AMB: Leading the Way By Doing the Right Thing

Interview with Hamid R. Moghadam, Chairman and CEO of AMB Property Corporation

AMB Property Corporation (NYSE: AMB), headquartered in San Francisco, is a leading owner and operator of industrial real estate around the globe. From its initial creation in 1983 as an institutional advisor, AMB has been near the proverbial cutting edge of change in the industry — evolving from a real estate investment manager for pension funds to a focused industrial REIT. Today, in an increasingly speed-oriented marketplace, AMB's predominant focus is on what it calls High Throughput Distribution® facilities — facilities that benefit from the growth in global trade and expedited movement of goods, strategically located near airports, seaports and interstate highways in key distribution markets across the U.S., Mexico, Europe and Asia.

AMB remains at the cutting edge of change in other ways as well. In 2002, AMB made a bit of history by becoming the first public company in years to expense stock options. In addition, AMB's Chairman and Chief Executive Officer, Hamid Moghadam, announced that he, AMB's President and its CFO would voluntarily certify financials in advance of SEC requirements. Especially in light of the recent financial reporting irregularities that have plagued Corporate America, some industry observers and pundits have called AMB's approach a harbinger of what might occur throughout the world of corporate governance.

Recently, PricewaterhouseCoopers real estate partner Bill Croteau sat down with Mr. Moghadam to discuss his company's approach to doing business and its increasing focus on global expansion.

PwC: *Let's start with a little background on the company and how it became a REIT. I know that goes back a bit in time, but it might help set the strategic backdrop for where AMB is today.*

HM: I view AMB's historical background in two distinct ways — as an evolution in our corporate structure as well as how we've refined our property focus over time.

From 1983 to about 1986, when we were just starting out, we mainly provided a wide range of real estate consulting/advisory-type services to investors and corporations. That was the "pre-adolescent" stage of the company.

Beginning in 1986 we evolved from a consultancy to a more focused investment advisory business. Our big start in

the investment management business came when we attracted our first major institutional investor, The Estate of James Campbell. The Campbell Estate, which is a large private trust based in Hawaii, needed to diversify its real estate interests from the Hawaiian Islands to the mainland, and hired us to facilitate that process. Shortly thereafter, we began forming advisory relationships with other private real estate investors, and by 1989 we expanded our franchise into the pension fund arena. We took over the management of real estate assets from pension funds that had fallen on hard times; the investors hired us to turn their investment funds around. We were then able to build a track record based on our investment performance, and that significantly eased our capital-raising efforts.

Finally, between 1989 and 1997, we built our advisory business to a point where we had about $3 billion in assets under management; that set the stage for our transition into a public company in 1997.

We have also been evolving our investment strategy over the years. Our initial investments in the mid-80s were primarily in office buildings and secondarily in shopping centers. Industrial was really a tertiary category for us.

About the time of the stock market crash in 1987, we concluded there were some fundamental challenges facing the office business and that property values were not going to hold up. We advised many of our investors to get out of office ownership, managed the sales of those assets by 1988, and as a result, helped clients avoid much of the pain and agony of the eventual office market meltdown.

We redeployed that money into industrial and neighborhood retail investments — defensive, higher-yield non-trophy types of real estate that performed very well during the 1990s and became the cornerstones of our investment platform. When we went public, about one-third of our portfolio consisted of retail properties; the rest was industrial. Ultimately, we exited the retail business in 1999 and have since focused exclusively on industrial property.

PwC: *During that period, the evolution of the industrial market has been fairly dramatic regarding movement of goods, particularly in the United States. Perhaps you can reflect on that and how your strategy has evolved with changing markets.*

HM: Sure; it's actually pretty simple: Industrial real estate represents a very mature segment of the U.S. economy, and over the last 50 years has been growing at a rate that is

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somewhat lower than domestic GDP. That's because businesses have been using technology to reduce inventory and move goods more rapidly through the supply chain. So while we're in a business where inventories have been growing at a lower rate than GDP in the aggregate, the global trade aspect of inventory movement has actually been growing at a faster rate than domestic GDP. The world is becoming increasingly globalized when it comes to trade; much of the manufacturing that used to take place in this country is now taking place elsewhere, with finished goods being imported to — and distributed throughout the U.S.

Our investment philosophy in industrial property reflects this shift. The overall industrial business is not very attractive to us, but sectors of it are very attractive, because they are tied to this massive engine of growth — international trade. AMB has focused its investments within the markets that benefit from global trade. That explains the demand side for our properties.

On the supply side, the locations where industrial supply appears to be more limited also line up perfectly with the markets tied to global trade. That's why we are interested in submarkets around major cargo airports or major container ports such as Los Angeles, Miami, and New York/New Jersey. These are all important markets for AMB; not coincidentally, they also happen to be markets where there is a relatively limited supply of undeveloped land, and therefore barriers for entry to competitive product down the road. International airports tend to be in large urban areas; and they are major infrastructure investments — they don't get moved around very often. So if you build a position around some of these nodes, you will have some uniquely irreplaceable assets. By focusing on global trade, and on these markets that have major airports and major seaports, AMB is putting itself at the intersection of rapidly growing demand and diminishing supply — this is what leads to more rapidly growing rental streams.

By eschewing these global distribution markets for those tied exclusively to domestic storage of goods, one might find oneself in markets where there is a considerable amount of land, a lot of undifferentiated product, and ample opportunity to build competitive new buildings. Basically, that puts you into the development business as opposed to the investment business. While development can be a perfectly good business, the cash flows tend to be more erratic. We prefer to be in the business of cash flows that are steady, recurring and growing faster than the overall market. That's a deep-seated investment philosophy and point of differentiation for us.

PwC: *An important part of your strategy going forward involves overseas interests. How do you make that kind of transition from a domestic real estate company to a global player, accommodating tenant needs around the globe?*

HM: There really is no difference between our international and domestic approaches. Our business model is built on collaborations with local entrepreneurs through alliance relationships. Fundamentally, real estate has a very significant local aspect to it; for a long time, most successful real estate companies operated in limited geographic areas domestically. It's only recently — in the last 10 or 20 years — that we've seen the advent of multi-market or even national companies, much less international real estate companies. The reason for that is simple: There are tasks that are more easily accomplished by big public companies, such as capital raising and allocation, and the management of national or international tenant relationships. There are some skills that are the strong suit of local players — fostering local tenant relationships and navigating the local regulatory processes, for example.

Our operating approach in targeted international markets mirrors our domestic approach: We form alliance relationships with proven local partners who share our values, who have high integrity and whose financial interests are aligned with ours. Our goal is to avoid duplicating another significant real estate organization from the top down and export it to other countries; rather, we find the best local entrepreneurs with whom to partner — creating alliances that capitalize on our respective strengths.

We bring those relationships capital, research on product innovations, and global customer relationships. Most of our biggest customers are global businesses; they don't draw artificial lines around each country — so there's no reason why their real estate providers should. Working through international alliances helps us both provide that seamless network of distribution facilities for our customers and achieve our global investment objectives.

There are also certain dynamics that we look for in our target markets: high growth tied to international trade and barriers to supply. We've simply run out of domestic markets that provide those attributes. In fact, our strategy domestically has been to reduce the number of markets in which we operate from about 25 to about a dozen. Over the next three-to-five years, we plan to exit about 12 domestic markets — markets that today account for 10-15% of our total portfolio. We're substituting these non-strategic domestic markets for strategic international targets in Mexico, Europe and Asia — 10 markets with similar distribution attributes to our core domestic markets.

PwC: *You've obviously had your toe in the water and are closing deals in Asia and Europe. Are there lessons learned? Has your perspective broadened in terms of the complications or issues that have arisen?*

HM: Starting any kind of a new initiative, even a domestic one, usually takes longer — and takes more resources — than you originally contemplate. But in this case, we have exceeded my expectations in both quality and scale. We made our first investment in the first quarter of 2002, in Mexico, after about three years of studying that market. The results have been outstanding — both in the quality and the quantity of business we've done since, and in the calibre of partners that we've lined up in France, Singapore and Mexico. We're very optimistic we will achieve similar traction in our other target markets.

PwC: *So from an infrastructure standpoint, what has this expansion meant to the company?*

HM: We have about a dozen people spending most of their time on our global effort, identifying and building alliance relationships with the local players. It has not required meaningful increases to resources — in either incremental additions or overhead. In many cases, we have redeployed employees who have been active in our U.S. markets toward our global efforts.

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PwC: *I think one of the interesting things about AMB is the way you have maintained, as a public company, your private client relationships and co-investment ventures. I'm curious about your perspective on managing those sources and the other forms of capital you bring to your business. How do you see your capital structure taking shape going forward?*

HM: Real estate is clearly a very capital-intensive business. The raw material of our business is essentially 'capital.' Our success as a company ultimately depends on the availability and cost of capital, so we have to be very flexible about finding that capital. The public markets are a good place to create liquidity and to have a currency, but they are not always the best source for funding growth.

We feel there are two legitimate, important and deep capital markets for real estate and we have to be active in both to be successful on a sustainable basis. Therefore, we look for capital in both the private and public markets. Companies that raise money exclusively in the public markets have one major disadvantage: Their equity never becomes scarce. Investors are less likely to pay premiums for those companies if they know that the minute the company starts trading at or around NAV, there will be new capital issued to dilute their share value.

AMB is unique in that we've never raised public equity beyond our initial IPO. In fact, since our IPO, we've retired over 5 million shares of stock through buybacks. So we've actually shrunk our capital base in the public markets whenever we've seen a good opportunity to buy our stock at a discount to NAV. In the meantime, we've raised a substantial amount of capital in the private markets because we can do so on more attractive terms for our shareholders.

In addition to augmenting the growth of our business, we can earn significant ongoing investment management and incentive fees by managing that capital.

Our business is creating recurring streams of cash flow, whether from rental operations of properties or from significant investment management relationships. It's a great way to create incremental value for our shareholders. Again, it's about supply and demand: We keep the supply of our public equity scarce by not issuing new equity and by repurchasing and retiring stock, and we generate higher returns by earning investment management fees on top of real estate returns. The improved return on this limited equity base is then enhanced by the reduced number of shares outstanding.

PwC: *One of the things that I have sensed over the past 10 years — in the U.S., certainly — is that real estate businesses have gone from largely private to more public. Clearly there are different drivers to the business as a public company: specifically, the pressure to meet investors' stock price expectations as opposed to asset value or other measures that you might focus on as a private company. How does that pressure influence the way you operate the business and develop your strategy?*

HM: Ultimately, strategy by its very definition is long-term. It's a mistake to run a real estate business from quarter to quarter at the whims of the public markets. It is the job of management to develop a good strategy for the long term, stay the course and execute well. If management is right about that strategy, the company will be rewarded in the market.

People often talk about private real estate as if it's homogeneous. There are many different kinds of private real estate activities. For example, when I began my career in 1980, most of the real estate was owned by single market, entrepreneurial developers. They built projects, borrowed 100 percent or more of the capital, and basically significant economic value for themselves and their families on the difference between the debt on the property and the property's value. And they held on to those properties for a long time. I see very few of those players today. The biggest private players today are people who manage institutional capital for pension funds, endowments and foundations. While they are referred to as private companies, I would argue that they actually have a lot more in common with public companies in terms of disclosure, transparency, governance and reporting.

I don't think the industry falls neatly into "public" and "private." Whenever you are the steward of someone else's capital — whether they are public shareholders or investment managers for a pension fund — you have a responsibility to tell those people what's going on. You have an obligation to articulate a clear strategy and to stay accountable for the strategy's near- and long-term results. I would argue that as a public company, we share many attributes with a lot of private companies that manage institutional capital.

The bottom line is — we run our business for the long term. We are less concerned about quarter-to-quarter events. Obviously we need to ensure that short-term fluctuations in our business are met with contingency plans, but we don't operate our business based on the reactions of the marketplace over a quarterly period. You just can't do that in a long-term business like ours.

PwC: *Since we're discussing the environment of a public company, I'd be remiss if I didn't ask for your views on some of the issues that Corporate America in general is facing. I think it's apparent that you, individually, and AMB as a company, have been advocates of good corporate practices. Clearly the decision to expense stock options and the decision you made for voluntary certification are indicative of that. How do you feel about being at the helm of a public company, given this time in history? How do you see the current situation in the industry playing out?*

HM: It's interesting you mention the expensing of stock options and the voluntary certification. People tend to think of our corporate governance practices in those terms because those were the two things we did in 2002 when there was heightened focus on these aspects of governance. Actually, we've been proactive in a number of ways going back to our IPO in 1997. We've had, by far, a majority of independent directors on the board, and we made sure they came up for re-election every year as opposed to structuring a staggered board. We pay our directors primarily with equity-based compensation to create an alignment of interests. We don't have employment contracts for our management team, and we also waive the majority of anti-takeover provisions most REITs incorporate into their charters: We think that the company should be run for the benefit of the shareholders, not for the benefit or entrenchment of management. But you know what? In the first four and a half years of existence as a public company, no one asked us about any of this. Wall Street and investor attention was not focused on governance.

I give you this history because our decision to start expensing options or to certify financials was not a knee-jerk reaction to what happened in 2002. We have a fundamental belief about the right way to run a business, and it comes down to the simple fact that the company is owned by its shareholders. AMB's management happens to include some very significant shareholders in the company. Treating our shareholders well is a natural extension of our aligned interests.

Unfortunately, much of Corporate America does not have that kind of alignment. It only has one direction of alignment: If stock prices go up, management does well through stock options. But if the stock price does not perform, management doesn't lose anything. So there has been a built-in incentive at many companies — as it's now becoming clear — to run the business for the short term, drive the stock price up, and cash in the options before the long-term consequences come to light.

At AMB we've never had that view, because we have a long-term commitment to this business. I have not sold a single share of stock since we've been public. In fact, I have bought significant stock in the company just the way other shareholders do — by writing a check. I think that as CEO of a business, you should be prepared to put your money where your mouth is. The reason AMB treats its shareholders well and in a transparent way is that we are significant shareholders as well, and we like to be treated well by management. We are owners and therefore think and act like owners and we believe that makes a difference.

PwC: *How do you see the role of the board evolving, in terms of corporate governance, your strategy, and support of the execution of that strategy? Is it any different today than it was on day one?*

HM: I don't think the role of the board has changed, but I think some of the practices and policies now in place reflect the requirements of the current environment. I don't think ethics, morality or behavior can or should be legislated. I'm afraid what resulted from these indiscretions in Corporate America is a set of formulaic approaches or rules — many of which are good, and some of which are not — will be implemented. Now that the horse is out of the barn and all the way into the next county, we seem to be trying to create a fix by pushing through new legislation and regulations. I fear the pendulum is going to swing too far in that direction and it will become very difficult for companies to attract and retain quality board members — particularly in businesses that have more complexity to them than our simple business of developing, buying and managing industrial real estate. I think one of the perverse effects of this

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will be that the good available directors — meaning people who really should be there, people who can really add value — are going to say, "life is too short" and won't want to get involved. So, in that respect, I'm not wild about the direction in which things are going.

At AMB, the role of the board has always been the same: to hire and fire senior management; to make sure there is a succession plan for the company; to make sure there is a long-term strategic plan and governance structure in place that everyone understands; to regularly review the performance of the company's management and the board itself; and to make sure that shareholders have information about the company's activities in a complete and timely fashion. Those are the appropriate roles for any board.

PwC: *One subject that has been bandied about over the past 10 years is an "impending" consolidation among public REITs. It hasn't happened for a variety of reasons. As an active leader in NAREIT, you're close to the issues facing the industry. What's your perspective on consolidation and how you see it playing out industry-wide?*

HM: Five years ago, everyone assumed we'd go from over 200 companies to under 100 and that smaller players would be merged out of existence. What's happened is that we've probably gone from 200 companies to about 170. And it's been Avalon and Bay, EOP and Spieker, Archstone and Smith; it's the bigger companies that have merged.

Long term, there are going to be fewer, bigger real estate companies — part of the impediments have been generational. There are a lot of family businesses in which the patriarch or the founder is still involved and is still the

CEO. As we move to the next generation, I think we'll see more family-run companies merging.

Secondly, there has not been compelling evidence that scale has created value for shareholders. In theory, what 'scale' should deliver is lower costs, a better brand, and further reach. I think the real estate business has not been able to extract economies of scale from large portfolios because, by and large, they are operated in a balkanized manner. These companies have yet to embrace a technology platform or human resource platform that capitalizes on the scale that's being created.

There will eventually be opportunities to realize benefits from scale by integrating merged company platforms, but that process will take some time. Also the efficiencies are likely to be modest — not as dramatic as in other industries that have significant fixed costs. It boils down to fixed and variable costs. On fixed costs, scale helps. On variable costs, it doesn't. Real estate's biggest cost is the cost of capital (a variable cost), followed by operating expenses — many of which are variable costs. It's really just corporate overhead and a few other line items that are fixed costs in our business — and they are not significant in the overall scope of the business. Bottom line, the benefits of scale — in terms of costs — are lower in real estate than in other businesses. This certainly applies to the industrial and office sectors. I'm not convinced that office or industrial companies have the ability to reduce their costs beyond four or five percent. The mall business may be an exception because of the importance of a limited number of large retail chains.

PwC: *In our discussion, you've highlighted the importance of capital and access to capital. Looking forward, two things in particular interest me. First, what keeps you up at night regarding AMB, and second, how do you generate the growth you're projecting for your business?*

HM: As you know, real estate is not a growth stock. There was a view a few years ago that real estate companies were growth stocks, largely based on expectations from investors and analysts. Nobody was willing to admit that, across the cycle, we're really a low-teens return business. When the NASDAQ was going up at 80 percent a year, many CEOs didn't want to admit that they were in the single-digit, low-teen business. But as we all know, a low-teens business is actually a pretty good business — that's more than the stock market has returned over the last 100 years. I am actually very optimistic about real estate - for once, return expectations are lined up with business' ability to deliver those returns.

If our industry delivers consistent returns in a responsible fashion and if the industry avoids the blowouts and dividend cuts, then its recurring, stable, modestly growing, reliable cash flows will be valued at a very attractive discount rate in the marketplace for two reasons: One, there aren't many businesses that can consistently produce that kind of cash flow growth — most other industries are constrained by operating leverage that real estate doesn't have. Two, investor demographics have changed such that the need for yield and reliable return — as baby boomers age and reach retirement — is going to be valued more highly than speculative growth. So I think AMB's — and our industry's — prospects are excellent going forward because of more realistic return expectations for the capital markets generally and the real estate sector specifically.

These days, there's actually not a lot that keeps me up at night, because I believe we've built a really good business. My greatest concern is that we are not immune from the economy. We have now experienced two years of very slow growth and the global economy has some issues that are influenced by political events we don't control. If anything, it's uncertainty that keeps me up at night. Terrorism, wars, and global recession worry me. These are the uncertainties that affect our customers' businesses and in turn, affect demand for our product. But I can't control these things — and there's not much point in losing

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sleep over what I can't influence. We can only position the company to be able to respond to any resulting hardships.

One of the ways we've prepared for an uncertain future is through balance sheet management. We were very careful to position our balance sheet in anticipation of the downturn in the market. We have sold a lot of assets and de-leveraged, and as a result have achieved a very strong balance sheet. Frankly, the opportunities to reinvest have not emerged domestically in the way we would have normally have expected at this part of the cycle. As a result, we have excess liquidity in our company, which has cost us some short-term earnings and stock price appreciation. But I'm confident we will make that up in the long term. We decided to take advantage of this environment by being a more active seller domestically and a more active investor/developer globally — where we find more attractive opportunities.

Another subject I think a lot about — and feel any senior executive ought to consider— is talent. You can never have too much of it in any organization. Management needs to make sure new employees possess the same values that have historically made the company successful, yet also bring in fresh ideas to make the company even more successful in the future. That's an important distinction: You want your employees to share core values, but you want them to be effective, independent thinkers as well.

PwC: *Last July your company introduced the AMB Industrial Absorption Indicator (the AMB IAI) that got you a fair amount of media attention. Would you talk about the IAI and the reasoning behind it?*

HM: There are reliable predictors of demand for apartments, retail and office space, but to date we haven't had a good predictor of industrial demand. That's a problem, since our investment strategy is based on our ability to predict demand and supply. For some time, we've tried to come up with a tool that could accurately predict shifts in industrial demand. We found a highly correlative relationship between the manufacturing component of the U.S. industrial production index and forward demand for industrial space.

We then tested this data back 13 or 14 years and found it had about a 90 percent correlation to industrial absorption six months down the road. Unfortunately, it doesn't indicate where to invest, but it does show if the market is turning or getting better or worse in the aggregate. So we decided to share that with the investment community for a very self-serving reason: The more owners and developers know about likely industrial demand in the future, the less the market will be prone to cycles of overbuilding or over-investment, leaving supply and demand in better alignment. Generally, industrial is the one product type that has avoided over-building cycles, because of its short delivery timeframe. On the margin, The AMB IAI should help make the industry even less volatile than it already is.

Last July was a heck of a time to introduce a new indicator of demand. The industry had just gone through the sixth consecutive quarter of negative absorption following ten years of economic growth. Our new indicator was actually projecting positive absorption for the very next period — but guess what? That's exactly what transpired. It's been terrific; it has shown a remarkable ability to call the corners, which is key. So we think it's a useful tool, and as we tweak it over time and publish the results, others can suggest ways to improve it further. At that point, it could become a valuable tool for the industry, supporting capital allocation decisions industry-wide.

PwC: *Given the personalities in this industry, I'd be curious about whom you believe best emulates the values and kind of business you respect. A competitor, perhaps? Or someone who has preceded you generationally?*

HM: There are many talented individuals and colourful personalities in the real estate business, but one person who is a real class act in this industry is (Kimco Realty's) Milton Cooper. He has always had his investors' interests united with his own. He's always done the right thing for his shareholders. While his company doesn't happen to be in our sector, I still admire him and think he's a really great individual. In terms of personal qualities, and the combination of his business and values, my hat is off to Milton Cooper.