT rules (five or 50%) and OP Units that can trigger a taxable transaction for many insider owners. Both AvalonBay and Gables Residential are UPREITs, and each has OP units outstanding, complicating any potential privatization since in many instances the REIT agreed not to sell the property it acquired with OP units for a specific number of years to defer capital gains tax for the seller. Privatization is unlikely for both AvalonBay and Gables Residential under current market conditions and does not make sense in this environment. AvalonBay has a very large equity market capitalization, and its stock price is not trading at a substantial discount. Gables, on other hand, is trading at a notable discount, but given that the real estate cycle is ending and that development is one of the company's core competencies, it is unlikely that management or outside investors would attempt to privatize at this time. Finally, management is the most likely buyer of the company, and in the case of Gables, new management is trying hard to communicate its newly developed strategy to the investment community. Furthermore, there is no need to take the entire company private to realize value since the company can always liquidate part of its portfolio and sell its assets in the private market (so long as the Company does not violate the REIT rules while doing this).

If Gables was trading at a much more significant discount to its NAV, i.e. 40%-50%, management should consider privatization as the benefits would likely outweigh the risk of generating taxable transactions and the end of the cycle. Given the current market environment, though, combined with the fact that the new management is trying to communicate its message,

and Abby Joseph Cohen's recent recommendation of the REIT sector, it is likely that the company's stock price will rebound during the next 6-12 months.

Privatize?	<i>AvalonBay Communities</i>	<i>Gables Residential</i>
NAV	\$39.00	\$29.00
Price	\$37.00	\$23.38
Discount	5%	24%
Insider Ownership	3%	14%
Units	0.94mm	6.50mm
Float	66mm	24mm
Institutional Ownership	82%	72%

In analyzing the ideal capital structure for both companies, one must ask whether or not the structure is serving the goals of the firm. In the case of both AvalonBay and Gables, the REIT structure is the best option. This is because this structure provides REITs with the most choices in financing, even if they are not all inexpensive at any one time. This structure also allows for the elimination of the corporate income tax. Most importantly though, the REIT structure provides for an external influence on these companies, as cumbersome as it may be with respect to raising capital, which ultimately will ensure the REITs survival over the long-run. The evolution of public real estate companies has led to a much more disciplined real estate market. In fact, Jeff Olson, CIBC senior REIT analyst said in an interview that the real estate cycles will be much more "muted" because of the REITs. The current Wall Street governance resulting in a tightening of equity capital is consistent with the end of the real estate cycle approaching. Mr. Olson argues that the tightening of capital is not necessarily a bad thing because over the long-run the REITs will have healthier occupancies, better resources, and enhanced stability, unlike the REITs of the early 70s. Should privatization sweep through the industry, market cycles will again become more pronounced.

Specifically, AvalonBay and Gables should continue with their joint venture partner financing. The disposition for development strategy should be implemented cautiously. AvalonBay can take on more debt and possibly issue OP units for acquisition of assets. Gables Residential should continue its disposition strategy and use these proceeds to buy back stock, thereby facilitating privatization if the stock price continues to decline. Equity capital from stock issuance will again become available to these companies over time, as there is inherent value that is not yet being realized.

So What is the Right REIT Strategy?

In analyzing the multifamily sector and its current trends, it is clear that both the nationally diversified approach and the regional selective market/submarket approach are viable strategies. In order to maximize its existing asset base, AvalonBay must become a leader in residential services, take advantage of its size and scope with respect to new opportunities, and utilize local market knowledge. Gables, on the other hand, must grow to maximize economies of scale, strengthen its niche portfolio, and utilize third party management to gain superior market knowledge to improve market selection and benefit from economies of scale.

Sources:

Annual Report 1999; Gables

Annual Report 1999; AvalonBay

Company websites

Goodman, Jack, "The Changing Demography of Multifamily Rental Housing," Housing Policy Debate, Volume 10, Issue 1, 57 pages

"Housing Market Statistics," National Association of Home Builders, February 2000, 43 pgs

"Institutional Ownership of REITs," CIBC World Markets, March 13, 2000.

Interview with Tracey Brown, Development Director, AvalonBay Communities

Interview with Matt Lantz, NAREIT

Interview with Jeff Olson, senior REIT Analyst, CIBC World Markets

Interview with Chris Wheeler, CEO Gables Residential

"Multifamily Industry 4th Quarter Review – Value/Internet Create Opportunity"; Banc of America Securities; March 7, 2000.

"Multifamily REIT Third Quarter Review: Demographic Setting Stage for 2000 Growth," Banc of America Securities Equity Research, November 24, 1999, pg1-16.

National Multifamily Housing Council Website

"REIT 1999 Review and 2000 Outlook", PaineWebber Equity Research, January 2000, pg. 77

The Wisconsin CULER Report, Fall 1998.

Various Equity Research Reports from all the investment banks.

REIT VS C-CORPORATION SUMMARY

REIT

NOI =	1000
D&A =	(340)
Interest Expense =	(230)
Taxable Income =	430
Taxes =	0
Retained Earnings =	383

C-Corporation

NOI =	1000
D&A =	(340)
Interest Expense =	(230)
Taxable Income =	430
Taxes =	(151)
Retained Earnings =	619

Multifamily Capital Transactions 1999

