Mergers and Acquisitions in the Equity Apartment REIT Sector
A Framework for Selecting Candidates
by
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Submitted to the Department of Urban Studies and Planning in Partial Fulfillment of the
Requirement for the Degree of
MASTER OF SCIENCE
in Real Estate Development
at the
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Department of Urban Studies and Planning
August 11, 1995

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and

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Abstract:

The boom in equity apartment REITs between late-1992 and mid-1994 was a direct result of the conditions in the private real estate markets. Fueled with capital from dividend hungry investors, these recapitalized real estate companies faced seemingly unlimited growth prospects due to historically low interest rates, rising rental rates and depressed real estate prices. However, by mid-1994 interest rates had risen, asset values were being bid up and the number of equity apartment REITs had swelled, from a handful in 1992, to over 30 companies. The market, and more specifically its' growth opportunities, have rapidly changed and REITs unable to adapt have suffered. Many REITs now find themselves dead in the water, unable to access either the debt or equity capital markets. This situation has led many market participants to the conclusion that the market is entering a period of consolidation. This thesis examines the pricing of REIT shares and how the market has revalued the equity REITs as avenues of growth have disappeared. Merger and acquisitions are investigated as a vehicle to attain growth and a framework is presented as to which apartment REITs are likely merger candidates. Finally, the structural impediments protecting REITs from hostile takeovers are explored.

Thesis Supervisors:  William C. Wheaton
Professor of Economics
W. Tod McGrath
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Acknowledgments

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CHAPTER 1: The Pricing of REIT Stocks

On August 2, 1994, when Wellsford Residential Property Trust and Holly Residential Properties announced that they were entering into a merger agreement, it was described by one analyst as a merger of two “have nots”. These two companies were the first of a new breed of apartment REITs to come public in 1992 and 1993, and both had suffered miserably in the public markets. Wellsford's shares were trading at $21.875 only 12.5 cents above its IPO price of $21.75 from November 1992, and a 29% decrease from the share's high of $30.875 on October 22, 1993. Holly was in even worse shape at the time of the announcement: its shares were trading at $14.875 which represented a 42% decrease from the share's high in the fourth quarter of 1993, and a 35% decrease from the IPO price of $23 in June '93.

To establish itself as a contender within the Apartment REIT sector, many industry observers believed that Wellsford needed to become more fully integrated by adding management and development expertise to its existing acquisition and capital markets expertise. This was considered necessary by both analysts and management given the changes in growth opportunities and increasing competition within the Apartment REIT industry. With this in mind, Wellsford contacted Holly. Although Holly was an experienced operator and developer of multifamily properties in the Puget Sound region of Washington, its poor operating performance since its IPO had effectively shut it off from the access to capital necessary for it to grow. By combining, the merged firm could utilize the property management and development expertise of Holly and the financial markets sophistication of Wellsford.

Wellsford had raised approximately $100 million in its IPO of November, 1992. Holly which came public on June 11, 1993 raised approximately $153 million. Yet, within 2 years (1 year for Holly), both REITs found themselves in dire need to grow their assets and earnings and re-attract Wall Street's attention. Like the rest of the apartment REITs, both Holly and Wellsford came to the public market with high dividend yields and promises of high growth opportunities. The market largely believed these promises, as both issues were sold at IPO with dividend yields of

1 Green Street Advisors, Real Estate Stock Index, August 25, 1994, Page 2
about 7.75% (7.72% for Wellsford and 7.83% for Holly). At the time of the merger announcement, however, the shares were selling at dividend yields of approximately 12% for Holly and 7% for Wellsford. The market no longer believed the growth stories of these two REITs, and their share prices were driven down to reflect diminished expectations of profitability. The issues that both Wellsford and Holly faced in August 1994 are now clearly in the path of the entire Apartment REIT sector. REIT shares are trading at yields of 7.8% and projected growth within the industry is viewed by many as anemic. Having promised growth, REITs now face the challenge of delivering growth as the real estate industry rapidly changes around them.

These are the issues that this thesis addresses. As the REIT industry faces what many experts believe to be a major period of consolidation and merger and acquisition activity, we will discuss how the REIT industry arrived at this point, how consolidation may effect the industry, and who is most likely to benefit from such consolidation. Chapter 1 will explain how REITs are valued and how that valuation has changed significantly since Wellsford first came public in 1992. Chapter 2 explains how REITs grow and how the growth opportunities of the industry have diminished since Wellsford's IPO. Chapter 3 explores how M&A activity provides superior returns for some, inferior returns for others and an exit strategy for still others. Chapter 3 further examines who will benefit from the expected M&A activity within the apartment REIT sector. Chapter 4 details the Wellsford/Holly merger as a case study of how such mergers will take place and how they will be valued by the market. Chapter 5 introduces a common sense analysis as to which REITs are potential takeover candidates. Finally, Chapter 6 investigates the REIT-specific issues that are deterrents to hostile acquisitions.

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3 Salomon Brothers May 95 Real Estate Review, June 2, 1995.
The Model

Securities are priced as a function of expected cashflow and risk. A security's price is based on an expected return, which is the amount and timing of cashflows an investor expects to receive, given the cost of the investment and the expected risk of receiving the cashflows. The cost of the investment is easily identifiable as simply the cash outlay required for the given security. Cashflow is more complicated. Cashflow to investors comes in two forms 1) cash dividends and 2) capital gains or losses. Investors usually expect to receive both dividends and capital gains. Risk is the most complicated of the pricing components and can be separated into market risk and unique risk. Market risk is economy wide factors that affect all businesses. Unique risk is risk specific to a particular security.

Presented below is a simple one year formula for measuring a security's expected return \((E_r)\), where today's price \((P_0)\), the expected dividend \((D_{iv_1})\), and the end of year selling price \((P_1)\) are all given:

\[
E_r = \frac{D_{iv_1} + (P_1 - P_0)}{P_0}
\]  

This formula separates the cashflows into a dividend component \(D_{iv_1}/P_0\), and a capital gains component \(P_1 - P_0/P_0\). The dividend component, known as the dividend yield, measures the dividend as a percentage of the initial cash outflow (price). The capital gains component, representing the realization of growth opportunities, measures the increase in the value of the security as a percentage of the price. Combining these two components give us the expected return.

The above model can be expanded beyond the simple one year term. Where the dividend growth rate and the expected return are both constant, a multi-year pricing equation is as follows:

\[
P_0 = \frac{D_{iv_1}}{(E_r - g)}
\]

---

4 The model derived in this chapter is from Principles of Corporate Finance 4th Edition, Richard A. Brealey and Stewart C. Myers
This formula explains today's price \( P_0 \), in terms of next year's expected dividend \( \text{Div}_1 \), the projected annual growth rate \( g \) of future dividends, and the expected return \( \text{Er} \) for the investment.

Rewriting this equation to separate the current dividend yield, dividend growth, and expected return components results in:

\[
\text{Er} = \frac{\text{Div}_1}{P_0} + g
\]  

(3)

This formula defines the total expected return for the investment as the dividend yield \( \frac{\text{Div}_1}{P_0} \) plus the expected annual growth \( g \) in dividends. When compared to equation (1), \( g \) is a proxy for the annual growth in share price \( P_1 - P_0 \). Similarly, the expected annual growth in dividends can be solved for as follows:

\[
g = \text{Er} - \frac{\text{Div}_1}{P_0}
\]  

(4)

The expected return \( \text{Er} \) component of this simple, constant-growth discounted cashflow formula, can be further refined. In the next section, the Capital Asset Pricing Model (CAPM) is used to better define the expected return \( \text{Er} \). Once expected return is more clearly defined, the market price \( P_0 \) and projected dividend \( \text{Div}_1 \) are used to identify the dividend yield. With the dividend yield and expected return understood, the implied annual growth component of the security's price \( g \) can be isolated.

**Capital Asset Pricing Model**

CAPM provides an estimate of the relationship between the risk of a security and its expected return. CAPM allows us to estimate what a particular security's expected return is given the relationship between the security's returns and those of alternative equity investments.

Risk is determined by measuring how volatile a security's returns have been in comparison to the returns of the broader equity markets ("the Market"). The measurement of risk for a given security is denoted as its Beta (\( \beta \)). Beta represents the correlation of the particular security's returns to those of the Market.

\[
\beta = \frac{\text{Covariance} (R_i, R_m)}{\sigma_m^2}
\]

(5)
The equation above shows that a security's Beta is equal to the covariance of its return with the return of the Market, divided by the variance of the Market.

Beta signifies how an investment behaves in relation to the Market. Using Beta, we can determine how much of the movement of the security's price is caused by the movements of the Market. For example, a Beta of .5 indicates that a given security's price movements is only one half of the movement of the Market (half as "risky" as the Market). CAPM uses the Beta of a stock, along with the risk free rate of return\(^5\) and the market rate of return, to determine the expected return of the security:

\[
\text{Er} = r_f + \beta(r_m - r_f)
\]

In this equation expected return (Er) equals the risk free rate (\(r_f\)) plus the risk premium \(\beta(r_m - r_f)\), which is the market return minus the risk free rate, multiplied by the security's Beta. Note that Er is the security's expected total annual rate of return, including expected dividends and share price appreciation.

With this CAPM generated expected return we can return to the formula from the previous section:

\[
g = \text{Er} - \left(\frac{\text{Div}_1}{P_0}\right)
\]

Using market data we can determine the security's dividend yield. Expected annual dividend growth (g) is then isolated.

As outlined above, the price of a stock is composed of both the dividend and its expected annual growth rate. "Expected total rate of return...is the appropriate basis on which to measure and compare values in REIT securities. Near-term share price performance, however, will largely relate to changes in investor yield requirements rather than the combined income and capital appreciation components of the total rate of return."\(^6\)

\[\]

\(^5\) Treasury Securities are considered risk free because of the backing of the US Government

Expected Total Return

The expected total return of a security is the combination of its annual dividend yield and expected annual increases in share price represented by the expected growth in the dividend.

\[ Er = \left( \frac{\text{Div}_1}{\text{P}_0} \right) + g \]  

(3)

<table>
<thead>
<tr>
<th>REIT</th>
<th>June 12, 1995 FFO Yield Rate</th>
<th>1995-96 FFO Growth</th>
<th>Expected Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apt Investment &amp; Management</td>
<td>13.2%</td>
<td>10.2%</td>
<td>23.5%</td>
</tr>
<tr>
<td>Evans Withycombe</td>
<td>13.7%</td>
<td>7.9%</td>
<td>21.6%</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>11.0%</td>
<td>10.0%</td>
<td>21.0%</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>11.3%</td>
<td>9.4%</td>
<td>20.8%</td>
</tr>
<tr>
<td>Walden Residential</td>
<td>9.8%</td>
<td>10.7%</td>
<td>20.5%</td>
</tr>
<tr>
<td>Southwest Properties</td>
<td>8.6%</td>
<td>11.5%</td>
<td>20.1%</td>
</tr>
<tr>
<td>Gables Residential</td>
<td>10.4%</td>
<td>9.6%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Property Trust of America</td>
<td>11.8%</td>
<td>8.2%</td>
<td>20.0%</td>
</tr>
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<td>United Dominion Realty Trust</td>
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<td>8.3%</td>
<td>19.8%</td>
</tr>
<tr>
<td>Mid-America Apartments</td>
<td>11.1%</td>
<td>8.5%</td>
<td>19.6%</td>
</tr>
<tr>
<td>Post Properties</td>
<td>11.4%</td>
<td>7.8%</td>
<td>19.2%</td>
</tr>
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<td>Wellsford Residential</td>
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<td>10.8%</td>
<td>18.9%</td>
</tr>
<tr>
<td>Columbus Realty</td>
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<td>8.6%</td>
<td>18.7%</td>
</tr>
<tr>
<td>Summit Properties</td>
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<td>9.9%</td>
<td>18.4%</td>
</tr>
<tr>
<td>Camden Property Trust</td>
<td>8.3%</td>
<td>9.4%</td>
<td>17.7%</td>
</tr>
<tr>
<td>Avalon Properties</td>
<td>9.3%</td>
<td>8.1%</td>
<td>17.4%</td>
</tr>
<tr>
<td>Irvine Apartment Comm.</td>
<td>7.1%</td>
<td>10.2%</td>
<td>17.3%</td>
</tr>
<tr>
<td>Bay Apartments</td>
<td>7.9%</td>
<td>9.2%</td>
<td>17.2%</td>
</tr>
<tr>
<td>Associated Estates</td>
<td>7.7%</td>
<td>9.2%</td>
<td>16.9%</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>7.5%</td>
<td>9.3%</td>
<td>16.7%</td>
</tr>
<tr>
<td>Merry Land Investment</td>
<td>8.1%</td>
<td>8.6%</td>
<td>16.6%</td>
</tr>
<tr>
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<td>15.8%</td>
</tr>
<tr>
<td>Aml Residential</td>
<td>6.3%</td>
<td>9.5%</td>
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</tr>
<tr>
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<td>3.3%</td>
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<tr>
<td>Town &amp; Country</td>
<td>2.3%</td>
<td>11.4%</td>
<td>13.7%</td>
</tr>
</tbody>
</table>

Source: Lehman Brothers REIT Valuation Handbook, June 12, 1995

In the above chart the formula from equation 3 is illustrated, total return equals dividend yield plus expected growth in dividend. Dividend yield is replaced with FFO yield (FFO per share divided by the share price) because of management's control of dividend policy. This permits a more reliable comparison between REITs in that it adjusts for dividend policy. The indicated total return required by investors of apartment REITs ranges from 13.7% to 23.5%. It is expected from the model that the REITs with the lowest projected FFO growth will have the highest FFO yields. It will be explained below how market fundamentals and a REIT's capital
structure can combine to produce wide pricing discrepancies. When growth prospects are perceived by the Market to diminish, the security will tend to move in a manner more reflective of a pure income security (i.e., a bond). In other words, in the absence of a perceived reduction in risk, as expected FFO growth diminishes, dividend yields must rise and share prices must fall.

The following chart displays the correlation of the selected REIT shares with various fixed income securities, Ten Year US Treasuries, One Year US T-Bills, 30 Year US Treasury Bonds, and Five Year US Treasury Notes. The correlation used week ending data for all the securities, not adjusting for dividend or interest payments.

<table>
<thead>
<tr>
<th>REIT Correlations with:</th>
<th>U.S. 10 Year Treasury Bond</th>
<th>U.S. 1 Year Treasury Bill</th>
<th>U.S. 30 Year Treasury Bond</th>
<th>U.S. 5 Year Treasury Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armit Residential</td>
<td>-0.25</td>
<td>-0.73</td>
<td>-0.20</td>
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<tr>
<td>Apt Investment &amp; Management</td>
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<td>-0.88</td>
</tr>
<tr>
<td>Associated Estates</td>
<td>-0.26</td>
<td>-0.39</td>
<td>-0.25</td>
<td>-0.30</td>
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<tr>
<td>Avalon Properties</td>
<td>-0.09</td>
<td>-0.36</td>
<td>-0.07</td>
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<tr>
<td>Bay Apartments</td>
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<tr>
<td>Camden Property Trust</td>
<td>-0.40</td>
<td>-0.54</td>
<td>-0.40</td>
<td>-0.45</td>
</tr>
<tr>
<td>Charles E. Smith Residential</td>
<td>0.38</td>
<td>-0.22</td>
<td>0.41</td>
<td>0.24</td>
</tr>
<tr>
<td>Columbus Realty</td>
<td>-0.14</td>
<td>-0.38</td>
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<td>-0.23</td>
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<tr>
<td>Equity Residential</td>
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<tr>
<td>Essex Property Trust</td>
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<tr>
<td>Gables Residential</td>
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<td>-0.67</td>
<td>-0.18</td>
<td>-0.39</td>
</tr>
<tr>
<td>Irvine Apartment Comm.</td>
<td>-0.22</td>
<td>-0.57</td>
<td>-0.17</td>
<td>-0.34</td>
</tr>
<tr>
<td>Merry Land Investment</td>
<td>-0.57</td>
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<td>Mid-America Apartments</td>
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<td>Post Properties</td>
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<td>0.14</td>
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<td>0.11</td>
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<td>Property Trust of America</td>
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<td>-0.78</td>
<td>-0.54</td>
</tr>
<tr>
<td>Southwest Properties</td>
<td>-0.64</td>
<td>-0.26</td>
<td>-0.73</td>
<td>-0.47</td>
</tr>
<tr>
<td>Summit Properties</td>
<td>-0.21</td>
<td>-0.70</td>
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<td>-0.40</td>
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<tr>
<td>Town &amp; Country</td>
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<td>-0.93</td>
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<td>United Dominion Realty Trust</td>
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<td>-0.35</td>
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<tr>
<td>Walden Residential</td>
<td>-0.12</td>
<td>-0.51</td>
<td>-0.07</td>
<td>-0.26</td>
</tr>
<tr>
<td>Wellsford Residential</td>
<td>-0.79</td>
<td>-0.83</td>
<td>-0.74</td>
<td>-0.83</td>
</tr>
</tbody>
</table>

As illustrated, approximately 80% of the REITs in our sample have share prices whose movements are negatively correlated with the various US Treasury securities. Negative correlation indicates an inverse relationship between two variables. Here, as interest rates rise (or fall), apartment REIT share prices will fall (or rise). This negative correlation would indicate that the Market perceives the majority of the REIT's value is in current dividends and not in
future dividend growth. This supports the theory that investors are not currently convinced that REITs are growth stocks.

**Identifying The Growth Component**

Because of the certain tax compliance rules, REITs need to payout 95% of their net income. “Declared dividends, in fact, routinely exceed annual net income.” The 95% distribution requirement and the dividend policy of REITs permits the growth component of a REIT’s expected total return to be easily identified. It is our argument that the estimated growth in FFO as compiled by First Call can serve as a proxy to the growth expectation of the Market. Based on the financial theory outlined previously, there should be an inverse relationship between dividend yield and expected dividend growth, risk held constant. As mentioned, FFO yield is substituted for dividend yield because of management's control of dividend policy. The dividend policy (payout ratio) varies for each of our sample REITs and, therefore, FFO per share is used to provide a more reliable comparison.

**Conditions Necessary for the Re-emergence of the REIT Market**

Three factors led the way for wave of securitization from 1992 through the first half of 1994. They were; (1) a depressed private real estate market; (2) the retrenchment of traditional lending sources (credit crunch); and (3) historically low interest rates. In the second half of 1994 REIT prices stalled and declined, much of this can be explained by changes in these conditions.

**The Recent Real Estate Cycle**

From 1990 to 1992 the institutional real estate investment industry began a restructuring process. This restructuring was caused by the significant over building in most property sectors combined with over-leveraging. Over building led to a significant decline in institutional real estate values as exhibited by the Russell-NCREIF Capital Value Index, which shows that for the period between 1990 and 1992 property values depreciated approximately 25%. This index represents

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7 Ibid. Page 19.
office, retail, industrial and multifamily properties. Each property sector follows its own cycle. Therefore, individual sectors differ from the total index. Capital values declined an additional 9.6% between the end of 1992 and the 4th quarter 1994. As can be seen on the following chart of the Russell-NCREIF Capital Value Index real estate values continued to decline through the 3rd quarter 1994.

The decrease in property values between 1990 and 1992 led to the complete erosion of the equity positions of building owners who had financed their properties in the late 1980s at 75% to 80% loan to value ratios. This over-leveraging led to increases in foreclosures and saddled lenders with properties which were often worth significantly less than their loan values.

The redistribution of ownership from borrower to lender led to what many have called a credit crunch. However, industry participants dealing with the situation explained that, "it is not a liquidity but a pricing problem: capital will flow back into real estate if the assets are priced realistically."8 There was a serious pricing gap between buyers and sellers that caused a lack of

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transaction activity between 1990 and 1992. Most property owners, and their lenders, were not willing to acknowledge that their properties were worth up to 40% less than they were only three years prior. In addition, the underwriting criteria at most remaining lending sources tightened to require a much greater equity investment by the borrower. It is fair to say that buyers, whose required returns are based on expected cashflows and risks, re-valued real estate at substantially lower prices.

**Absence Of Traditional Lending Sources**

During this period, the traditional sources of financing (pension funds, commercial banks and life companies) were involved with managing their current real estate positions and were not actively pursuing additional real estate investments.

**Pension funds**, perhaps the largest source of real estate equity, were preoccupied withdrawing from commingled funds and/or terminating or restructuring direct investments. For those funds that were making mortgages, conservative spreads on mortgages financed off of current cashflow were in excess of 200 basis points over treasuries of comparable maturities.

**Commercial banks** went from being the largest lenders in the real estate sector to the largest owners of real estate during this period. Outstanding commercial mortgages were $336 billion in 1991, of which approximately $197 billion were construction and mini-perm loans scheduled to mature between June 1991 and June 1993. According to industry participants surveyed in *Emerging Trends In Real Estates 1993*, approximately 80% of these loans did not have take outs.

Commercial banks were under pressure from the federal regulators to realize the decreases in property values and mark their values to market. This pressure caused the OREO holdings of banks to more than double from just under $10 billion in 1986 to approximately $25 billion by 1991.

This increase in OREO holdings led many Wall Street analysts to downgrade bank stocks. Many banks began to realize that managing these new real estate portfolios was expensive and diverted attention from their traditional lines of business. In order to increase their stock prices, banks began to offer bulk packages of OREO assets and non-performing loans for sale. The prices of
the early sales tended to range from twenty to fifty cents on the dollar of original loan amount. These prices attracted the opportunistic money of Wall Street.

**Life companies** were in a situation similar to the commercial banks. At year end 1990, life companies’ real estate exposure was approximately 24% of total assets. Life companies typically made long term mortgage loans. However, during the high interest rate period of the early 1980’s, lending changed to shorter-term bullet loans. Like the commercial banks, life companies had approximately $75 billion in short-term bullet loans scheduled to mature between June 1991 and June 1993. Historically, delinquencies averaged about 3% of total mortgages. This average began to increase to about 6% of the total portfolio. Distressed loans (restructured and delinquent) as a percentage of the total real estate portfolio began to increase significantly at the end of 1991 from approximately 7% to the high of 15% in 1993.

The life companies were not regulated by a federal agency like the commercial banks, but were regulated by the credit rating agencies. The rating agencies, by decreasing the insurer's credit rating, were pressuring the life companies to reduce their real estate exposure.

**New Money Sources**

As property values bottomed and the traditional lending sources retrenched, there was a tremendous need for capital in the real estate sector. This was at a time when interest rates had hit a 50-year low. Enter Wall Street.

As the following chart illustrates, from the first quarter 1991 through the first quarter 1993, interest rates had declined significantly while mean required real estate yields for all property types, as indicated by the Real Estate Research Corporation's Real Estate Investment Survey, had increased. During this period corporate bonds rated Aaa and Bbb by Moody's declined 130 and 190 basis points, respectively, and Ten Year Treasuries declined 210 basis points.

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9 Salomon Brothers Real Estate Research, That's 50 Cents on the Dollar "Stupid", November 1993
As interest rates and stock dividend yields fell, the spread between real estate and alternative dividend yielding investments noticeably widened. The spread between real estate yields and Ten Year Treasuries went from 250 basis points in 1989 to approximately 600 basis points in 1993. These spreads, reflective of both perceived risk and lack of capital, were attractive enough to lure in the investment banks that typically could not compete with the commercial banks and life companies.

During the period from 1991 to 1994, both the real estate capital markets and the broader capital markets were in unique positions. The real estate capital markets were cash starved and offered tremendous spreads to Treasuries, while at the same time the broader capital markets were yield starved because of the decline in interest rates. The time was ripe for Wall Street to merge the two markets, allowing ailing property owners an opportunity to re-capitalize their balance sheets with equity, and banks, life companies and the RTC a vehicle to dispose of their burdensome real estate holdings.
The above chart illustrates the path of both short and long term interest rates. Property owners who were faced with upcoming debt maturities and or high mortgage rates looked to refinance at the lower short term rates. Over leveraged property holders, that were on the cusp of default, could refinance and use the short term rates to either lower their annual debt service or decrease their leverage, but most importantly maintain control of their properties. A number of REITs used short term floating rate debt as a strategy to maximize the cashflow of their newly refinanced portfolio and, hence, the proceeds from their initial public offering (IPO).

REITs Initial Advantage

The REITs that were formed between 1992 and 1994 were well received in the market among investors largely because of their current dividends in comparison with other dividend/interest yielding securities. In 1992 there were 5 REIT initial public offerings totaling $726 million with a weighted average IPO yield of 9.04%. In 1993 there were 43 REIT initial public offerings totaling $8.62 billion with a weighted average IPO yield of 7.51%. In 1994 there were 41 REIT initial public offerings totaling $7.20 billion with a weighted average IPO yield of 8.32%\textsuperscript{10}.

\textsuperscript{10} Realty Stock Review, April 24, 1995
As of April 13, 1995, dividend yields had increased for all the REITs that came public between 1992 and 1994. The weighted average dividend yields for the 1992, 1993, and 1994 IPOs increased to 9.75%, 9.01% and 9.13%, respectively. At the same time, the prices of the stocks changed 1.6%, -8.4% and -4.3%, respectively.

**REIT Dividend & Price Changes as of 4/13/95**

<table>
<thead>
<tr>
<th></th>
<th>1992 IPO's</th>
<th>1993 IPO's</th>
<th>1994 IPO's</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Dividend Yield</td>
<td>9.75%</td>
<td>9.01%</td>
<td>9.13%</td>
</tr>
<tr>
<td>Change in Price</td>
<td>1.60%</td>
<td>-8.40%</td>
<td>-4.30%</td>
</tr>
</tbody>
</table>

*Source: Realty Stock Review, April 24, 1995*

**1995: Market Outlook**

Since mid-1994, there has been a general decline in the price of REIT stocks, as indicated by increasing dividend yields. It is our hypothesis that this decline is due to changes in the three factors discussed above; asset prices, capital availability, and interest rates. Originally, many of the REITs at their IPO were promising significant growth in their funds from operation. This growth was to come, in large parts, from the REIT's ability to purchase properties at capitalization rates (initial cash yields) higher than its nominal cost of capital (dividend yield or long-term borrowing rate). This was known as positive spread investing, an example of which is presented below.
Positive Spread Investing

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI of Acquisition</td>
<td>$500,000</td>
</tr>
<tr>
<td>Current Price</td>
<td>$4,166,667</td>
</tr>
<tr>
<td>Going In Capitalization Rate</td>
<td>12.00%</td>
</tr>
</tbody>
</table>

Issue Equity for Acquisition

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Shares to Issue</td>
<td>334,375</td>
</tr>
<tr>
<td>Gross Proceeds @ $13.33</td>
<td>$4,458,333</td>
</tr>
<tr>
<td>Less Cost of Issuance 7%</td>
<td>$291,667</td>
</tr>
<tr>
<td>Net Proceeds from Issuance</td>
<td>$4,166,667</td>
</tr>
</tbody>
</table>

REITs Equity Market Capitalization = $13,333,333

<table>
<thead>
<tr>
<th>Income Statement Pre-Acquisition</th>
<th>Income Statement Post-Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>FFO</td>
<td>FFO</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Shares Outstanding</td>
<td>Shares Outstanding</td>
</tr>
<tr>
<td>1,000,000</td>
<td>1,334,375</td>
</tr>
<tr>
<td>FFO/Share</td>
<td>FFO/Share</td>
</tr>
<tr>
<td>$1.00</td>
<td>$1.12</td>
</tr>
<tr>
<td>Dividend Yield (100% payout ratio)</td>
<td>Dividend Yield</td>
</tr>
<tr>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>Stock Price</td>
<td>Stock Price</td>
</tr>
<tr>
<td>$13.33</td>
<td>$14.99</td>
</tr>
<tr>
<td>Percent Increase in FFO</td>
<td>12.41%</td>
</tr>
</tbody>
</table>

For example, positive spread investing was the main growth vehicle for Wellsford. Wellsford marketed themselves as acquisition experts. As the example above illustrates, positive spread investing is, by definition, accretive to FFO.

The significance of the movement of interest rates is illustrated below in the all debt analysis. As shown by comparing the two examples, positive spread investments are more accretive to FFO when acquired using all debt. This is one reason that REITs will pursue acquisitions with debt and only return to the equity capital markets when debt levels are maximized. When the cost of debt increases, positive spread opportunities become more difficult, as the required yield will rise to maintain the spread on a given investment.
## Positive Spread Investing

<p>| | |</p>
<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI of Acquisition</td>
<td>$500,000</td>
</tr>
<tr>
<td>Current Price</td>
<td>$4,166,667</td>
</tr>
<tr>
<td>Going In Capitalization Rate</td>
<td>12.00%</td>
</tr>
</tbody>
</table>

### Issue Debt for Acquisition

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Debt</td>
<td>4,166,667</td>
</tr>
<tr>
<td>Annual Interest Rate</td>
<td>6.5%</td>
</tr>
<tr>
<td>Cost of Debt</td>
<td>2 points</td>
</tr>
<tr>
<td>Total Loan Amount</td>
<td>$4,250,000</td>
</tr>
</tbody>
</table>

### REITs Equity Market Capitalization

<table>
<thead>
<tr>
<th>Income Statement Pre-Acquisition</th>
<th>Income Statement Post-Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>FFO</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Shares Outstanding</td>
<td>1,000,000</td>
</tr>
<tr>
<td>FFO/Share</td>
<td>$1.00</td>
</tr>
<tr>
<td>Dividend Yield (100% payout ratio)</td>
<td>7.50%</td>
</tr>
<tr>
<td>Stock Price</td>
<td>$13.33</td>
</tr>
</tbody>
</table>

### Russell-NCREIF Total Index

![Graph of Russell-NCREIF Total Index](image)

However, positive spread opportunities began to disappear by mid-1994 when real estate prices began to rebound (exhibited above by the Russell-NCREIF Capital and Income Index) and interest rates began an upward movement. This rebound in price was completely attributable to
the growth in income as capital growth was flat (shown in previous Russell-NCREIF Capital Value Index graph). Additionally, most of the traditional lending sources had worked out their real estate problems and were again attracted to real estate by the spreads offered on mortgages. The reemergence of the traditional lending sources, rebounding property values, increases in interest rates, and the explosion in the number of REITs all led to a cooling in the REIT market.

Property owners who survived now have alternatives to public market capital which allow them to privately refinance without the painful process of going public or selling out to a REIT. Increasing property values in many sectors, notably apartments, have been caused by both improving economics and aggressive bidding by growth oriented REITs. This phenomena has led to the disappearance, (the disappearance being a function of increasing interest rates and dividend yields, and decreasing cap rates), of the “positive spread” investing which was a major component of the growth stories of the REITs that came public in 1993 and 1994. In the absence of positive spread investing opportunities, a fundamental issue facing many of the apartment REITs is what are the avenues for growth?

In the next chapter we will explain and examine the way in which REITs grow and the means by which growth is measured.
Chapter 2: REIT Growth

Wellsford/Holly

Chapter 2 focuses on how REIT growth is measured and how REITs grow. Wellsford and Holly each had different avenues for growth. Wellsford's expertise was its acquisition ability, and its growth came largely from positive spread investing. Wellsford was not a fully-integrated REIT because it lacked management and development expertise; all of Wellsford's properties were managed by third parties.

Holly, on the other hand, was known for its management and development experience. Holly focused on properties in the Puget Sound region of Washington State. Holly managed all of its properties, plus provided third party management services. In addition, Holly developed almost all of its properties. Holly's main growth story was efficient management, development expertise, and a purportedly improving rental market.

From late 1992 through mid 1994 capitalization rates were high and interest rates were low which allowed REITs like Wellsford to undertake positive spread investing. There was not much emphasis placed on management ability. However, as the competition for properties increased and interest rates rose, the opportunities for positive spread investing diminished. In addition, in 1993 eleven apartment REITs came public. Many of the managers of these REITs were experienced property operators, and REIT investors began to assess management as an integral part of the long term growth story.

As public companies, REITs also need to maintain a capital structure that ensures continued access to the public capital markets. Wellsford was known for its experience and ability to access the capital markets; Holly, however, was lacking in this area.

How Growth is Measured

In order to measure growth, appropriate financial performance benchmarks must be established. REIT financial performance is typically measured in three ways: earnings before interest, taxes,
depreciation and amortization (EBITDA); funds from operations (FFO); and cash available for
distribution (CAD). This accounting hierarchy is presented below:

```
Portfolio Revenues
Less Portfolio Expenses
EBITDA (Portfolio NOI)
Less Depreciation and Amortization
Less Portfolio Interest
Net Income
Plus Depreciation and Amortization
FFO
Less Capital Expenditures
Less Accounting Adjustments
CAD
```

Net operating income is not considered a good measure of performance due to the significant
amount of depreciation and amortization associated with real estate. The inclusion of
depreciation and amortization in net income makes it difficult to compare REITs because the
depreciable basis differs for each REIT. EBITDA, FFO, and CAD are more typically used as
performance benchmarks. EBITDA is a standard measure of before-tax corporate financial
performance, and is the starting point in measuring REIT operating performance because it is the
financial statistic closest to the more traditional real estate net operating income.

FFO\(^{11}\) became, and still remains, the benchmark for comparison. There are several issues
associated with FFO and its calculation, however, which will be discussed below, and which led
to the adoption of CAD.

**Earnings Before Interest Taxes Depreciation and Amortization (EBITDA)**

EBITDA is considered among some industry participants as the best indicator of a portfolio's
performance. EBITDA is the equivalent of the portfolio's net operating income. A benefit of
using EBITDA as a measure of financial performance is that it is capital structure neutral, i.e., it
eliminates management’s ability to influence per share earnings through discretionary

\(^{11}\) As explained in Chapter 4, the current NAREIT FFO definition eliminates debt amortization, and includes capital
structure influences on operating performance.
adjustments to the REIT's capital structure; i.e. the use of short term debt, buying down debt to below market levels, or other methods of financial engineering.

However, one of a REIT's more valuable assets is the ability of management to effectively manage both sides of the balance sheet. While management's operational experience is captured by EBITDA, management's capital structure/financial strategy is not.

**Funds From Operations (FFO)**

**EBITDA (Portfolio NOI)**
- Less Portfolio Interest
- Less Depreciation
- Less Amortization
- **Net Income**
- Plus Depreciation
- **Plus Amortization**
- **FFO**

FFO has been a center of debate for the last few years because of certain latitudes taken in its interpretation. "In 1991, (the National Association of Real Estate Investment Trusts) NAREIT adopted a definition of FFO in order to promote an industry wide standard measure of REIT operating performance that would not have certain of the drawbacks associated with net income under GAAP." The 1991 definition of FFO was:

Funds From Operation means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from debt refinancing and sales of property, plus depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

FFO was intended solely as a measure of comparison. "FFO was not intended to be used as a measure of the cash generated by a REIT, nor of its dividend paying capacity." However, the REIT community adopted FFO and it was often cited by REITs during their IPO as an indication of the REIT's operating cash flows. The original intention of the authors of FFO was lost on the

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13 Ibid.
new REITs of 1993 and 1994 and the inadequacies of the definition were exposed and exploited. The two primary areas of abuse centered on amortization and depreciation.

The REIT surge of 1993 and 1994 was the result of a need by many portfolio owners to recapitalize their balance sheets. As discussed previously, there was a significant decrease in overall asset values with many assets being valued at less than the outstanding mortgage balance. REIT sponsors, some of whom were technically insolvent, needed to maximize the values of their new securities in order to make going public beneficial. Investors had latched onto FFO as a measure of performance and a benchmark for valuing REIT shares. Therefore, it became in the sponsors’ best interest to maximize its presentation FFO in order to maximize the proceeds from the offering, which could be used to retire existing debt and reestablish its equity position.

Specifically, the 1991 FFO definition is too vague concerning the treatment of cost amortization and depreciation. In terms of cost amortization, the most abused item is the capitalization and amortization of deferred financing costs, specifically prepaid interest, over the life of the loan. Prepaid interest is used to reduce the face rate of a mortgage resulting in below-market interest expense. Because the cost of the debt buy-down is amortized over the life of the loan, and amortization is added back to FFO this positively affects FFO. Other financing tools which are capitalized and added back to FFO, but also lower debt costs, include the purchase of interest rate caps and pre-payment penalties.

Another part of the FFO definition that is freely interpreted centers on what capital items are added to the depreciable basis and depreciated and which ones are expensed. In the operation of real estate there are two types of capital expenditures, recurring and non-recurring. Recurring capital expenditures are capital expenditures necessary to maintain current systems and are typically expensed as repairs and maintenance. Non-recurring capital expenditures are significant improvements necessary to maintain an asset's competitive position in a market such as resurfacing of a parking lot or replacement of a roof. From a financial reporting standpoint, it is often in a REIT manager's best interest to capitalize and depreciate capital items and not expense them, as expensing them would have an immediate negative affect on FFO while deprecimating them would not affect FFO.
Realizing issuer's broad interpretation of FFO, NAREIT, in conjunction with pleas from analyst and investors, set out to revise the definition of FFO to narrow its interpretation. However, the new FFO definition as of February 10, 1995, and pending formal adoption would not change the definition adopted by the Board of Governors in 1991 but instead would provide a conceptual background for the definition as well as suggested clarifications.\textsuperscript{14} Such clarifications might eliminate the allowance for amortization, which would force REIT managers to recognize the costs associated with financing, thus making buying down debt to below market levels less advantageous from a financial reporting standpoint. Further, clarifications could prevent REIT manager from depreciating non-property items.

Under the 1991 definition there is no criteria to determine which items should be capitalized and which should be expensed. The definition should be revised to specify that only items of real property can be depreciated for the purposes of calculating FFO. Other items that are considered reasonable to capitalize and depreciate are tenant improvements, turning costs in apartments and leasing commissions. There is no consensus as to what is the proper method, capitalization or expensing, but there is pressure on REIT managers to improve the disclosure and standardize the accounting methodology used.

**Cash Available for Distribution (CAD)**

\[
\text{FFO} \\
\text{Less Capital Expenditures} \\
\text{Less Accounting Adjustments} \\
\text{CAD}
\]

Deferred financing costs, tenant allowances, and leasing costs all need to be considered to accurately reflect cash flow. CAD incorporates all these recurring non-revenue enhancing capital expenditures and provides a better measure of financial performance from the standpoint of cash available to distribute to security holders. CAD adjusts FFO to reflect the fact that buildings depreciate and that regular capital improvements, above repairs and maintenance, are necessary.

\textsuperscript{14} From NAREIT Memorandum "FFO" February 10, 1995
for an asset to maintain its competitive position in the marketplace. Therefore, analysts can choose to adjust FFO by an appropriate amount.

CAD also adjusts FFO for certain accounting adjustments mandated by GAAP; most notably, the straight-lining of rents. Straight-lining levels rental payments by averaging the total rental payment (base rent including steps ÷ term of lease) over the life of the lease. This has the potential to overstate current revenue levels in the early years of a lease by factoring in rent steps that may occur near the end of the lease. CAD attempts to adjust for these items by reversing the accrual basis GAAP accounting back to a cash basis presentation.

**Example of Straight Lining Rent**

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 9</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>$5.00</td>
<td>$5.00</td>
<td>$5.00</td>
<td>$15.00</td>
<td>$20.00</td>
</tr>
<tr>
<td><strong>Straight Line Rent</strong></td>
<td><strong>$10.00</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Straight-lining rental payments ignores the time value of money by equally weighing rent payments, regardless of their timing. Straight lining of rents inflates FFO in the early years of a lease.

**Avenues of Growth**

"Aside from certain financial engineering techniques, such as substituting short-term debt for long-term fixed rate obligations, income growth must be generated internally through higher occupancy rates and/or higher rents; lower expenses or higher levels of tenant expense reimbursements; acquisitions of existing properties that can respond positively to active management and increase cashflow; or finally through the development of new properties."\(^{15}\)

There are two avenues for per share cashflow growth: (i) internal growth, increasing current portfolio income, and (ii) external growth, augmenting existing portfolio cashflow through new investment opportunities.

\(^{15}\) Salomon Brothers Real Estate Research, The REIT Reemerges, August 1993, Page 19.
Internal Growth

Internal growth is growth from the existing portfolio. There are two ways to generate internal growth, decrease expenses or increase revenues. “From a securities valuation perspective, therefore, those select REITs with a demonstrated ability to create or enhance the value of its properties through active asset management despite the weak underlying fundamentals should be valued more highly than the broader universe of REITs, which either do not have a successful history of adding value through the asset management function or are located in property markets with limited prospects for a recovery in property valuations in the near term.”

**Decreasing expenses** -- Expenses are reduced by either superior management or economies of scale. For example, typical expenses for apartments are: personnel, advertising and promotion, repairs and maintenance, real estate taxes, management fees, and general and administrative expenses. Expenses typically are compared either on a per unit basis or as a percentage of gross revenue. According to *IREM Trend Reports 1994 for Conventional Apartments*, in 1993 expenses for unfurnished apartments ranged from 46.2% to 49.2% of total collections. These expenses are based on individual buildings and are expected to be lower for portfolios of buildings due primarily to economies of scale. The following chart shows the total property and REIT operating expenses for 25 apartment REITs.

As can be seen the weighted average property operating and general and administrative expenses are 40% and 4% respectively and range from 32% to 50% and 2% and 8%, respectively.

---

<table>
<thead>
<tr>
<th>REIT</th>
<th>Property Expenses</th>
<th>General &amp; Administrative</th>
<th>Market Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Residential</td>
<td>43%</td>
<td>2%</td>
<td>$2,257,556,000</td>
</tr>
<tr>
<td>Property Trust of America</td>
<td>41%</td>
<td>8%</td>
<td>$1,494,090,000</td>
</tr>
<tr>
<td>United Dominion Realty</td>
<td>41%</td>
<td>3%</td>
<td>$1,274,605,000</td>
</tr>
<tr>
<td>Post Properties</td>
<td>37%</td>
<td>5%</td>
<td>$1,067,785,000</td>
</tr>
<tr>
<td>Irvine Apartments</td>
<td>36%</td>
<td>4%</td>
<td>$1,060,889,000</td>
</tr>
<tr>
<td>Merry Land &amp; Investments</td>
<td>38%</td>
<td>2%</td>
<td>$974,567,000</td>
</tr>
<tr>
<td>Charles E. Smith</td>
<td>46%</td>
<td>2%</td>
<td>$890,687,000</td>
</tr>
<tr>
<td>Wellsford/Holly Residential</td>
<td>39%</td>
<td>4%</td>
<td>$817,925,000</td>
</tr>
<tr>
<td>Avalon Properties</td>
<td>38%</td>
<td>4%</td>
<td>$777,072,000</td>
</tr>
<tr>
<td>Evans Withycombe</td>
<td>33%</td>
<td>3%</td>
<td>$605,620,000</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>34%</td>
<td>4%</td>
<td>$603,399,000</td>
</tr>
<tr>
<td>Gables Residential</td>
<td>39%</td>
<td>5%</td>
<td>$572,284,000</td>
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<tr>
<td>Town &amp; Country</td>
<td>40%</td>
<td>5%</td>
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<td>Camden Property Trust</td>
<td>50%</td>
<td>5%</td>
<td>$540,900,000</td>
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<tr>
<td>Paragon Group</td>
<td>45%</td>
<td>2%</td>
<td>$527,842,000</td>
</tr>
<tr>
<td>Summit Properties</td>
<td>38%</td>
<td>3%</td>
<td>$515,298,000</td>
</tr>
<tr>
<td>Amli Residential</td>
<td>41%</td>
<td>3%</td>
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</tr>
<tr>
<td>Apartment Investment &amp;</td>
<td>42%</td>
<td>4%</td>
<td>$461,058,000</td>
</tr>
<tr>
<td>Management Co.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Associated Estates</td>
<td>40%</td>
<td>8%</td>
<td>$437,767,000</td>
</tr>
<tr>
<td>Mid-America Apartment</td>
<td>40%</td>
<td>6%</td>
<td>$435,432,000</td>
</tr>
<tr>
<td>Communities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bay Apartments</td>
<td>32%</td>
<td>4%</td>
<td>$426,261,000</td>
</tr>
<tr>
<td>South West Property Trust</td>
<td>46%</td>
<td>3%</td>
<td>$381,510,000</td>
</tr>
<tr>
<td>Walden Residential</td>
<td>46%</td>
<td>5%</td>
<td>$363,788,000</td>
</tr>
<tr>
<td>Columbus Realty</td>
<td>34%</td>
<td>5%</td>
<td>$319,549,000</td>
</tr>
<tr>
<td>Essex Property Trust</td>
<td>34%</td>
<td>4%</td>
<td>$296,340,000</td>
</tr>
</tbody>
</table>

**Totals and Weighted Averages**: 39.97% 3.96% $18,162,163,000

*Source: Lehman Brothers REIT Valuation Handbook, June 12, 1995.*

It is the objective of management to reduce expenses to the lowest prudent level. However, investors will be concerned if expenses are too low. This could be indicative of neglect and the eventual deterioration of a property's competitive position and it’s rental stream. There are also benefits to larger companies due to increased purchasing power and centralization of operations, both providing greater operating efficiencies. There are limits to operating efficiencies, however, and tradeoffs due to the eventual need for an enhanced management structure.

**Increase Existing Revenue** -- Increasing existing portfolio revenue is the second avenue to increase per share financial performance. This can be accomplished through increasing occupancy rates and tenant retention, and adjusting rental levels to market in a rising market.
According to the June 1995 National Association of Home Builders Housing Market Statistics, the fourth quarter 1995 vacancy rate was 7.4%. The following chart show the vacancy rate since 1978.

Historically, vacancy rates average approximately 5%. However, following the over building of the mid-1980's, the vacancy rate has remained at approximately 7.5%. This over building was partially due to the increasing median rents between 1978 and 1988. As the chart shows, there was a drop in the median rent between 1991 and 1993 with a slight increase in 1994. The drop could partially be explained by the increase in the housing affordability among first time buyers due to the decline in housing prices and historically low long-term interest rates. However, with the lack of construction in the early 1990s and the increase in interest rates, rents are positioned once again to increase.

**Tenant Retention**

Increasing tenant retention rates significantly impact per share cashflow by eliminating rent loss between tenancies, turning costs, leasing commissions, credit checks, and marketing expenses. According to the IREM report, tenant turnover ranged from 41.7% to 63.3% for elevator and garden apartments respectively. A sign of competent management is how often they monitor
their competition and how aggressively they adjust rents to market levels. In apartments with varying lease expirations, the need for constant monitoring is imperative.

The final way to increase revenue is to reposition existing properties to appeal to a different market segment. This can be accomplished by upgrading the existing units, redirecting the marketing, and the addition of new amenities.

External Growth Opportunities

There are two traditional methods for a REIT to grow externally, through acquisitions and through development of new product. As mentioned previously, the REITs in their IPO road shows were promising strong growth associated with their acquisition expertise and the available opportunities to execute positive spread investing.

Acquisitions: Positive Spread Investing

Positive spread investing provides instant gratification from a financial reporting perspective, by purchasing property at an initial cash yield exceeding a company's nominal cost of debt or equity capital, the REIT can immediately add growth to FFO. A firm's cost of capital is a weighted average of its cost of debt and its cost of equity. In late 1992 and 1993, many REITs were able to borrow short-term at very low, floating rates. In the first quarter 1992 through the first quarter 1994, One Year US Treasury Bills were yielding between 2.5% and 3.5% and 5 Year US Treasury Notes ranged from approximately 4.5% and 5%. The nominal cost of equity, as measured by the dividend yield on the IPOs, ranged from 6.5% to 8.5%. At the same time, property values had been decreasing and were ripe for acquisition at prices well below replacement cost. Most of the REITs, as part of their IPO, had options to purchase a number of properties, and a portion of the proceeds from the IPO were earmarked to fund such acquisitions. REITs typically purchase properties by leveraging up their balance sheet, borrowing on their credit lines, or encumbering non-encumbered assets, and later refinancing the debt with equity, (assuming the equity markets are receptive). This use of their available credit frees REITs from having to access the equity markets when it may not be advantageous. The following is an example of positive spread investing:
Positive spread transactions are immediately accretive to a REITs FFO and, often times, its share price. The results of positive spread investing allowed investors to capitalize on desperate sellers and participate in the real estate recovery. These acquisitions were no-lose situations as long as the dividend yields and the cost of borrowing remained low. Positive spread investing was the main growth vehicle for Wellsford. Wellsford marketed itself as an acquisition machine. As the example above illustrates positive spread investing is accretive to FFO. However, the larger the REIT, the less percentage impact positive spread acquisitions have on FFO. Therefore, the effect of positive spread investing diminishes as the REIT becomes larger.

In 1994, apartment REITs acquired $4.5 billion of property with an average cost of $42,684 per unit. But the activity of positive spread investing has all but ended because of 1) the intense competition between REITs to acquire new product has driven up prices, and 2) increased interest rates have driven up required dividend yields.

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However, there are still REITs that claim to be closing positive spread acquisitions, but the capitalization rates of these transactions may not be what they are advertised. The capitalization rate may be higher or lower if; 1) the operating numbers are projected, as opposed to actual; 2) capital expenditures are not included in the transaction; 3) the operating numbers are not based on a stabilized year; 4) the vacancy rate is based on historical or projected numbers, 5) the cost of management is not included in the operating numbers; 6) the transaction costs are not included; or 7) there are behind the scene transactions, i.e. buying out a partner.\textsuperscript{18} As with FFO, there are also ways to manipulate a transactions capitalization rate.

\textbf{Development}

Development is the second source of external growth. “We believe that the hallmark for 1995 will be investors’ increasing focus on internal growth opportunities rather than growth from external sources, specifically acquisitions. However, as many real estate markets show signs of strength, we anticipate that development will replace acquisitions as the vehicle for REITs to grow (externally).”\textsuperscript{19} Development is another form of positive spread investing. Development will not occur until market rents and demand provide the economic incentives to develop. Typically, development will provide returns in excess of those from acquisition of stabilized projects. This is because the risks associated with construction and lease up require a higher return. Development interest is picking up as evidenced by the increase in land transactions. In 1994, Salomon Brothers reported 62 land transactions completed by REITs. Of these transactions, 52 out of the 62 were completed by apartment REITs. Of the transactions that were reported, approximately 13,000 apartment units are planned. The per unit land costs ranged from $9,514 to $74,494.\textsuperscript{20} Can new development be supported? There are concerns that the drive for growth will sponsor the same degree of over building as the mid-1980s. However, it is expected that the public markets will impose its discipline and prevent non-economically sound


\textsuperscript{19} Salomon Brothers Ibid.

\textsuperscript{20} Ibid.
development by adjusting equity share values to punish imprudent development. Another control over development is the defacto realignment of developers/owners interest. In the pre-REIT era, most developers developed for a fee and were willing to accept risky projects because of the fee and the put option inherent in the non-recourse financing. As a REIT, this agency conflict is largely removed, because developers, who now are REIT managers and major shareholders, will evaluate development based not on fees but on accretion to FFO per share.

**Financial Engineering**

The third way for REIT managers to increase per share cash flow is through financial engineering. Aggressive capitalization policies are one way to increase FFO per share. The other popular method is through the use of short-term floating rate debt. This debt is cheaper than permanent long-term debt but exposes the cash flow to interest rate risk and refinancing risks.
<table>
<thead>
<tr>
<th>REIT</th>
<th>Variable Rate Debt As Percent of Total Market Capitalization</th>
<th>Variable Rate Debt as Percent of Total Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amli Residential</td>
<td>25%</td>
<td>55%</td>
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<tr>
<td>Apartment Investment &amp; Management Company</td>
<td>5%</td>
<td>15%</td>
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<tr>
<td>Associated Estates</td>
<td>18%</td>
<td>58%</td>
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<tr>
<td>Avalon Properties</td>
<td>11%</td>
<td>45%</td>
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<tr>
<td>Bay Apartments</td>
<td>22%</td>
<td>46%</td>
</tr>
<tr>
<td>Camden Property Trust</td>
<td>20%</td>
<td>65%</td>
</tr>
<tr>
<td>Charles E. Smith</td>
<td>3%</td>
<td>6%</td>
</tr>
<tr>
<td>Columbus Realty</td>
<td>27%</td>
<td>89%</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>14%</td>
<td>30%</td>
</tr>
<tr>
<td>Essex Property Trust</td>
<td>28%</td>
<td>55%</td>
</tr>
<tr>
<td>Evans Withycombe</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Gables Residential</td>
<td>14%</td>
<td>28%</td>
</tr>
<tr>
<td>Irvine Apartments</td>
<td>23%</td>
<td>46%</td>
</tr>
<tr>
<td>Merry Land &amp; Investments</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Mid-America Apartment Communities</td>
<td>5%</td>
<td>14%</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>20%</td>
<td>51%</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>4%</td>
<td>10%</td>
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<tr>
<td>Post Properties</td>
<td>19%</td>
<td>54%</td>
</tr>
<tr>
<td>Property Trust of America</td>
<td>5%</td>
<td>18%</td>
</tr>
<tr>
<td>South West Property Trust</td>
<td>14%</td>
<td>29%</td>
</tr>
<tr>
<td>Summit Properties</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>Town &amp; Country</td>
<td>18%</td>
<td>35%</td>
</tr>
<tr>
<td>United Dominion Realty</td>
<td>5%</td>
<td>11%</td>
</tr>
<tr>
<td>Walden Residential</td>
<td>17%</td>
<td>35%</td>
</tr>
<tr>
<td>Wellsford/Holly Residential</td>
<td>23%</td>
<td>54%</td>
</tr>
<tr>
<td><strong>Weighed Average</strong></td>
<td><strong>13%</strong></td>
<td><strong>32%</strong></td>
</tr>
</tbody>
</table>

*Source: Lehman Brothers REIT Valuation Handbook, June 12, 1995*

As of June 12, 1995, the weighted average of variable rate debt among apartment REITs covered by Lehman Brothers was 13% and it ranged from 0% to 25%. The weighted average of variable rate debt as a percent of total debt was 32% and ranged from 0% to 89%. At the time of the merger, 74% of Wellsford's total debt was variable and its variable rate debt as a percent of market capitalization was approximately 32% (total market cap of $515,490,000 and variable rate debt of $168,000,000).
REIT Wave of 1992-94

The first of the wave of 24 apartment REITs to come public was Wellsford, on November 11, 1992. This REIT and the subsequent apartment REIT IPOs were promising exceptional growth in per share FFO. These stories were believable given the conditions in the national apartment market. As previously shown in the chart of the Russell-NCREIF Apartment Sub-index Income Returns, there had been a significant increase from the first quarter 1991's low of 1.71%. For the year ending, December 31, 1991, the income return was up 7.10% from 1989's low of 6.84% but down from the previous years' 7.49%. However, in 1992 and 1993 the income returns were 8.35% and 9.09% respectively. As the income returns were rising, property values were declining.
In 1991, 1992 and 1993 the Russell-NCREIF Apartment Sub-Index Capital returns were -1.06%, -8.99% and -4.66% respectively. The increases in the income returns were, in large part, a reflection of an improving economy and the movement towards supply demand equilibrium (decreased asset prices) in the asset market. There were significant increases in the capital index in the second and fourth quarters of 1994. These upticks are reflective of the increasing asset prices because of bidding among REITs. These upticks may not be reflective of the activity in those quarters because of appraisals lags which are imbedded in the Russell - NCREIF Index.²¹

As the following graph illustrates, the apartment industry in the mid-1980s was over built, reaching a peak of over 650,000 units built in 1985. By 1993 apartment construction had fallen to approximately 163,000 units. This lack of construction was one of many factors that led to a tightening of the market and therefore increasing income returns.

²¹ The Russell - NCREIF index is thought to lag the actual real estate market by approximately one year. This lag is because of the values reported to Russell - NCREIF from the institutional owners are appraisal based. Appraisal methodology, because it relies on past transactions, inherently lags the actual property markets. For more information refer to “Estimating Market Values from Appraised Values without Assuming an Efficient Market”, Geltner, David, Journal of Real Estate Finance, Volume 8, Number 3, Summer 1993.
The increase in the income returns allowed the new REITs to demonstrate increases in their portfolio rental income in their IPO filings. This coupled with the depressed property values, provided the REITs with the ability to purchase property at depressed prices despite rising rents. This gave REITs a compelling statistical backdrop from which to sell their growth stories.

Conclusion

We have outlined the traditional ways REITs can increase per share earnings. REITs also have an option of acquiring or merging with other REITs. This can be looked at as a twist on the positive spread game. As dividend yields have increased, certain REITs appear attractive, i.e. high dividend yield. Mergers and acquisitions have been the subject of numerous seminars over the past few years. In the next chapter this thesis will examine the academic literature on mergers and acquisitions in general and discuss who will benefit from these “eventual” mergers and acquisitions.
Chapter 3: Mergers and Acquisitions

As discussed above, it is believed that the REIT industry is on the threshold of a major period of merger and acquisition activity. Competition for new properties has made new acquisitions less attractive, limited growth prospects and rising interest rates have increased dividend yields, declining share prices have limited access to public capital, lessened demand for new REIT IPOs has left potential entrants on the sidelines, and frustration on the part of certain REIT management from the demands of running a public company has created the desire for an exit strategy. These are all reasons which lead to merger and consolidation activity within an industry. Further, the small market capitalization of the industry, roughly $50, and the relatively large number of REITs, approximately 200, also suggests that consolidation would offer an acquirer cost savings through economies of scale i.e., the elimination of redundant activities and increased purchasing power.

This chapter examines the Merger and Acquisition (M&A) process. Because this thesis is principally concerned with M&A as a vehicle for growth, we will discuss the basic arguments that advance M&A as a growth vehicle. We will then review empirical research relating to these growth claims and summarize the relevant findings. There has been limited M&A activity within the modern REIT industry. Accordingly, we will first examine how and why managers have pursued M&A in the corporate world, and discuss the results of such attempts. We will then relate this experience to the REIT industry, and discuss whether M&A is likely to provide the REIT industry with a realistic growth strategy.

The Basics

In a traditional corporate merger, the "acquiring" company negotiates an agreement with the management of the "target" company to acquire control of the target's assets. The proposed agreement is then submitted to a vote of the target's shareholders. If ratified, the two firms merge, with the acquiring firm absorbing the target. An alternative to
negotiating an acquisition agreement directly with management is to pursue a tender offer for the controlling equity securities of the target. In a tender offer, the acquiring company makes an offer directly to the target shareholders to buy some or all of the stock of the target firm. Tender offers can be either friendly or hostile. A friendly tender is supported by the target's management, a hostile tender is not.

The basic rationale behind takeovers is that takeovers correct the failures of companies that have strayed from the path of cost minimization and profit maximization\(^2\). Outside interests seeing that profit would be higher if different strategic choices were made, bid in the public equity market for a controlling stake in the firm. Once control is gained, the new owners can install new management to enforce new profit maximizing policies. Because of this attempt at maximizing profits, mergers are presumably efficiency enhancing. The presumed efficiencies may stem from the displacement of inefficient managers, a reorientation of the business strategy, or the realization of economies of scope or scale. Takeovers are also viewed as an avenue for companies with strong cashflows in mature industries to enter new higher growth businesses. The argument contends that the cashflow of a mature company will supply the capital needs of a young growth business.

**M&A: The Growth Arguments**

Within the corporate world, mergers and acquisition activity is referred to as "The Market for Corporate Control\(^3\) as M&A is the process by which one set of managers gains command over the assets of another set of managers. The most common reason given by acquirers in the merger market during the 1980s was that the acquisition allowed them to


achieve "synergies"\textsuperscript{24}. Companies argue that through economies of scope or scale, they will be able to create additional value beyond the existing management's ability. Such growth in value can theoretically arise through a variety of avenues, but can be divided along the lines of the balance sheet into asset and liability related opportunities\textsuperscript{25}. On the asset side, acquiring management contends that it can run the acquired assets more efficiently or with some other strategic advantage which will make them more valuable. On the liability side, the acquiring management argues that its superior financial capabilities or competitive access to capital allows for the creation of value in the purchase.

**The Efficiency Arguments**

Creating growth through M&A can be achieved if the acquirer is able to take advantage of some existing inefficiencies of the target. By correcting such inefficiencies, the target's value should increase to the acquirer's benefit. Economies of scope and scale are realized when the merged firms are able to take advantage of their new size or combined operations or both, to operate more efficiently. Examples include; the elimination of redundant personnel; lower costs due to increased bargaining power with suppliers; and decreased marketing costs from the elimination of duplicate efforts.

**Market Efficiency as Opportunity for Growth**

In an efficient market, the ability to create market value through acquisition depends on the under valuation of the target company. Efficient market theory provides that when mispricing occurs, arbitrageurs will correct the under valuation. Mispricing results from a variety of reasons, as over time, stock price movements resemble a random walk. Therefore, companies become mispriced due to the random errors of the market. These random errors may undervalue or overvalue the company, regardless of the underlying


\textsuperscript{25} M&A Handbook. Id.
fundamentals. Undervalued companies become takeover targets and overvalued companies become the acquirers. These random under and overvaluations allow the acquirer to pay a premium to gain control of undervalued companies yet still acquire the target for a fair price. As explained above, even in an efficient market there are opportunities to take advantage of the random errors of valuation.

**Efficient Management**

The next efficiency argument advances the idea that "synergy", the combination of two firms, will provide cost savings or increased asset productivity and create value. Synergy can result from economies of scope and scale, such as increased productivity or decreased costs. These arguments coincide with the view that a more efficient bidder will create value by maximizing the underutilized assets of the target.

Bidders may have a competitive advantage at transferring wealth from employees, suppliers, and managers of the target company to the shareholders. The takeovers redistribute wealth in situations where incumbent management is unable or reluctant to do so.

**Financial Efficiency**

Takeover activity of the early 80s concentrated on bidders using financial strategies to try and unlock value from the targets. Such strategies included replacing equity with debt to reap benefits from the tax advantages of corporate debt deductions. Conversely, an acquirer with a lower cost of capital may create value by re-engineering the target's capital structure. By replacing higher cost debt with less expensive financing, the acquirer is able to increase the cash flow of the target.

**Exit Strategy**

In mature industries, growth opportunities diminish. As discussed in chapter 1, a security's value decreases as growth opportunities decrease. Horizontal mergers during industry consolidation allow fewer competitors to share a mature industry's limited
growth prospects. In this scenario, a merger might enhance the growth prospects of the acquirer which otherwise may be legitimately discounted due to competition for limited opportunities. In effect, via acquisition, the acquirer purchases the target's opportunities, and reduces the competition for its own.

In this manner, takeovers play an important role in facilitating exit from, and efficiency within, an industry. Exit is cheaper to accomplish through merger and the orderly liquidation of the marginal assets of the combined firms than by bankruptcy or wholesale liquidation of all assets. A study by Morck, Shleifer and Vishny suggests that hostile takeovers more often affect industries in decline or sharp change where managers fail to shrink operations rapidly enough or to make other adjustments. This resembles the situation for Holly (explained in Chapter 4) where they found themselves no longer able to compete as the REIT environment rapidly changed.

Managers have trouble abandoning strategies they have spent years devising and implementing. Takeovers generally occur because changing technology or market conditions require a major restructuring of corporate assets and direction. In these situations, it is easier for new managers with a fresh view of the business and no ties to current employees or communities to make such changes. Moreover, normal organizational resistance to change is lower with new management. The market recognizes management entrenchment, and discounts a firm's value accordingly. M&A activity allows the market to re-value the firm without the discount for the existing management entrenchment.

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26 Note: Due to required IRS holding periods for REIT assets, the ability to dispose of assets after acquisition may be limited.


Empirical Studies

Researchers have analyzed the results of M&A activity from various perspectives. There is near unanimous agreement that target stockholders benefit from mergers, as evidenced by the premium they receive for selling their shares. The stock price studies of takeovers also indicate that bidders generally break-even, and the combined equity value of the bidding and target firms increase. These increases in equity values are typically attributed to some unmeasured source of real economic gains such as synergy. But as mentioned previously, the equity value gains could also be due to capital market inefficiencies. For example, the equity value gains may simply arise from the creation of an overvalued security or the revaluation of an undervalued security.

Studies have failed to distinguish between capital market inefficiencies and real economic gains as the reason for the value increases. Gains from merger could arise from a variety of sources such as operating synergies, tax savings, transfers from employees or other stakeholders, increased monopoly rents, or simply adjustments to market expectations.

The following section will review various studies which have attempted to ascertain if M&A is a growth vehicle, and if so, how and why?

Asset Productivity Increases

Healy, Palepu and Ruback\textsuperscript{29} examined the post-acquisition operating performance of merged firms using a sample of the 50 largest mergers between US public industrial firms completed from 1979-83. The study used cashflow measures of economic performance to mitigate both the impact of financing the acquisition and the method of accounting. The study compared post-merger performance with industry performance. The study found that merged firms have increases in post-merger operating cashflow performance relative to their industries. The study suggests that increases arise from post-merger

improvements in asset productivity. This increase in asset productivity is focused on increases in asset turnover, and increases in margins on sale\textsuperscript{30}.

Healy et al explored three main avenues from which improvements in pre-tax cashflow returns in the post-merger period can arise: improvements in operating margins; increased asset productivity; and decreased labor costs.

The study found that \textit{increased asset productivity accounted for most of the gains in performance}. Further, such gains provide significant cashflow improvements in the five years following a merger. Operating margins, when adjusted for the industry and compared pre and post merger, were found to be insignificant to increases in cashflow, even though mergers reduced labor costs. These findings contradict the results of studies by Jensen & Ruback and Magenheim and Muller which found post acquisition negative returns (discussed below).

One reason we suggest, as to why Healy et al found positive returns as opposed to other studies, is that the Healy study failed to include the year of the merger in the pre and post merger comparisons. Although this makes it easier to compare apples to apples without the confusion of different merger accounting and one time merger costs, such costs and operating results for the merger year may have significant impact on the merger's ultimate return.

\textbf{Stock Returns at Merger Announcements}

Healy et al, also looked at market-adjusted stock returns for the target and acquirer at the announcement of the merger. Returns for both the target and acquirer were measured from 5 days before the first offer was announced to the date the target was ultimately delisted from trading. Target shareholders earned large positive returns through merger

\textsuperscript{30} Asset turnover for the sample group went from -.3 to .1 indicating that the merged firms went from generating .30 cents less per dollar than the industry average pre-merger to .10 cents more than the industry average post-merger. See Healy Id.
(mean 45.6% + median 41.8%). On the other side of the transaction however, the study showed that *acquiring shareholders earned insignificant returns.*

During the same time period, Healy et al compared pre-merger abnormal returns with post-merger corporate performance to see if pre-merger value increase is from expectation of future cashflows. The abnormal equity returns for the combined firms at the merger announcement were broadly consistent with the value increases implied by the post-merger cashflow increases. This indicates that *expectations of economic improvements underlie the equity revaluations of the merging firms at merger announcement.* The results are consistent with the hypothesis that the stock market reevaluation of merging firms at merger announcements reflects expected future improvements in operations. As discussed prior, it appears that upon announcement the market adjusts the target's price in anticipation of the acquirer's synergies.

**Post Merger Corporate Performance**

As discussed above, mergers will lead to increased asset productivity if inefficient policies pursued by the target or the acquirer prior to the merger are eliminated, or if the combination provides new opportunities for using the existing resources of the merging firms. In contrast, if mergers arise from inefficient valuation of the target firms by the stock market, improvements in cashflows will arise whether or not there is a merger.

As previously discussed, a popular structural model of how mergers improve cash flow is they provide opportunities for economics of scale and scope, synergy, or product market power. Healy et al examined this theory by comparing mergers between firms with related products or production and those without. The implications being that mergers between firms that have related products or production will show greater cash flow improvements than mergers between unrelated firms. In contradiction to the above hypothesis, the study found no difference in the post-merger industry adjusted operating cashflow returns between related and unrelated mergers.

31 Healy et al, Id.
Dennis and McConnell (1985) also looked at corporate mergers and security returns\textsuperscript{32}. The Dennis and McConnell study examined the effect of mergers on the wealth of various classes of merging firms' security holders. The study used a sample of mergers that took place between 1962 and 1980. The study looked at daily rates of return for each class of securities for both acquired and acquiring firms around the announcement dates. Dennis and McConnell further examined changes in total market value for the combined firms due to the merger.

The Dennis and McConnell study concluded:

1. Common Stockholders of acquired firms gain in mergers.

2. Common stockholders of acquiring companies do not lose in mergers and there is some statistically reliable evidence that the stockholders of acquiring companies gain in merger. \textit{The majority of the gain in mergers occurs in the days immediately following the initial announcement of the impending merger.}

Dennis and McConnell indicate that merger announcements on average have a significant positive effect on the market value of acquired companies' common stock. The study further finds that the average effect on the acquiring companies' common stock is positive, although different from zero at only a very small level of significance. This supports the hypothesis that the target shareholders receive the majority of the gain.

The Dennis and McConnell research indicates that the merger announcements are associated with a positive effect on the total market value of both the acquired and acquiring firm. Additionally, the study found that the merger announcements had a positive effect on the total market value of the combined firms. In this study, as opposed to other studies, the gains are more equally divided between acquired and acquiring firms stockholders, in that the acquiring firm shareholders share in some of the gain.

The Jensen and Ruback study confirms that the target shareholders receive the majority of the gains generated by merger.

1. Takeovers benefit shareholders of target companies. Premiums in hostile offers historically exceed 30% on average.

2. Acquiring firm's shareholders earn about 4% on average in hostile takeovers and roughly zero in mergers.

3. Takeovers generate substantial gains in market value: historically, 8% of the total value of both companies.

A study by Jarrell, Brickly, and Netter had similar results to the above. From 1981-86 shareholders of target firms in successful takeover bids received payments in excess of 54 billion over the value of their holdings before the tender offers\(^{33}\). Shareholders of acquired companies between 1980-85 received an average premium of 30%. Shareholders of acquiring companies had small but statistically significant gains of 1-2% in the immediate period around the public announcement. However, 159 cases from the 1980's show statistically insignificant losses to bidders.

**Long Term Losses for Acquiring Firms**

Several studies have examined performance of merged firms over a longer time frame. These studies find that when the time frame for examining acquiring firms returns is extended to one to three years after the merger, the acquiring firms are found to experience negative abnormal returns (as mentioned above, the Healy study contradicts these findings). Research by Jensen & Ruback\(^{34}\) (1983) looked at a one year time frame post-merger and reported negative abnormal returns which averaged -5.5%. A similar

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study by Magenheim and Muller\textsuperscript{35} (1987) looked at the 3 year post-merger period and found negative returns which averaged -16%. It must be noted however that the results of both studies turn out to statistically insignificant. This may be due to the random movement of the market. Market variances rise with the length of time period studied, making any long term trend difficult to prove statistically.

Scherer explored the efficiency arguments by testing two hypotheses\textsuperscript{36}:

1. If tender offers are precipitated by incumbent management failures, tender offer targets should be less profitable than peer companies in similar industry groups.

2. If takeover displaces inefficient management or in other ways facilitates a movement to higher profit business strategies, post-takeover profitability should rise relative to pre-takeover profitability.

Scherer looked at data which was compiled specific to the individual operating units of the target and the acquirer, to compare performance pre and post merger. The study found the following:

1. Tender offer targets were under-performers by about 8% relative to their home industry norms.

2. Acquired units continued to have slightly inferior cashflows and sales performance after takeovers.

The Scherer report concludes that operating performance neither improved nor deteriorated significantly following takeover. Further, the hypothesis that takeovers improve performance was not supported.


Corporate Mergers: Conclusions

After reviewing the prior empirical evidence, we can summarize as follows:

It is clear that mergers provide substantial gains in value to the target shareholders. Gains to the acquiring shareholders are less certain and seem to range from negative 1-2% to positive 1-2% depending on the study. The bulk of the value created, therefore, goes to the target shareholders. Asset productivity was shown to increase in the Healy study, which the study used to justify the increase in value at the announcement. Other studies have not been able to pinpoint why the value of the combined firms increased on merger. Synergies between firms does not appear to make a difference in post-merger performance. Additionally, most studies contradict Healy, in that they find no improvements in post-merger performance.

From a market efficiency view, target firms cannot be depicted generally as being "undervalued" by the stock market. The studies failed to explain takeover gains as a redistribution or find systematic losses which offset the gains. Evidence suggests that gains from corporate merger transactions reflect economically beneficial reshuffling of productive assets.

Application of M&A Theory to REITs

After reviewing the previous research, it is appropriate to discuss how M&A activity will impact the REIT industry. Because there has not yet been a significant amount of REIT merger activity, it is impossible to replicate any of the prior research in a REIT-specific manner. Therefore, the discussion will focus on corporate M&A research and apply it to the intricacies of the REIT industry. A study that looked at REIT mergers in the period from 1977-1983 is also reviewed, and applied to today's changed REIT industry.

REITs currently provide an interesting background for M&A consideration. As discussed in Chapter 2, the current REIT environment has left many in the industry struggling to grow. As the growth opportunities of the early 90's disappear, the REIT market is starting to resemble a mature industry. Thus, M&A has become an attractive opportunity.
for some REITs to survive and others to exit. The issues we attempt to address through the rest of this chapter are who, if anyone, will benefit from prospective REIT mergers.

The previous research suggests that REIT mergers will provide significant gains to the target shareholders and insignificant gains to the acquiring shareholders. The following, REIT specific M&A issues, incorporates the growth arguments (market efficiencies and management efficiencies) as discussed previously in the chapter. As discussed in chapter 2, REITs grow either internally, by increasing productivity of existing assets, or externally, through profitable investment in new assets

**Market Efficiency**

This thesis promotes the hypothesis that REITs are fundamentally mispriced by the market due to structural inefficiencies in the REIT entity. Anti-takeover provisions that are written into the incorporating documents ostensibly as a matter of tax code concern, and inherent conflicts between the public equity holders and management, are both issues that affect the markets pricing of REITs. Jensen and Ruback's study shows that defensive strategies against takeovers negatively affect stock price, and super-majority amendments and state anti-takeover laws are both economically harmful to shareholders. Willard McIntosh researched the effect of poison pill securities on REIT stock prices between 1985 - 1989. McIntosh found that the announcement of poison pill adoption by 16 publicly traded REITs resulted in a statistically significant decline in stock price of negative .86%. McIntosh's results support the management entrenchment hypothesis, previously discussed, which holds that the market will discount the value of a firm in response to management efforts to reduce the likelihood of hostile takeover. By creating obstacles to a hostile acquisition, the management is isolated from efficiency and value enhancing takeovers.

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Specifically, because the market believes that hostile takeovers cannot occur, and thus random pricing inefficiencies cannot be corrected, the market is not currently establishing a "floor" for the securities of the firm, despite the fact that a REIT's assets, unlike many other corporation's, can be valued with reasonable precision. In effect, the market values the REIT shares based solely on its existing per share FFO and growth prospects. This view creates a pricing discrepancy which permits equity share prices to slide below liquidation values. The slide is to compensate for depreciated growth prospects along with the inability to profit from value creating mergers. In other words, the market focuses almost exclusively on space market dynamics which directly affect FFO, and largely ignores dynamics in the asset markets which ultimately establish real asset values. This is illustrated in chapter 1, and also in the Wellsford/Holly situation as discussed in chapter 4. The situation suggests that there may be large real gains available through mergers in the REIT sector. If the acquirer can take advantage of these pricing discrepancies, it would be able to purchase assets at below market costs.

Because REIT mergers will most likely be friendly (discussed in detail in chapter 6), the acquirer will likely be able to take advantage of the market mispricing in its negotiations, and thus be able to avoid the large market jump that a hostile bid might create.

**Management Efficiencies**

Synergies in operations among REITs are much easier to incorporate than other industries. Operating real estate provides for large economies of scope and scale, that are quickly and easily achieved. The elimination of duplications of operations provide increased labor productivity, as the acquiring management group absorbs the workload of the target. Such operational efficiencies can provide immediate cashflow increases.

Efficiencies can also be achieved in financial engineering; REITs with superior access to capital will be able to acquire weaker REITs and recapitalize them to create value.

An article written in 1987 by Paul R Allen and C.F. Sirmans entitled: *An Analysis of Gains to Acquiring Firms Shareholders: The Special case of the REIT*, investigates the acquiring firm's stock price reaction to merger proposals when both buyer and seller are
REIT's over the period 1977-83\(^\text{38}\). The study attempts to determine whether the same pattern of wealth distribution exists for REIT mergers as for corporate mergers as a whole.

Allen and Sirmans hypothesized that it may be more advantageous for a REIT to acquire an existing trust than to expand internally for a variety of reasons. 1) Net operating losses that can be used to offset capital gains tax liabilities, and 2) replacement of inefficient management in the acquired trust may result in better utilization of assets.

The study showed that tax motivation was not an important motive in REIT combinations. Unlike the corporate mergers studied, the announcement of an impending REIT acquisition increased the wealth of the acquiring REIT's owners. With respect to the acquiring REITs, the results indicate that estimated abnormal returns over the 40 days prior to the first announcement date deviate only slightly from zero. The 2 day time period that falls on both sides of the announcement date is marked by significant and positive returns of 5.78% to the acquiring REIT.

Data relating to returns of the target trusts provided only insignificant results. Over the period, however, the study indicated positive returns of 10.43% for the 2-day time period falling on both sides of the announcement date.

Unfortunately, because of fundamental differences, it is difficult to compare the older REITs of the Allen and Sirmans study with today's REITs. The following chart illustrates the differences\(^\text{39}\)


\(^{39}\) Chart taken from Moody's Industry Outlook; Real Estate Investment Trusts (REITs) Review and Outlook May 1995.
Fundamental Differences Between REITs of the 1970s and REITs Today

<table>
<thead>
<tr>
<th>REITs in the 1970s</th>
<th>REITs in the 1990s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Predominantly mortgage REITs.</td>
<td>Predominantly equity REITs.</td>
</tr>
<tr>
<td>Often tied to banks, limited inside ownership.</td>
<td>Mostly independent companies with significant inside ownership.</td>
</tr>
<tr>
<td>Relatively small size.</td>
<td>Average REIT size in 1993 was more than 5 times that of a 1973 REIT.</td>
</tr>
<tr>
<td>Externally managed.</td>
<td>More likely to be internally managed.</td>
</tr>
<tr>
<td>Short-term funded, often with commercial paper.</td>
<td>Longer term funded, with the use of unsecured debt becoming industry standard.</td>
</tr>
<tr>
<td>High leverage, weak covenant protection.</td>
<td>More conservative leverage and more creditor friendly covenants.</td>
</tr>
<tr>
<td>Focus on land, development, and construction loans</td>
<td>Primarily equity interests in mature properties.</td>
</tr>
<tr>
<td>No UPREIT structure.</td>
<td>Use of tax-driven UPREIT structure.</td>
</tr>
</tbody>
</table>

Because of these differences it is difficult to suggest that the merger results of the future will mimic those of the Allen and Sirmans study. However, the underlying fundamentals of the real estate upon which REITs trade is constant. Further, when the non-real estate issues which are affecting the valuation of today's REIT shares are identified, it can be hypothesized how the returns of REIT mergers will be divided. This thesis advances the argument that the returns will be less dramatic to the target shareholders, and more significant to the acquirer.
Chapter 4: Case Study - Wellsford/Holly

The only pure merger between two apartment REITs has been the Wellsford Residential Properties (Wellsford) and Holly Residential Properties (Holly) merger that was announced on August 2, 1994, and completed at year end 1994. This merger was a strategic move for Wellsford, and ostensibly Holly’s only option. This chapter will outline the condition of Wellsford and Holly pre-merger, the strategic reasons advanced by both companies to merge, as well as the details of the merger.

Wellsford Residential Property Trust

Wellsford, the surviving company, was the first of the apartment REITs to come public in November 1992. The IPO raised approximately $100 million and shares were offered at $21.75, a 7.72% dividend yield on a projected annual dividend of $1.68.

Pre-merger, Wellsford operated 49 multi-family properties totaling 15,318 units located in the southwestern and rocky mountain regions of the United States. As of October 31, 1994, Wellsford's properties had an average occupancy rate of 95%.

Strengths:

As mentioned in Chapter 3, one reason for a merger is to combine companies’ strengths to address changes in the marketplace.

Wellsford’s main engine of growth was positive spread investing. Edward Lowenthal, Wellsford’s President and CEO, mentioned that Wellsford had no day to day management or development experience. Wellsford marketed itself as acquisition experts with a mission statement that read, “Wellsford’s mission is to maximize long-term profitability for its shareholders while maintaining quality housing for its residents. Wellsford attempts to achieve

its mission by acquiring apartment properties at favorable prices, applying effective management and operating techniques, and maintaining a conservative capital structure."

From January 1, 1993, through June 30, 1994, Wellsford acquired 29 multifamily properties. The following chart outlines Wellsford's acquisitions:

<table>
<thead>
<tr>
<th>Date</th>
<th>Location</th>
<th>Number of Projects</th>
<th>Number of Units</th>
<th>Acquisition Price</th>
<th>Per Unit Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/5/93</td>
<td>Dallas, TX</td>
<td>NA</td>
<td>490</td>
<td>$18,300,000</td>
<td>$37,346</td>
</tr>
<tr>
<td>7/27/93</td>
<td>Las Vegas, NV Ft. Collins</td>
<td>4</td>
<td>1,107</td>
<td>$44,100,000</td>
<td>$39,837</td>
</tr>
<tr>
<td>9/2/93</td>
<td>San Antonio, TX</td>
<td>3</td>
<td>569</td>
<td>$14,300,000</td>
<td>$25,131</td>
</tr>
<tr>
<td>5/10/94</td>
<td>Tulsa, OK Oklahoma City</td>
<td>14</td>
<td>5,101</td>
<td>$133,000,000</td>
<td>$26,073</td>
</tr>
</tbody>
</table>

However, Edward Lowenthal stated by mid 1994 Wellsford’s ability to complete positive spread transactions were gone. The focus had to be on internal growth prospects. This, as outlined in Chapter 2, required experienced and integrated management, which was not one of Wellsford’s strengths, as all of Wellsford’s properties were managed by third parties.

Wellsford was also known for its knowledge and experience in the public capital markets. This strength was exhibited by its ability to successfully access the public markets to finance acquisitions and take advantage of debt and equity arbitrage opportunities. The following chronicles Wellsford’s post-IPO public market experience:

**July 1993**
Secondary offering, sold 2,594,000 shares of common stock at $25.00 per share, netting approximately $64,000,000.

**November 1993**
Sold 4,000,000 convertible preferred shares for $25.00 per share, netting approximately $100,000,000.

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Sold, (in two transactions) $22,000,000 in tax exempt bonds, 25 year at 6.05% average maturity and rate.

Sold 1,550,000 shares of common stock for $21.00 per share in a private placement, netting approximately $32,550,000.

Increased Bank of Boston credit facility to $150,000,000, borrowing an additional $58,000,000 to increase outstanding balance to $108,000,000. The additional borrowing went to consolidation and retirement of debt.

Access to the public capital markets is critical in order to continue growth. REITs typically leverage up their portfolio, maximizing their credit lines to acquire properties. Once they acquire the properties, they, assuming the market is favorable, issue additional equity and pay down the credit line. In order to maintain the necessary flexibility to always be in a position to acquire attractive investments, a REIT needs to maintain a certain amount of unencumbered assets. This allows the REIT to increase its credit lines by pledging additional properties. When a REIT encumbers all its properties under one credit facility, the lender is less likely to increase the limit, in order to preserve the integrity of their loan. The REIT can also issue equity to purchase properties; however, as we have seen from the fluctuation in equity values, the public markets are not always receptive to new equity issues. Losing the flexibility of additional debt hinders the growth prospects of a REIT because its ability to fund acquisitions is subject to the conditions in the equity markets.

As of the date of the merger proxy statement, 36 of Wellsford’s 49 properties were pledged as collateral. Wellsford had 14 unencumbered properties that they could pledge to fund additional acquisitions. Wellsford's recognition of the importance of, and its ability to retain, this flexibility further demonstrates their experience and knowledge of the capital markets.
Another indication of a company's financial strength and flexibility is its payout ratio. As we have suggested previously, a REIT's share price is a combination of dividend yield and the expected growth of the dividend/FFO per share. A REIT with a low payout ratio has the flexibility to increase the payout ratio to maintain, or even raise the dividend in periods of tight cash flow. As the previous chart illustrates Wellsford's payout ratio is in line with the average of all the apartment REITs as reported by the Salomon Brothers Apartment REIT statistics from April 1994 through May 1995.

The above activity indicates an experience and a certain level of sophistication in the public financial markets, and management’s ability to recognize opportunities in the capital markets. As stated, acquisitions and access to the public markets were Wellsford’s primary strengths.

Weaknesses

One of Wellsford’s weaknesses was its lack of direct real estate management, another was its lack of development experience. These two factors were not issues in Wellsford’s early life because it could hire outside management and growth was achieved through positive spread investing and improving market conditions. Development experience was not necessary because
asset values were still significantly below replacement costs. However, as prices in certain regions were increasing, the positive spread investment game was ending and development opportunities were replacing acquisitions as the growth vehicle. The tide had turned against Wellsford as indicated by its stock price, and its growth engine was running out of gas.

Green Street Advisors, a private REIT analyst, commented at the time of the merger that, "Wellsford is guilty of not taking advantage of the opportunity to build itself into a fully-integrated real estate organization before the REIT market became saturated with higher quality apartment developer/operators, and management missed the chance to get rid of the company’s variable rate debt when the stock price was high enough to do so without inflicting great pain to cash flow. Instead of reducing the high amount of variable rate debt, WRP has, in fact, gone on a buying spree that has greatly increased its reliance on this risky source of financing."44 At the time of the merger, Wellsford's total debt consisted of approximately 74% variable rate debt, and only 33% was hedged with interest rate caps. As mentioned previously, as of June 12, 1995, the weighted average of variable rate debt among apartment REITs covered by Lehman Brothers was 13% and it ranged from 0% to 25%. The weighted average of variable rate debt as a percent of total debt was 32% and ranged from 0% to 89%.

**IPO and Stock History**

Wellsford came public in 1992 raising approximately $100,000,000 at a price of $21.75 indicating a 7.72% dividend yield.

Since its IPO the stock has fluctuated widely reaching a high of $30.13 during the week of April 2, 1993. The only corporate activity during this period was an acquisition of 490 units. The price did not maintain its high and proceeded to fluctuate, as the chart illustrates. The price hit an all time high during the week of October 22, 1993, on the tail of two acquisitions that added 1,676 units, and a successful secondary offering. Since its high, the price began a precipitous decline, and was in a decline even while merger talks were publicly ongoing. On August 19, 1994, the agreement of the merger was announced which may have caused the uptick in the stock price. However, this was only temporary as the stock dropped to $18.63 during the week of August 21, 1994. Wellsford's pre-merger low of $18.13 occurred during the week of October 21, 1994.
Holly Residential Trust

Holly's IPO was on June 11, 1993, at a price of $23.00 per share with a yield of 7.83%, raising approximately $152,700,000. Holly was the first of eleven apartment companies to go public in 1993, and the second after Wellsford. As the following chart illustrates the eleven apartment REITs raised approximately $2,325,200,000. The market capitalization ranged in size (equity market capitalization) from $10,800,000 to $434,100,000 and the dividend yields ranged from 6.51% to 8.46% with a weighted average yield of 7.19%.

1993 Deals

<table>
<thead>
<tr>
<th>Company</th>
<th>Offer Date</th>
<th>Dollar Amount</th>
<th>Offer Price Per Share</th>
<th>IPO Dividend Yield</th>
<th>IPO Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holly Residential</td>
<td>6/11/93</td>
<td>$152,700,000</td>
<td>$23.00</td>
<td>7.83%</td>
<td>$1.80</td>
</tr>
<tr>
<td>Post Properties</td>
<td>7/15/93</td>
<td>$234,600,000</td>
<td>$25.50</td>
<td>6.51%</td>
<td>$1.66</td>
</tr>
<tr>
<td>Camden Property Trust</td>
<td>7/21/93</td>
<td>$188,000,000</td>
<td>$22.00</td>
<td>7.27%</td>
<td>$1.60</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>8/11/93</td>
<td>$299,000,000</td>
<td>$26.00</td>
<td>6.96%</td>
<td>$1.81</td>
</tr>
<tr>
<td>Town &amp; Country Trust</td>
<td>8/16/93</td>
<td>$341,300,000</td>
<td>$22.00</td>
<td>7.00%</td>
<td>$1.54</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>10/14/93</td>
<td>$169,700,000</td>
<td>$21.75</td>
<td>6.99%</td>
<td>$1.52</td>
</tr>
<tr>
<td>American REIT</td>
<td>11/4/93</td>
<td>$10,800,000</td>
<td>$10.00</td>
<td>8.00%</td>
<td>$0.80</td>
</tr>
<tr>
<td>Associated Estates Realty Corp.</td>
<td>11/10/93</td>
<td>$159,500,000</td>
<td>$22.00</td>
<td>7.27%</td>
<td>$1.60</td>
</tr>
<tr>
<td>Avalon Properties</td>
<td>11/10/93</td>
<td>$434,100,000</td>
<td>$20.50</td>
<td>7.02%</td>
<td>$1.44</td>
</tr>
<tr>
<td>Irvine Apartment Communities</td>
<td>11/30/93</td>
<td>$206,500,000</td>
<td>$17.50</td>
<td>7.77%</td>
<td>$1.36</td>
</tr>
<tr>
<td>Columbus Realty Trust</td>
<td>12/22/93</td>
<td>$119,000,000</td>
<td>$17.25</td>
<td>8.46%</td>
<td>$1.46</td>
</tr>
<tr>
<td><strong>Total &amp; Weighted Averages</strong></td>
<td></td>
<td>$2,315,200,000</td>
<td>$21.94</td>
<td>7.19%</td>
<td>$1.58</td>
</tr>
</tbody>
</table>

Holly was known as a development company. Holly wholly owned and operated 28 multifamily properties containing 4,645 units in the Puget Sound region of Washington State. In addition, Holly had a 50% non-controlling interest in 4 multifamily projects containing 309 units. Additional assets consisted of Holly's headquarters building and the option to purchase a second building, both in Tacoma, an in-process multifamily development, and a multifamily development site. Holly received additional revenues from its third party management contracts. However, many of these contracts were canceled when Holly became a public company.

Strengths

Holly's strengths were in its property management and development experience.
Holly managed all of its projects and also had a successful third party management company. Holly’s other strength was its development experience. As mentioned previously, Holly had developed the majority of its properties. This development-management relationship meant that Holly was committed to its projects and that the quality of development would reflect this long term commitment. Also, as experienced managers Holly was able to maximize efficiencies in design. As we previously discussed, the market dynamics and growth opportunities were changing to Holly’s favor.

Weaknesses

While Holly was experienced in property operations and development, it did not have the experience with acquisitions or the public capital markets. Holly’s biggest weakness was its capital structure. As of the date of the proxy statement, all of Holly’s 28 wholly-owned projects were encumbered under one mortgage loan. This limited Holly’s ability to access the debt capital markets. When Holly came public, however, there was a tremendous appetite for REIT stocks, and this likely limitation on accessing the debt capital market was apparently not an issue. Holly’s payout ratio also limited its financial flexibility. Holly’s payout ratio was considerably higher than the industry average that fluctuated between 80% to 85%.
Stock Trading History

Holly came public on June 11, 1993, at $23.00 per share, a 7.83% dividend yield. As the following chart shows Holly’s share price jumped up briefly for two quarters in the end of 1993. Since the first quarter of 1994 Holly’s share price began a precipitous fall. Holly’s dividend was $0.45 per share in 1993 and through 1994. However, as previously mentioned, the payout ratio increased to a high of 105% of available cash flow. The importance of maintaining the dividend was of the utmost importance for Holly because of the competition for investors' money. In 1993 there were 11 apartment REITs competing for money. The inability to access the equity and debt markets caused Holly to essentially be dead in the water with no way to grow their dividend.

![Graph showing Holly's share price fluctuations](image)

Holly’s stock price was trading at significantly below it’s IPO price, and the payout ratio and the financial straight-jacket of the encumbered properties hand-cuffed management with no way to increase the dividend (actually, the Board of Directors was considering a dividend cut).

Merger Time-Line

As outlined in the previous sections, Wellsford and Holly were two companies with specific, yet different, weaknesses: Wellsford’s growth engine had stalled, and Holly’s financial boat was
taking on water. This section will provide the background on the merger talks as outlined in the Wellsford Proxy Statement.

**Early May**  
Edward Lowenthal (Lowenthal), President and CEO of Wellsford called Daniel Kelly (Kelly), President and CEO of Holly to determine Holly’s interest in merger. During the conversation Lowenthal pointed out the benefits of a merger including: combining respective talents, reducing corporate overhead, and creating a larger more attractive company.

**May 19**  
Lowenthal and Kelly met in Chicago with John Magnuson (Magnuson), Holly’s COO, to discuss benefits of the merger. Lowenthal expressed an interest in Holly’s management capabilities and Holly expressed an interest in Wellsford capital market capabilities. Also discussed were the integration of senior management and how to value Holly's stock.

**May 27**  
Jeffrey Lynford (Lynford), Lowenthal, Kelly plus senior management of both companies met to discuss terms of merger. Preliminary discussions and due diligence were conducted.

**June 2**  
NatWest (Holly’s advisors) made a presentation to Holly’s Board of Directors to discuss strategic alternatives to increase profitability, including a financial restructuring to achieve cost savings. At this meeting the Board was informed of merger discussions.

**June 7**  
Wellsford met with representatives of Merrill Lynch, Robinson, Silverman, Pearce, Aronsohn & Berman and Fried, Frank, Harris, Shriver & Jackson (Wellsford’s Advisors), to draft merger agreement in order to prioritize merger issues.

**June 15**  
Preliminary draft was circulated proposing a .75:1 exchange ratio of Wellsford for Holly shares.

**June 20**  
Wellsford informed its Board of Directors of the merger and it’s proposed benefits. Wellsford's Advisors presented the techniques that would be
used to value the merger. The Board of Directors gave approval to continue merger discussions.

**June 24**

Wellsford worried that the merger might not be accretive to FFO at the current exchange rate. Lynford contacted Kelly to propose a .72:1 exchange ratio instead of a .75:1 exchange ratio. Holly rejected the offer.

**July 14**

Lowenthal, Lynford and Kelly met in Chicago. Wellsford proposed a .75:1 exchange ratio (with .72 in stock and .03 in cash).

**August 1**

Both companies had substantially completed their due diligence and held separate, special Board meetings. Holly’s Board of Directors requested: no liquidation damages; there be a $1,000,000 limit on expenses Holly was obligated to pay Wellsford for draft expenses if the merger was not completed; Holly be permitted to terminate merger if the implied value of Holly’s stock, based on exchange ratio were to drop below $16.50; and Holly be given three seats on the new Board of Directors. After negotiations Wellsford only agreed to reduce the liquidated damages to $4,800,000, limit Holly’s expense reimbursement to $2,000,000. Wellsford did not agree to put a floor on Holly’s implied stock price.

**August 2**

Both companies agreed to the merger.

**Reasons for the Merger**

The negotiations took less than three months to get approval of the respective Board of Directors. Throughout the process both companies met with their advisors to determine the risks, benefits and the pricing of the merger. It was estimated that the cost of merger would be $5,500,000 consisting of: fairness opinions, $3,000,000; legal and accounting fees, $1,700,000; termination of employment contracts, $520,000; buyout of Holly stock options, $119,000; and miscellaneous cost of $161,000. In gaining the Board of Directors approval, both companies' management had to explain why the merger was the best alternative available.
Wellsford presented several reasons for the merger. The merger would allow Wellsford to acquire 5,223 units in a single transaction and expand its geographic focus. The merger would result in a more integrated real estate company incorporating Holly’s in-house management and development expertise. The merger would allow the new company to recognize an estimated $1,200,000 in annual cost savings. These savings would come partially from: salaries and benefits, $230,000; directors and officers’ insurance and trustee fees, $131,000; professional fees, $71,000; and miscellaneous, $41,000. The merger would also result in a larger company that management and its advisors believed would increase the liquidity of the company’s stock. Finally, the merger would be completed without a public offering of debt or equity.

Holly’s management recommended to its Board of Directors that the merger would allow Holly to participate in a more diverse company and benefit from Wellsford’s acquisition experience and its access to the public capital markets. The exchange ratio would result in a premium to Holly’s current and recent trading value. Also, Holly would be given two seats on the new board of directors and would retain several of Holly’s senior management and would not create a taxable event.

A final reason for Holly’s Board of Directors approving the merger was the alternative to a merger. “The Board of Directors agreed that, at that time, there were no feasible alternatives that were available to Holly that were likely to significantly improve the profitability of Holly’s existing operations, and that Holly, as a stand alone entity would experience difficulty in accessing the capital markets on acceptable terms in order to fund future growth.”

In addition, if the merger did not occur, Holly’s management would recommend a reduction in the current dividend that would lower the payout ratio to a level comparable to the industry level of approximately 85%.

**Fairness Opinions**

Both companies had financial advisors, Wellsford hired Merrill Lynch and Holly hired NatWest Securities and each advisor provided a fairness opinion to its client. The advisors looked at the

merger using several methods: ratio analysis, public market equity valuation, discounted cash flow analysis, going-in capitalization analysis, pro-forma contribution analysis, and an analysis based on each stock's trading history. The purpose of these analyses was not to arrive at a value, but to determine the fairness and reasonableness of the proposed merger price.

In determining the price that could be paid, Wellsford needed to consider two issues. The first was the price offered would have to be a premium to Holly’s current equity value. Wellsford had to offer Holly a price that it would not realistically achieve in the market. This price would have to be tempered by the knowledge that Holly, if the merger did not occur, would more than likely have to cut its dividend. This would further reduce Holly's share price. Based on the price of Wellsford stock on August 2, 1994, $21.875 and the .75:1 exchange ratio, the indicated premium to be paid per share was approximately 10%.

In determining a price, Wellsford also had to achieve its goal of the merger being accretive to FFO per share. Therefore, Wellsford completed a pro-forma analysis of the two companies to determine the effect of various exchange ratios on its FFO. The following chart outlines the pro forma financial profile of the merged companies. The calculations contain the agreed upon exchange ratio. The current exchange ratio results in a 39% increase in Wellsford's net income per share.

<table>
<thead>
<tr>
<th>Revenues/Expenses</th>
<th>Wellsford</th>
<th>Holly</th>
<th>Pro Forma Merger Adjustments</th>
<th>Wellsford After Merger</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property operating and maintenance</td>
<td>$29,878,000</td>
<td>$9,239,000</td>
<td>$0</td>
<td>$39,117,000</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>$5,881,000</td>
<td>$3,071,000</td>
<td>$0</td>
<td>$8,952,000</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>$18,550,000</td>
<td>$4,994,000</td>
<td>$2,898,000</td>
<td>$26,442,000</td>
</tr>
<tr>
<td>Property management</td>
<td>$3,776,000</td>
<td>$885,000</td>
<td>$0</td>
<td>$4,661,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$16,709,000</td>
<td>$7,180,000</td>
<td>$0</td>
<td>$23,889,000</td>
</tr>
<tr>
<td>General and administrative</td>
<td>$2,816,000</td>
<td>$2,190,000</td>
<td>($926,000)</td>
<td>$4,080,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$77,610,000</td>
<td>$27,559,000</td>
<td>$1,972,000</td>
<td>$107,141,000</td>
</tr>
<tr>
<td>Share of net loss of partnerships</td>
<td>$0</td>
<td>($232,000)</td>
<td>$0</td>
<td>($232,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$9,517,000</td>
<td>$4,826,000</td>
<td>($1,972,000)</td>
<td>$12,371,000</td>
</tr>
<tr>
<td>Distribution to preferred shareholders</td>
<td>$7,000,000</td>
<td>0</td>
<td>0</td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Net income applicable to common shareholders</td>
<td>$2,517,000</td>
<td>$4,826,000</td>
<td>($1,972,000)</td>
<td>$5,371,000</td>
</tr>
<tr>
<td>Net Income per common share</td>
<td>$0.23</td>
<td>$0.32</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weighted average of common shares outstanding</td>
<td>10,743,000</td>
<td>5,985,000</td>
<td>16,728,000</td>
<td></td>
</tr>
</tbody>
</table>

The following chart illustrates the premium and the increase in net income at different exchange ratios. All of the numbers are based on an August 2, 1994, stock prices of $21.875 and $14.875
for Wellsford and Holly, respectively. The exchange rate clearly indicates Wellsford's bargaining power and Holly's desperation. According to the analysis, Wellsford could have offered significantly more and still have the merger be accretive to its per share earnings.

![Bar Chart]

**Premium to current price of Holly's stock**
**Percent increase in per share earnings**

**Exchange Ratio**

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**Senior Management**

One of the strategic reasons for the merger was for Wellsford to acquire Holly's in-house management and the development experience. This made the issue of dealing with Holly's senior management easier. According to Lowenthal, the most difficult part of the merger was dealing with the personalities of Holly's senior management. The issue was who would remain with the new company. The members of Holly's senior management that were at the center of the issue were: Daniel Kelly, President and CEO; David Kelly, Chairman of the Board; John Magnuson, Executive Vice President and COO; Bradley Berg, Vice President and CFO; and Tracy Shier, General Consul.

Daniel Kelly was named Vice Chairman of the Board of Trustees, President of the surviving corporation, and president of a to-be-formed development subsidiary. He was given a three-year employment contract providing an annual base salary of $220,500, $231,500, and $243,100 for the years 1995, 1996, and 1997, respectively. In addition, he will be eligible for a bonus equal
to 50% of his annual salary if NOI increase 5% from the prior year, and was given 100,000 common share options with an exercise price of $21.00.

David Kelly was given a two-year consulting contract worth $170,000 per year and 100,000 common share options with an exercise price of $21.00. Lowenthal mentioned that this was the most difficult part of the merger, telling David Kelly that there was no room for him in the new company.

John Magnuson was named Vice President of Property Management and President of Wellsford’s property management subsidiary. He was given a two-year employment contract with an annual base salary of $157,500 and $165,375 for 1995 and 1996, respectively. He was also given 12,000 option to purchase Wellsford’s common stock at an exercise price of $21.00 and a lump sum payment of $100,000.

Berg and Shier both received lump sum severance payments of $350,000 and $170,000, respectively, and $24,591 and $23,522 in exchange for their Holly options.

Lowenthal indicated that the most important issue associated with the merger was the treatment of Holly’s senior management. This is important to note because many of today’s REITs were originally private companies built by their owners, and as such, there is a high level of pride and egos associated with their portfolios. Therefore, the prospects of how the personalities of the two management structures mix is often a deciding factor in executing a merger.

According to Lowenthal, the amount of institutional ownership also helped in completing the merger. This was partly because of the need for increased liquidity which is thought, but not verified, will come from a larger capitalized company. Also, institutional owners of real estate are more long-term in their views and were thought to be more interested in the value added from the development and management capabilities of Holly.

Diversification was cited by both companies as a reason for the merger. Management which is heavily invested in its company will want to diversify to limit the company’s exposure to one market. However, this conflicts with investors who do not want a firm to diversify because they can diversify on their own account. “If investors were not able to hold a large number of
securities, then they might want firms to diversify for them. But investors can diversify.  

"No one has shown that investors pay a premium for diversified firms--in fact, discounts are often common."

**Conclusion**

So, does the Wellsford-Holly merger make sense? According to Green Street Advisors, "Although the Wellsford/Holly merger may set an important precedent for the industry on its own, the deal is a yawner. In a nutshell, two “have not” apartment REITs with balance sheet problems are merging to form a bigger “have not” apartment REIT with a balance sheet problem. Wellsford is guilty of not taking advantage of the opportunity to build itself into a fully-integrated real estate organization before the REIT market became saturated with higher quality apartment developer/operators, and management missed the chance to get rid of the company’s variable rate debt when the stock price was high enough to do so without inflicting great pain to cash flow. Instead of reducing the high amount of variable rate debt, WRP has, in fact, gone on a buying spree that has greatly increased its reliance on this risky source of financing. It is doubtful that investors will give this company a second chance to make good, and the fact it will now be bigger does nothing to address this concern."

However, since the merger there has been an increase in Wellsford’s share price which would indicate that the public market viewed the merger favorably. It may be for the following reasons: Wellsford was able to acquire the management and development experience needed to replace the growth opportunities lost because of the disappearance of positive-spread investing; and Holly was able to offer its shareholders a premium in the transactions as opposed to the

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47 Ibid. page 824.
anticipated reduction in the dividend. However, the reasons of diversification and liquidity are not supported by traditional financial theory and are therefore, not considered valid reasons for a merger.
Chapter 5: Identifying Acquisition Candidates

Chapter 5 introduces a common sense analysis to identify takeover targets from the existing equity apartment REITs. The universe of REITs we will analyze are the 25 REITs covered by the Lehman Brothers REIT Valuation Handbook. This source provides quarterly financial data for 25 apartment REITs.

We use the information we have developed in the previous 4 chapters to explain why certain REIT fundamentals help identify specific firms as acquisition candidates. We first identify the REIT's FFO yield. FFO yield measures the levered operating cash flows (before capital expenditures) as a percentage of the share price. As explained in chapter 1, the share price is composed of both the current dividend and the expected growth of dividends (or FFO per share, as explained above). We next examine each firms total debt to market capitalization. As discussed in chapter 2, leverage affects the REITs ability to grow, in both its cost of and ability to incur additional debt. Finally, we introduce the issues of chapter 3 which suggest that REIT specific structural issues prohibit hostile acquisitions (explored deeper in chapter 6), and thus cause REIT shares to be discounted by the market. By comparing private to public valuations we can identify which firms are trading at discounts and thus are likely acquisition targets.

FFO growth estimates are derived from the Salomon Brothers May 1995 Review. The FFO estimates for 1995 and 1996 are used to calculate FFO growth rates for 1996. The following table presents such FFO growth rates for our sample.
<table>
<thead>
<tr>
<th>REIT</th>
<th>1995-96 FFO Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evans Withycombe</td>
<td>13.74%</td>
</tr>
<tr>
<td>Apartment Investment &amp; Management Company</td>
<td>13.24%</td>
</tr>
<tr>
<td>Property Trust of America</td>
<td>11.81%</td>
</tr>
<tr>
<td>United Dominion Realty</td>
<td>11.48%</td>
</tr>
<tr>
<td>Post Properties</td>
<td>11.42%</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>11.31%</td>
</tr>
<tr>
<td>Mid-America Apartment Communities</td>
<td>11.11%</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>10.99%</td>
</tr>
<tr>
<td>Gables Residential</td>
<td>10.41%</td>
</tr>
<tr>
<td>Columbus Realty</td>
<td>10.17%</td>
</tr>
<tr>
<td>Walden Residential</td>
<td>9.80%</td>
</tr>
<tr>
<td>Avalon Properties</td>
<td>9.30%</td>
</tr>
<tr>
<td>South West Property Trust</td>
<td>8.57%</td>
</tr>
<tr>
<td>Summit Properties</td>
<td>8.47%</td>
</tr>
<tr>
<td>Camden Property Trust</td>
<td>8.26%</td>
</tr>
<tr>
<td>Wellsford/Holly Residential</td>
<td>8.09%</td>
</tr>
<tr>
<td>Merry Land &amp; Investments</td>
<td>8.06%</td>
</tr>
<tr>
<td>Bay Apartments</td>
<td>7.94%</td>
</tr>
<tr>
<td>Associated Estates</td>
<td>7.73%</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>7.46%</td>
</tr>
<tr>
<td>Charles E. Smith</td>
<td>7.26%</td>
</tr>
<tr>
<td>Irvine Apartments</td>
<td>7.10%</td>
</tr>
<tr>
<td>Amli Residential</td>
<td>6.28%</td>
</tr>
<tr>
<td>Essex Property Trust</td>
<td>3.33%</td>
</tr>
<tr>
<td>Town &amp; Country</td>
<td>2.26%</td>
</tr>
</tbody>
</table>

**Identifying Growth Prospects: FFO Yield vs. FFO Growth Projections.**

As discussed in chapter 2, FFO is subject to some manipulation. However, when compared to the dividend yield, the FFO yield is less arbitrary than dividend policy and is less easy to manipulate. FFO yield isolates the REIT's operating performance. When the Wellsford/Holly merger was announced, Wellsford was paying out 80% of its FFO as dividends whereas Holly was distributing 105% of its FFO (the industry average is 85%). FFO yield, therefore, gives us a better comparison between REITs of how the market is pricing the firm's shares.

Equation 2, in chapter 1, tells us that share price is the combination of current dividend and future dividend growth. A firm with a low FFO yield is valued to a larger degree based on the firms growth opportunities. Conversely, a high FFO yield indicates that the
firm's value is in its existing cashflow, and not in its future growth potential. It becomes a catch-22, as firms which the Market sees as having less opportunity to grow (and thus a higher FFO yield) will find it difficult to acquire properties that would be accretive to FFO due to higher nominal costs of equity. This higher cost of equity, or lower share price will prohibit the firm from competing for opportunities with a lower FFO-yielding rival. This was explained in the positive spread investing example of chapter 2. From this analysis, we can predict that a REIT with a higher FFO yield will be at a competitive disadvantage when pursuing new opportunities and thus become a takeover candidate. The following chart graphs the FFO yield of the Apartment REIT's versus their projected FFO growth.

With the FFO growth estimates (percentage FFO growth projections for 1995-96), we compared the current FFO yields (as of June 12, 1995). The lines on the chart signify the weighted average, based on market capitalization, of the 25 apartment equity REITs in
our sample. The lines show that the weighted average of the sample is 9.4% for FFO yield and 8.7% for FFO growth. From chapter 1 we predicted that the firms with the highest FFO yields would have the lowest growth estimates. The results confirm our prediction. The firms with the highest FFO yield (Essex and Town & Country) both had the lowest FFO growth estimates. In line with our hypothesis in chapter 1, investors were pricing these stocks based on their current dividend (FFO) yield, and not on expected growth in the dividend. At the time merger discussions were initiated between Wellsford and Holly (May 1994, shown in the boxes on the chart), Holly's FFO yield was 12% and its FFO growth projections was 7.42%. This places Holly to the far left of the chart, indicating that the shares were yielding an industry high return. Wellsford's shares were yielding (based on FFO yield), less than 8.5% and projected growth was 6.45%. This shows that the acquirer, Wellsford, was trading at a significantly higher multiple than the target Holly. Through the acquisition, Wellsford created the potential to profit from Holly’s existing high return. From the results of this comparison the predicted potential takeover targets are located in the southwest quadrant. These firms are below the sample average in projected growth and above the sample average in FFO yield. The identified firms are, (in order of ascending FFO yield); Camden; Aml; Summit; Irvine; Wellsford (post-merger); Town & Country; South West; and Essex.

**Ability To Grow: Total Debt To Market Capitalization.**

As detailed in chapter 2, an important vehicle for REIT external growth is through the purchase of new assets. A REIT will typically pursue new acquisitions with its line of credit, temporarily increasing its debt to a given leverage limit\(^49\). Once a leverage limit is reached, the REIT will return to the equity market and raise new cash to buy down the debt and decrease leverage. The cycle can then begin again. For our sample, we have calculated each REIT's total debt as a percentage of its total market capitalization. By identifying which REITs' currently have higher debt leverage ratios, we can isolate those

\(^{49}\) REIT management typically sets limits on the amount of debt they will incur. However, it is at the management's discretion to exceed that limit.
that are in the equity refinancing period of the cycle. We then compare the debt to total market capitalization with the FFO yields. This shows us the cost of equity of those REITs' which need to re-access the equity markets. REITs' with high leverage and high costs of equity are more likely to be acquisition targets. These REITs' high leverage will limit their ability to pursue opportunities with debt. Additionally, their high cost of equity will limit their ability to either refinance their existing debt or pursue opportunities via the equity markets which will be non-dilutive to FFO per share.

The lines on the graph represent the sample weighted average for FFO yield (9.47%) and total debt to total market capitalization (38%). We believe that those REITs located in the Southwest quadrant will most likely be potential takeover targets. As explained above, these REITs will have trouble pursuing growth opportunities via either debt or equity financing. Figuratively speaking, these REITs are dead in the water. Those REITs with above industry average for both cost of equity (high FFO yield) and total debt to
total market capitalization are (in order of ascending FFO yield); Oasis; Aml; Gables; Summit; Equity; Irvine; Walden; Wellsford (post-merger); Town & Country; South West; and Essex.

Uncovering Hidden Asset Value: Public vs. Private Value

Some REITs are currently selling at a discount to their private market value. As discussed previously, this seems counterintuitive, and in conflict with efficient market theory. However, as earlier hypothesized in chapter 3, there are structural impediments inherent in REITs which make hostile acquisitions unlikely. Therefore, the Market discounts the value of certain REIT shares due to management's entrenchment within these REITs, which allows share prices to trade below liquidation value\textsuperscript{50}. We have discussed various reasons as to how such a market inefficiency can occur. Random valuation errors, discounts due to disappointing growth prospects, management inefficiencies, and penalties for anti-takeover provisions are all issues that contribute to this situation. If the Market does not believe in current management, and sees no vehicle with which to remove such management, the Market will punish the REIT's share price. Chapter 3 explains that takeover activity is seen by the Market as a natural efficiency enhancement process. When such process is eliminated, then unnatural pricing discrepancies will arise\textsuperscript{52}.

As described in chapter 1, both Wellsford and Holly were trading at a discount to their private asset values prior to the merger. Likewise, many REITs currently find their public market value at a discount to the value of the underlying real estate assets in the private market. We will identify the difference between public and private valuation as a means of predicting which REITs offer discounted asset value and are, thus, potential takeover targets.

The following chart shows the June 25, 1995 share price and the estimated per share breakup value, from Green Street Advisors.

\textsuperscript{50} This is discussed in detail in chapter 6
<table>
<thead>
<tr>
<th>6/12/95 Company</th>
<th>6/12/95 Stock Price</th>
<th>Green Street Current Value</th>
<th>Premium (Discount) to Market Value</th>
<th>Percent Premium (Discount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amli Residential</td>
<td>$19.63</td>
<td>$20.00</td>
<td>$(0.37)</td>
<td>-1.9%</td>
</tr>
<tr>
<td>Associated Estates</td>
<td>$21.63</td>
<td>$20.75</td>
<td>$0.88</td>
<td>4.1%</td>
</tr>
<tr>
<td>Avalon Properties</td>
<td>$20.83</td>
<td>$19.50</td>
<td>$1.33</td>
<td>6.4%</td>
</tr>
<tr>
<td>Bay Apartments</td>
<td>$19.50</td>
<td>$19.25</td>
<td>$0.25</td>
<td>1.3%</td>
</tr>
<tr>
<td>Camden Property Trust</td>
<td>$23.00</td>
<td>$24.00</td>
<td>$(1.00)</td>
<td>-4.3%</td>
</tr>
<tr>
<td>Charles E. Smith</td>
<td>$23.75</td>
<td>$22.25</td>
<td>$1.50</td>
<td>6.3%</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>$28.88</td>
<td>$26.75</td>
<td>$2.13</td>
<td>7.4%</td>
</tr>
<tr>
<td>Evans Withycombe</td>
<td>$20.50</td>
<td>$18.00</td>
<td>$2.50</td>
<td>12.2%</td>
</tr>
<tr>
<td>Gables Residential</td>
<td>$21.63</td>
<td>$20.75</td>
<td>$0.88</td>
<td>4.1%</td>
</tr>
<tr>
<td>Irvine Apartments</td>
<td>$17.00</td>
<td>$18.50</td>
<td>$(1.50)</td>
<td>-8.8%</td>
</tr>
<tr>
<td>Merry Land &amp; Investments</td>
<td>$21.13</td>
<td>$18.50</td>
<td>$2.63</td>
<td>12.4%</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>$22.75</td>
<td>$22.75</td>
<td>$0.00</td>
<td>0.0%</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>$18.00</td>
<td>$19.50</td>
<td>$(1.50)</td>
<td>-8.3%</td>
</tr>
<tr>
<td>Post Properties</td>
<td>$30.88</td>
<td>$29.50</td>
<td>$1.38</td>
<td>4.5%</td>
</tr>
<tr>
<td>Property Trust of America</td>
<td>$17.63</td>
<td>$17.25</td>
<td>$0.38</td>
<td>2.2%</td>
</tr>
<tr>
<td>South West Property Trust</td>
<td>$12.38</td>
<td>$13.50</td>
<td>$(1.12)</td>
<td>-9.0%</td>
</tr>
<tr>
<td>Summit Properties</td>
<td>$17.38</td>
<td>$16.50</td>
<td>$0.88</td>
<td>5.1%</td>
</tr>
<tr>
<td>Town &amp; Country</td>
<td>$14.50</td>
<td>$15.50</td>
<td>$(1.00)</td>
<td>-6.9%</td>
</tr>
<tr>
<td>United Dominion Realty</td>
<td>$14.50</td>
<td>$10.25</td>
<td>$4.25</td>
<td>29.3%</td>
</tr>
<tr>
<td>Wellsford/Holly Residential</td>
<td>$22.25</td>
<td>$23.25</td>
<td>$(1.00)</td>
<td>-4.5%</td>
</tr>
</tbody>
</table>


Most of the apartment REITs covered are trading close to their per share breakup value. This supports our prediction that the Market is discounting REIT shares to account for the structural inefficiencies. Where the public value is so close to asset value, the Market is attaching no value (or even deducting value) in association with the REIT's senior management.

It is furthermore, our opinion that there is not always an alignment of interest between management and shareholders; this is the management entrenchment argument advanced prior. Management of the 1990's REITs typically own a significant amount of the company. Management, therefore, receives not only its salary but, significant quarterly dividend payments. These new REITs were previously private operating companies founded by the current management. Therefore, it is not implausible that these managers may be more concerned with their control, salary, and dividend payments, than with the growth of the firm's share price.

This research incorporates the private versus public valuation differences as calculated by Green Street Advisors. The Green Street coverage, however, did not include 6 REITs
from our sample\textsuperscript{51}. Green Street's methodology involves determining the underlying current value of shareholders equity and comparing this with the equity value of the underlying real estate assets\textsuperscript{52}. We use Green Street's current value methodology in order to maintain consistency in our comparisons within the apartment REIT sample.

\textsuperscript{51} Essex; Walden; Columbus; Mid-America; Apartment Investors; Oasis were not included in the Green Street analyses

\textsuperscript{52} Real estate asset value is determined using Green Street's formula for capitalization. See REIT Pricing Green Street Advisors January 13, 1994
We predict that REITs selling at a share price which reflects a discount to their private valuation are more likely to become takeover targets. An acquirer, would in theory be purchasing the REIT's assets at a discount to their true market value. The chart shows that the equity shares of 7 REITs in our study (South West Properties; Camden Property Trust; Wellsford Property Trust; Paragon Group; Irvine Apartment Communities; Aml Residen; and Town & Country), are currently trading at a discount to private equity (liquidation) value. We compare the valuation results to both FFO yield and FFO growth projections, so that we can categorize which of the discounted REITs offer better investment potential to an acquirer. When we compare these two charts, (Premium/discount to asset value vs. Both FFO yield and FFO growth), we can identify the discounted REITs that are currently selling at a higher FFO yield and also offer higher FFO growth projections. As detailed in chapter 1, a REIT's price should reflect a combination of current yield and predicted growth. Here we isolate REITs offering (relative to our population), both higher yield and higher projected growth. The theory
being that an acquirer who purchases a discounted REIT with a high FFO yield is buying the target at a cheap share price. Further, a target with a high FFO growth projection offers the acquirer potential growth opportunities. When these two charts are reviewed together, we can identify REITs which are selling at a discount and offer an acquirer both high FFO yield and high projected FFO growth. South West Properties is identified as a REIT which satisfies these criteria.

**Potential Takeover Targets**

We believe that the combination of high debt to total market capitalization and high FFO yield are the most important variables in determining merger targets. Of the 25 equity apartment REITs covered by the June 12, 1995, Lehman Brothers REIT Valuation Handbook, we have identified nine REITs that are considered candidates based on these criteria. These nine were then compared to the Green Street Advisors discount to current value to further reduce the list to seven. The merger targets identified are as follows:

<table>
<thead>
<tr>
<th>REIT</th>
<th>Debt/Mkt Cap</th>
<th>1995-98 FFO Growth</th>
<th>FFO Yield</th>
<th>Implied Interest Rate</th>
<th>Premium (Discount) to Market Value</th>
<th>Market Cap</th>
<th>Percent Institutional Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amli Residential</td>
<td>45%</td>
<td>6%</td>
<td>10%</td>
<td>6%</td>
<td>($0.37)</td>
<td>$514,439,000</td>
<td>24%</td>
</tr>
<tr>
<td>Essex Property Trust</td>
<td>50%</td>
<td>3%</td>
<td>12%</td>
<td>7%</td>
<td>$0.00</td>
<td>$296,340,000</td>
<td>20%</td>
</tr>
<tr>
<td>Irvine Apartments</td>
<td>51%</td>
<td>7%</td>
<td>10%</td>
<td>5%</td>
<td>($1.50)</td>
<td>$1,060,839,000</td>
<td>10%</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>36%</td>
<td>7%</td>
<td>9%</td>
<td>7%</td>
<td>($1.50)</td>
<td>$527,842,000</td>
<td>21%</td>
</tr>
<tr>
<td>South West Property Trus</td>
<td>47%</td>
<td>9%</td>
<td>12%</td>
<td>7%</td>
<td>($0.62)</td>
<td>$381,510,000</td>
<td>56%</td>
</tr>
<tr>
<td>Town &amp; Country</td>
<td>52%</td>
<td>2%</td>
<td>11%</td>
<td>7%</td>
<td>($1.00)</td>
<td>$545,510,000</td>
<td>23%</td>
</tr>
<tr>
<td>Walden Residential</td>
<td>48%</td>
<td>10%</td>
<td>11%</td>
<td>8%</td>
<td>$0.00</td>
<td>$363,788,000</td>
<td>38%</td>
</tr>
</tbody>
</table>

Two REITs, Essex and Walden, were not covered by Green Street Advisors but were included in the list because of their high debt levels and their high cost of equity (FFO yield).

The above list also contains the percent of institutional ownership and the market capitalization of the respective REITs. It is our hypothesis that the institutional ownership, pension funds and mutual funds, represent sophisticated real estate investors who are committed to real estate as an asset class. These investors, it is hypothesized, would be instrumental in voting for a merger if it was in the company's overall best...
interest. The following chart outlines the percent ownership in the surveyed apartment REITs.\(^5\)

<table>
<thead>
<tr>
<th>REIT</th>
<th>Percent Institutional Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amli Residential</td>
<td>24%</td>
</tr>
<tr>
<td>Apartment Investment &amp; Mngt. Co.</td>
<td>0%</td>
</tr>
<tr>
<td>Associated Estates</td>
<td>41%</td>
</tr>
<tr>
<td>Avalon Properties</td>
<td>59%</td>
</tr>
<tr>
<td>Bay Apartments</td>
<td>69%</td>
</tr>
<tr>
<td>Camden Property Trust</td>
<td>55%</td>
</tr>
<tr>
<td>Charles E. Smith</td>
<td>21%</td>
</tr>
<tr>
<td>Columbus Realty</td>
<td>49%</td>
</tr>
<tr>
<td>Equity Residential</td>
<td>52%</td>
</tr>
<tr>
<td>Essex Property Trust</td>
<td>29%</td>
</tr>
<tr>
<td>Evans Withycombe</td>
<td>25%</td>
</tr>
<tr>
<td>Gables Residential</td>
<td>38%</td>
</tr>
<tr>
<td>Irvine Apartments</td>
<td>10%</td>
</tr>
<tr>
<td>Merry Land &amp; Investments</td>
<td>25%</td>
</tr>
<tr>
<td>Mid-America Apartment Communities</td>
<td>32%</td>
</tr>
<tr>
<td>Oasis Residential</td>
<td>70%</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>21%</td>
</tr>
<tr>
<td>Post Properties</td>
<td>37%</td>
</tr>
<tr>
<td>Property Trust of America</td>
<td>20%</td>
</tr>
<tr>
<td>South West Property Trust</td>
<td>56%</td>
</tr>
<tr>
<td>Summit Properties</td>
<td>49%</td>
</tr>
<tr>
<td>Town &amp; Country</td>
<td>23%</td>
</tr>
<tr>
<td>United Dominion Realty</td>
<td>28%</td>
</tr>
<tr>
<td>Walden Residential</td>
<td>38%</td>
</tr>
<tr>
<td>Wellsford/Holly Residential</td>
<td>32%</td>
</tr>
<tr>
<td><strong>Weighted Average</strong></td>
<td><strong>35%</strong></td>
</tr>
</tbody>
</table>

*Source: Lehman Brothers REIT Valuation Handbook, June 12, 1995
Morgan Stanley, Quarterly Review: The Institutional Ownership of Selected REITs, June 9, 1995*

The weighted average institutional ownership is approximately 35%. Southwest Property Trust (56%), Essex Property Trust (29%), and Walden Residential (38%) are the three REITs that contain a significant percent of institutional ownership from our list of merger targets.

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\(^5\) The percent ownership was based on May 31, 1995 closing share price and the percent ownership contained in the SEC 13-filings. The percentage was calculated using the market capitalization based on the June 12, 1995 closing share price and the financial information reported in the Lehman Brothers REIT Valuation Handbook, June 12, 1995. The weighted average was calculated using the total market capitalization based on the June 12, 1995 closing share price. The authors note that there may be discrepancies in the reconciliation of the two data sources and apologize for any confusion.
It is also our hypothesis that a smaller REIT is not able to acquire a larger REIT because of the dilution of control associated with a stock transfer. Therefore, market capitalization is another way to isolate merger targets. As mentioned previously, the average market capitalization of apartment REITs is $725 million. Of our list of selected targets, Southwest Property Trust (approximately $380 million), Essex Property Trust (approximately $300 million) and Walden Residential (approximately $380 million) are the three REITs that we believe are the most likely to be merger candidates.
Chapter 6: Technical Issues Influencing Hostile Takeovers

Many industry analysts currently believe that Merger and Acquisition activity within the REIT sector is inevitable\(^5^4\). Current fundamentals, discussed in Chapters 1-5, make M&A an attractive vehicle for REITs to pursue. This chapter addresses how the REIT structure effectively governs the level of such activity. Many REIT specific issues must be addressed to fully understand the consequences of M&A to both parties. This chapter identifies the key issues and addresses the ability to undertake a hostile acquisition of a REIT. If the ability to pursue a hostile bid is not feasible, acquisitions will have to be negotiated and, thus many potential targets disappear. Additionally, the ability to pursue a hostile tender offer is a strong tool even during a negotiated purchase, as it is a key incentive to the target, and an advantage to the bidder. We have previously discussed how pricing inefficiencies within the REIT industry can be attributed to the REITs legal structure. These impediments, which discourage M&A activity and create management conflicts, could be the reason that many REITs trade at less than private market values. These same structural issues, if unavoidable, will force M&A activity to take the form of negotiated agreements which result in smaller gains to target shareholders (as discussed in chapter 3), and larger returns for the acquirer. If the agreement is negotiated, the market has less chance to influence the ultimate share price, and thus more of the merger gains go to the acquirer.

This chapter begins with a fundamental overview of the M&A process. REIT specific issues are then addressed.

\(^{5^4}\) The opinions throughout this chapter reflect statements, research, and analysis compiled at a seminar entitled Consolidations, Mergers and Acquisitions in the REIT Industry, June 15-16, 1995, The Manhattan Club, New York, NY., sponsored by Executive Seminars.
Acquisitions Overview

The acquisition of a REIT can take a variety of forms. A purchaser can acquire all of the target REIT's outstanding shares by making either a unilateral offer or a tender offer. In a unilateral merger, the acquirer makes an offer to the Board to acquire the entire company. The acquirer typically uses his own stock or cash or some combination of both. In a tender offer, the acquirer makes an offer directly to the target's shareholders. If the tender offer is successful it is followed by a merger, the follow-up merger is used to eliminate remaining minority shareholders. As a result of a merger one of the corporations disappears, with the shareholders either cashing out or becoming shareholders of the acquirer. Three party merger transactions can be structured, either forward or reverse, to use a newly-formed subsidiary to keep the acquired target separate. Mergers ordinarily require shareholder approval. In a tender offer, the offer will usually be conditioned upon the bidder acquiring sufficient shares to assure the vote for the merger.

Hostile Transactions

Takeover activities in which an acquirer pursues the target without the approval of the target's Board of Directors are known as a hostile transactions. Hostile transactions usually begin with what is known as a "bear-hug" letter to the target's Board of Directors. In the letter, the acquirer discloses to the Board its plans for a business merger and the intentions to go directly to the shareholders if a friendly deal cannot be reached. If the target Board does not wish to proceed to negotiate with the acquirer, it will reject the offer. At this point, the acquirer will proceed to launch a tender offer and/or a proxy solicitation directly to the target's shareholders. The hostile tender offer is usually conditioned upon the removal by the target Board of any obstructions to the acquirer gaining control of the target. After any restrictions have been removed, and the acquirer receives the required amount of tendered shares for it to gain control, the acquirer will purchase the tendered shares. With a controlling number of shares in hand, the acquirer is in position to take control of the target, either by replacing the existing Board through a written consent procedure, or through a merger called for by the acquirer as a shareholder.
The hostile offer will be accompanied by proxy or consent solicitations to bypass any shareholders rights plans or excess share provisions (discussed below) which limit the accumulation of shares.

**Tax Considerations**

A key issue in any merger/acquisition is the tax consequences of the deal. Tax issues often drive the final structure of the transaction. The form of the transaction, consideration offered, and timing of the transaction, are all tax sensitive issues. Sections 351 and 368 of the Code detail the methods available to undertake tax-free incorporation and reorganizations. Failure to qualify the transaction under an applicable non-recognition provision can result in taxable gain to both the shareholders and the REIT itself. REITs must be particularly careful in merger and combination transactions to structure the deal so as not to jeopardize its REIT status. Section 856 of the Code which addresses REIT qualification provisions must be carefully considered (detailed below).

**Anti-Trust Considerations**

The Hart-Scott-Rodino Act of 1976, as amended, requires that acquisitions of greater than $15 million be precipitated by a filing by both parties with the Antitrust Division of the Department of Justice and the Federal Trade Commission. The purpose of the Act is to allow the agencies to determine whether antitrust grounds warrant an attempt to block the transaction with a preliminary injunction in a federal district court.

The Hart-Scott-Rodino rules do not apply to the acquisition by one REIT of another REIT. 15 USC sec. 18a(c)(i) contains an exemption for real estate transactions in the ordinary course of business. This has been interpreted by a series of FTC letters to exempt REIT acquisitions of other REIT’s. As a result, subject to 13D\(^55\) filings and the

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\(^{55}\) Any person acquiring beneficial ownership of 5% of a class of securities registered under section 12 of the Exchange Act must file a Schedule 13D within 10 days of crossing the 5% threshold. Pursuant to
threshold ownership limitations in a target's charter, an open market buying program can be conducted without reference to antitrust filings or waiting periods. This position, however, is currently in flux and care should be taken in each transaction to ascertain the availability of the exemption.

**Securities Law Considerations**

During change of control transactions, the disclosure duties that normally apply to public companies are heightened. In addition, there are rules and regulations regarding disclosure which apply to changes of control and potential changes of control. Any accumulation of 5% or more of the shares of a publicly-traded REIT must be disclosed. It is important to be aware of the activities of all corporate insiders regarding the leakage of non-public information. Such leaks, even inadvertently, can result in large personal liability. Tender offers must be accompanied by required disclosure documents, and held open for at least 20 business days. The target must respond within 10 business days of the tender offer, and explain the Board's deliberations with respect to the offer, including any fairness review by the Board's financial advisor.

**REIT Specific Issues**

Umbrella partnership REITs ("UPREITs") were created as a means to achieve tax deferral upon the contribution of property to an operating partnership in exchange for umbrella partnership units. UPREIT units have subsequently become an effective bargaining currency for REITs in the acquisition of additional property and potentially as currency in the acquisition of other REITs.

The typical umbrella partnership REIT involves a publicly-traded REIT as the general partner of the umbrella partnership and the REIT's sponsors as limited partners of the umbrella partnership which owns the real estate. The UPREIT structure is used to

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Schedule 13D, the "purpose" of the acquisition must be disclosed (i.e., intent to acquire control), source of financing and certain information regarding acquirer's background.
circumvent tax recognition events which would occur if appreciated properties were
directly contributed to a REIT in exchange for readily marketable REIT shares. The
UPREIT structure creates several important issues in merger and acquisition transactions.
Careful attention must be given to the UPREIT's limited partners in the operating
partnership and the operating partnership itself. Typically the operating partnership
limited partners are significant shareholders and would face an extensive tax burden were
a taxable event to take place. The dissolution of the operating partnership, the repayment
of the operating partnership debt, or the sale of the operating partnership's assets, are all
events that would create taxable recognition to the contributing partners. Avoiding these
potential tax consequences is typically the reason for using the UPREIT structure in the
first place. These issues, along with the fact that the limited partners subject to such tax
consequences are usually significant owners, become driving issues in the structure of
any merger or acquisition of an UPREIT. To avoid such tax consequences, several
structural alternatives are available. Two UPREITs can merge through two separate
merger transactions. The two REITs which are the corporate general partners merge, and
the two operating partnerships merge. This scenario was used in the merger of Horizon
Outlet Centers, Inc. and Horizons Outlet Centers Limited Partnership with McArthur
Glen Realty Corp. And McG Outlet Centers Limited Partnership. A second way to avoid
the tax consequences of the merger of a REIT or UPREIT with an UPREIT would be to
structure the deal such that the REIT or UPREIT "A" acquires or merges with the
UPREIT "B" without acquiring or merging with the UPREIT "B"'s operating partnership.
Additionally, the assets of an UPREIT could be contributed to the acquiring UPREIT's
operating partnership in a section 351 exchange for limited partnership units in the
operating partnership.

Transactions which involve UPREITs are subject to potential conflicts of interest
between the REIT shareholders and the limited partners of the operating partnership.
These conflicts of interest are inherent in the UPREIT operating structure, and will
become more evident in merger transactions. Merger transactions potentially contradict
both the limited partners tax avoidance objectives and the control necessary by the
limited to insure such objectives. In a merger transaction, one of the two management teams will lose control. In this situation, a UPREIT manager could lose control of the UPREIT's assets, and thus be subject to large tax consequences at the decision of the new management to sell certain heavily depreciated assets. This possibility is one of the major reasons that UPREIT management will seek to entrench itself with voting control and anti-takeover provisions. In this scenario, maximizing shareholder wealth has different meanings to management and outside equity shareholders.

Control of Management Company

REITs typically have subsidiary management companies which operate the REIT's assets. These management entities are usually structured because of the requirements of section 856(c), which requires that more than 90% of the voting stock is held by the REIT's sponsor or management even though the majority of the economic interests belong to the REIT. In an acquisition, the bidder will need to insure they can get control of the management company. As discussed, in chapter 4, the Wellsford - Holly transaction was conditioned on the transfer of the voting stock of the target's management subsidiary to the acquirer. In a hostile situation, where the target's management controls the management company, a merger will be much more difficult to complete.

Section 856 REIT Qualification Requirements

In any transaction involving a REIT, the deal must be structured not to violate the qualification requirements of section 856(a) of the Code. The specific areas of concern are (i) the "not-closely-held" or "5/50" requirement, (ii) the REITs related excess share provisions, (iii) the 100 shareholder requirement, and (iv) the REIT income and asset tests of section 856(c) of the Code. The 5/50 rule states that 5 or fewer individuals cannot own in excess of 50% of the value of a REIT's outstanding stock at any time during the last half of the REIT's taxable year. This requirement is not typically problematic when a REIT is acquiring or merging with another REIT, because of the "look-through" provision of section 544(a) of the code. The look-through provision provides that when applying the 5/50 test to a REIT of which a corporation owns stock, the shares owned by
the corporation are treated as being owned by the corporation's shareholders. The 100 shareholder rule of section 856(a)(6) requires that the beneficial ownership of a REIT must be held by 100 or more persons during 335 days of the taxable year. The 100 shareholder rule is not subject to the look-through provisions as applied to the 5/50 rule. Further restrictions imposed by section 856(c) regarding the kinds of assets and securities REITs can own and the type of income REITs may earn, can further complicate a merger transaction. This depends on the existing structures and incomes of the combining firms. Also rules regarding the holding period prior to asset disposition may effect the acquiring firm's ability to dispose of unwanted assets from the merger.

**Takeover Defenses**

As discussed, there are many anti-takeover devices and strategies available to the directors that can be implemented either before or after a takeover attempt arises. The courts have allowed anti-takeover actions after a takeover attempt begins, under what is known as the business judgment rule. However, such actions will be subject to a higher level of scrutiny than the same actions taken prior to the takeover bid\(^\text{56}\). Therefore, if a company wishes to increase its ability to successfully fend off a takeover attempt, it is wise to adopt a long-term strategy with such concerns in mind.

**Excess Share Provisions**

Excess share provisions are typically in a REIT's articles of incorporation with the intention of protecting the REIT from violating the 5/50 rule. The provision restricts the number of shares that any shareholder can own to 9.8%. As discussed prior, the 5/50 rule provides that five or fewer individuals are not allowed to own in excess of 50% of the shares of a REIT during the last half of the REIT's taxable year. A typical excess share provision would provide that any shares purchased by a shareholder in excess of the 9.8% restriction are stripped of all rights to vote or receive dividends. Such shares get back

\(^{56}\) See Moran, 500 A.2d @ 1350; Unocal, 493 A.2d @ 953-54.
these rights when they are transferred to a shareholder who does not violate the restriction. An excess share provision will typically provide the board of directors the discretion to waive the provision with respect to a particular shareholder, if the board believes the shareholder is not an individual for purposes of section 542(a)(2a) of the Code. Excess share provisions can be a powerful deterrent to hostile bids, if they are used to limit the acquirer's ability to accumulate more than 9.8% of the shares.

The big question facing the board when a hostile takeover situation arises is at what point do they have a duty to waive the provision. The law is not established on this point and courts have rejected and upheld different board decisions which refused to waive excess share provisions. It appears that excess share provisions adopted prior to a takeover bid which give the board discretionary power to waive the bid are more likely to be upheld. Conversely, where an excess share provision is adopted in response to a hostile bid, the court will be more likely to find the action beyond the scope of the board's authority. The courts seem more likely to permit an excess share provision to the extent that it is necessary to protect the REITs status, as opposed to where the provision is merely a tool to insulate management from takeover actions.

It must be noted that many of the excess share provisions are written into the articles of incorporation and thus adopted by the shareholders. Further, many prospectuses of modern REITs justify the excess share provision as a means of insuring compliance with section 856 of the Code, and only mention takeover defenses as an incidental or collateral

57 This is the "look-through" provision as discussed infra.

58 See; Realty Acquisition Corp. Fed.Sec.L.Rep.(CCH) ¶95,245 which upheld Property Trust of America's decision to refuse to waive its excess share provision when under hostile takeover attack from Realty Acquisition Corp.

59 See; Pacific Realty Trust v. APC Investments, Inc., 651 P.2d 163., where the court found the directors to have exceeded there authority when they adopted a excess share bylaw provision without shareholder approval in an attempt to block a partial tender offer by APC Investments, Inc.
effect. Such provisions seem vulnerable to attack from a bidder whose accumulation of shares will not threaten the tax status of the target.

Rights Plans

A share purchase rights plan, which is commonly referred to as a "poison pill", is intended to help a target firm repel uninvited bidders. Where the excess share provision is a temporary bar to voting and dividend rights, which cease as soon as the shares are transferred, the rights plan provides the threat of a permanent dilution of shares. Basically, a rights plan distributes a right to shareholders that allows them to buy additional shares under certain defined circumstances. The plan will vary between companies, but the underlying function will be that they are activated by events that signal a unsolicited change in control of the company by a hostile bidder. The hostile bidder, who is typically restrained from taking advantage of the rights offered by the plan, is generally defined as a bidder whose offer is not approved by the board. Typically, a bid must be approved by two-thirds of the board for it to be deemed friendly. In such instance, the rights plan becomes redeemable. The most common variations on a rights plan are referred to as "flip-in", "flip-over", "flip-out", and "back-end" pills.

Flip-in rights allow shareholders to buy additional shares, at a price significantly higher than the current market price. However, once a hostile bid arises, the flip-in rights become alive and the terms become far more attractive. Most flip-in pills become alive once a hostile bidder acquires a given percentage of shares and/or begins a tender offer for a given percentage. Once the pill "kicks-in", purchase of shares become more attractive. Typical pills allow holders to purchase two shares at the originally inflated price, or two shares at the then per share market price. The goal of the plan is to increase the number of outstanding shares and thus dilute the acquirer's position and increase his costs to gain control.

Flip-over pills are a second line of defense and usually kick-in once the acquirer has successfully gained control of the target. The flip-over provision allows target shareholders to buy shares of the acquirer at a discount. The purpose is to warn hostile
bidders that they risk dilution of their own shares should they activate the flip-over. Most rights plans offer both flip-in and flip-over rights. If the flip-in is not successful, the flip-over takes effect.

Flip-out pills allow shareholders the rights to buy shares in the target's subsidiaries and divisions should a hostile attempt kick-in the plan. This effectively leaves a hostile bidder with nothing but an empty shell.

Back-end pills are intended to straddle the target with debt, thus making it unattractive to a hostile bid. Once the back-end pill kicks in, debt securities are distributed to the holders. A successful takeover would then leave the hostile acquirer liable for the newly issued debt.

Rights plans must be properly drafted such that they comply with the firm's charter and state law if they are to survive judicial scrutiny. As discussed prior, in regards to the excess share provision, the scrutiny given a rights plan will depend on the method and timing of its adoption⁶⁰. A rights plan becomes more important when the bidder does not jeopardize the REIT's tax status, and thus the excess share provision becomes subject to attack as discussed above.

Defensive Charter and By-Law Provisions

These provisions include: Fair-Price provisions (which require equivalent payments if there is a two-tier bid, and thus protect against front-end loaded offers) and By-Law provisions (which govern the shareholder's ability to nominate directors and submit proposals). Such provisions are not intended to prevent hostile bids, but to define how such a bid is structured.

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⁶⁰ See Unocal, Id., also Moran v. Household International, Inc., 500 A.2d. 1346 where the court upheld a flip-over provision
Employment Agreements "Golden Parachutes"

Designed to protect senior management in the event of merger, these provisions are justified as a means to insure management's participation in share value maximization. When takeovers are attempted as a vehicle to create value by replacing inefficient management, the process will often be hostile. Hostile acquisitions, however, become both coercive and persuasive\(^{61}\). The hostile bid is coercive because by going over the heads of the incumbent target managers straight to shareholders, the bidder is able to remove these managers against their will. Where internal controls have failed, takeovers can often succeed. The hostile bid is persuasive when hostile takeovers are accompanied by large separation payments to managers of target companies ("golden parachutes"). The purpose of which is to attenuate the opposition of managers to the bid. As discussed prior, hostile takeovers are an effective way for shareholders to get rid of non-value-maximizing managers.

Passive Responses

A target under hostile takeover attack may be in a situation where it can simply refuse to respond to the acquirer's advances. The standard for response is determined by the bid and if it calls for a change in control\(^{62}\). Once any offer has been made however, in reality the firm is in play and the likelihood of competing bids which require control rises.

State Anti-Takeover Statutes -

States adopted anti-takeover statutes become another potential source of protection for a target REIT. Maryland anti-takeover law\(^{63}\) becomes effective if prior to a takeover bid, an

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\(^{62}\) The QVC standard requires that a proposal calling for a change of control is subject to advanced scrutiny beyond the business judgment rule (i.e. Unocal standard).

acquirer gains control of a block of shares in excess of 20% in a Maryland corporation. The statute provides that the controlling shares are stripped of their voting rights unless two-thirds of the target's shareholders other than the acquirer, officers or employee-directors vote otherwise at a meeting specially called for such purpose. The Maryland statute allows corporations to opt out of its protection through a charter or bylaw provision. The law basically prohibits a Maryland corporation from entering into a business combination transaction with a stockholder who acquires ten percent or more of the corporation stock within 5 years of such acquisition, unless the corporation's board approves the transaction before the 10% acquisition.

Rights of Limited Partners in UPREITs

Most UPREITs typically provide that the sponsors have the right to put, to the REIT general partner, their limited partnership units in the UPREIT's operating partnership. The REIT typically has the right to choose between cash and REIT shares as the consideration for the limited partnership units. Because of the large blocks of shares that the sponsors usually have, the put rights become a valuable anti-takeover device. However, as described prior, unless the exercise of such rights is properly structured, there could be significant tax consequences. It is also common for UPREIT partnership operating agreements to provide that sponsors have rights to veto transactions which would result in the sale of substantially all of a REIT's assets in a taxable transaction or the merger of the REIT with another entity in a taxable transaction. As explained prior, it is possible to structure UPREIT mergers such that they include the operating partnerships and thus don't create large tax consequences to the UPREIT sponsors (operating partnership limited partners). These issues further highlight the conflicts of interest that the UPREIT structure contains. The sponsor/limited partner's tax consequences may encourage them to veto a transaction that is in the best interests of the shareholder limited partners.
Control of Separate Management Company

Additional takeover protection might be found in the agreements between a REIT and its separate management company. When such a relationship is present, the terms of the agreement and the voting rights of the manager may hinder the ability of an acquirer to successfully undertake a hostile acquisition. Often the sponsors hold the management company voting stock, and for a hostile takeover to take place the sponsors may have to give up ownership of their voting stock. An issue with respect to the use of management company control as a takeover defense is whether the holders of the management company's voting have a duty to cooperate in the consummation of a takeover.

Conclusion

Given the REIT structure, it appears that a REIT which wishes to avoid a hostile tender offer has the ability to do so. Although, it is possible for an acquirer to attempt a hostile bid, such bid would probably have to turn friendly to consummate the deal. The costs, and uncertainties of a legal battle, make such efforts unlikely, given the limited return offered by the REIT takeover. Even when trading at below private value, the spread between values may not warrant an expensive and time consuming hostile attack. Further, because a REIT must hold assets for specific time periods in order to maintain REIT status, the ability to liquidate target properties is limited. This is likely to limit the premium an acquirer is willing to pay.
Bibliography


76. Moody's Industry Outlook; Real Estate Investment Trusts (REITS) Review and Outlook May 1995


