REITs & Market Power:  
An Analysis of Market Power Theory and Antitrust Policy

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ABSTRACT

During the late 1980's and early 1990's, Real Estate Investment Trust ("REITs") accumulated large portfolios of properties. During this period, REITs were able to grow through acquisitions alone, arbitraging their low cost of capital relative to private asset valuations. This changed the real estate industry and for the first time, real estate entities have concentrated ownership in an industry traditionally characterized by fractionalized ownership. Today, there is tremendous pressure from the public markets for REITs to continue to grow. This has lead the management of REITs to seek alternative growth strategies. These strategies include cost economies of scale, branding, growth of non-real estate related revenue, vertical integration, and exertion of market power.

This thesis studies market power in real estate, focusing specifically on whether REITs are currently exerting market power. The first part of the paper reviews the economic theory of market power and the antitrust laws. Economic concepts such as elasticity of supply, elasticity of demand, barriers to entry and market contestability are examined in a real estate context. The antitrust laws and the government's definitions of market power and relevant markets are reviewed and applied to the real estate industry.

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CHAPTER 1
INTRODUCTION

I don't want 20% of northern California. I much prefer 50% to 90% shares of particular submarkets. The market-share goal has never been addressed in real estate. It's been a fragmented business, a building here and a building there. My advantage is having ten buildings in a submarket instead of one. Guess who sets the rents? I do. And the real estate brokers have to deal with me. I am the market.1

-- Warren (Ned) Spieker, Jr., Chairman of Spieker Properties

[Crescent] acquires markets, not buildings.2

-- Gerald W. Haddock, Chief Operating Officer of Crescent Real Estate Equities

Real Estate Investment Trusts (“REITs”) have accumulated a tremendous portfolio of property during the mid-1990’s. The disintermediation that resulted from the real estate crash of the late 1980’s and early 1990’s left many firms looking for alternative ways to recapitalize. Many real estate companies turned to the public markets. The REITs that are now in dominant positions were able to utilize the advantage that easy access to public capital offered. During this period, REITs were able to grow through acquisition alone, arbitraging their low cost of capital relative to private asset valuations.

The result is that the landscape of the real estate industry has changed. For the first time, real estate entities have concentrated ownership in an industry traditionally characterized by fractionalized ownership. In addition, there is tremendous pressure from the public markets for REITs to continue to grow. This has resulted in a shift in how real estate investment strategy is viewed – from a passive asset by asset strategy to a more dynamic strategic positioning of asset portfolios. The strategies that REIT management currently employ include cost economies of

1 Robert Lenzner and Carrie Shook “The unstoppable REIT juggernaut” Forbes 12/29/97 Page 68
2 Stephanie Anderson, Richard A. Melcher, Kathleen Morris and Suzanne Whoolley “The New World of Real
scale, branding, growth of non-real estate related revenue, vertical integration, and exertion of market power.

The accumulation of concentrated portfolios and the dynamic management of real estate assets by REITs are changing the theoretical context in which real estate is viewed. Concepts such as market power, which until recently, were not thought of as relevant to the real estate industry, are now viable topics. As the introductory quotes illustrate, not only is market power a hypothetical possibility, it is an explicit strategy of some REITs.

We review the economic theory of market power to educate readers on the economic fundamentals required to exert market power. While having high market shares is a significant component of market power, other economic concepts such as elasticity of supply, elasticity of demand, barriers to entry, and market contestability are all important when evaluating the potential for market power to exist. Thus, we will explain these economic concepts in general terms and then relate them to the real estate industry.

Because real estate ownership has traditionally been fractionalized, the government’s current position is that real estate transactions do not raise antitrust concerns. However, with REITs stating market power strategies and becoming more geographically concentrated through mergers and acquisitions, the possibility of antitrust issues being raised exists. Thus, we review and summarize antitrust laws both generally and in a real estate context.
CHAPTER 2
AN ANALYSIS OF MARKET POWER & ANTITRUST POLICY IN THE REAL ESTATE INDUSTRY

Introduction

Traditional real estate economic theory has not addressed issues of market failure due to monopoly and concentration of ownership. Therefore, we will first concentrate our discussion on the broad perspective of monopoly market theory, exploring the concept of market power. Emphasis will be placed on the elements that influence the ability to exert market power. These elements include market share, elasticity of demand and elasticity of supply. The determinants of the elasticity of demand and supply, such as product substitution, barriers to entry, contestability of markets and the consumer’s ability to exit a market, will be explored in a real estate context. Given this background we will then explore the possibility of market power in the real estate industry. We will conclude this section by examining how market power is measured in a theoretical sense and in antitrust law.

The above discussion on monopoly market theory will provide a broad theoretical framework from which we will then review pertinent antitrust policy and its relevance and future application to the real estate industry. The review of the antitrust laws will highlight the government’s definitions of market power, product markets and geographic markets. The review will also encompass how concentration is measured in an industry and how it has evolved. This section will conclude by outlining the Federal Trade Commission’s (“FTC”) position on real estate and its related transactions including the FTC’s current statues that exempt real estate from antitrust reporting requirements.
Monopoly Theory

On the simplest level, a monopoly is defined as a market with a single seller or producer and many buyers. It is in markets characterized by monopolies that we traditionally think of the concept of market power. A monopoly sets the price and the quantity produced and faces no threat of competition, thus guaranteeing profits. Economists define market power as the ability to charge a price above marginal costs, where marginal cost is the cost of an additional unit of production. Unlike firms in competitive markets producing where marginal cost equals price (which is given), a monopolistic firm’s profit maximizing behavior is to produce at a quantity where marginal cost equals marginal revenue. In this case the monopolist is able to extract a profit equal to the difference between the price charged the consumer and the marginal cost. 3

The ability to extract monopoly profits comes with a social cost which is referred to by economists as a deadweight loss. Deadweight loss has two components. First, there is the loss to consumers because they are over paying relative to competitive market prices. Second, there is the social cost that results when production is at a level below what would be demanded in a competitive market, resulting in an unfulfilled demand. 4 Limiting this deadweight loss is the objective of present day antitrust policy.

This simple scenario of a monopoly is rarely seen in the US economy (although some exist in regulated industries such as utilities), and is extremely unlikely to occur in the real estate industry given the traditional dispersion of ownership. The practical application of monopoly market theory is found in markets that are dominated by a single firm or in markets characterized by having a few dominant firms that behave in an oligopolistic manner. Oligopolies are where a few firms have large market shares that in the aggregate approach monopolistic levels. In these

markets the question for economists and the antitrust regulators becomes whether, and the degree to which, firms are able to exert market power.

The ability to exert market power is a factor of three elements: market share, elasticity of demand and elasticity of supply. Market share is the most obvious component, without a significant market share, market power is unlikely. The threshold at which market share reaches the point for market power to exist depends on both the elasticity of demand and the elasticity of supply of the market.

**Elasticity of Demand**

Elasticity of demand measures the responsiveness of quantity demanded to a change in price. In other words, if a firm raises prices, how much will sales decline? The more elastic the demand curve for a particular product, the more severe the consumers reaction to the price increase resulting in a decrease in sales. Therefore, in the presence of an elastic demand curve the firm is unable to exert market power. If a firm has the ability to raise prices without realizing an offsetting loss in sales, demand is considered inelastic. In this case the firm’s increase in profits due to the higher prices is not out-weighed by the loss in sales; therefore, a firm is able to exert market power. The concept of elasticity of demand can be thought of within the real estate industry by breaking it into some of the factors that influence real estate demand. These factors include product substitutability and the ability of tenants to exit the market.

The greater ability or willingness of real estate consumers to substitute one real estate product for another, for example, Class A office versus Class B office, the more elastic the demand curve. The range of substitutability of product varies widely from market to market and

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sector to sector. For example, a law firm located in an office tower downtown is not likely to move to a suburban office park if faced with excessive rents. This is because of the value the law firm perceives in the prestigious address or the agglomeration effects of being located in close proximity to related firms. In contrast, a consumer in the apartment sector might be willing to consider additional options such as purchasing a condominium.

The ability of a consumer to exit a market also affects the elasticity of demand. In the real estate industry there are two market definitions, the product market and the geographic market. In the apartment sector, if rents approach a level were it makes economic sense to purchase a home a consumer will exit the product market. The other form of exit is geographic, for example in the apartment sector a consumer may decide to relocate to another market where rents are less expensive and incur the additional cost of commuting. Thus, the consumer has exited the geographic market.

**Elasticity of Supply**

The elasticity of supply is the percent change in production for a given change in price.6 In other words, it addresses the question of how quickly will additional supply enter the market when there is an opportunity to realize excess profits. If supply is inelastic an existing firm in the market can enjoy excess profits without fear of competition. In contrast, if a firm is in a market that is characterized with elastic supply any attempt by the firm to raise prices will result in new supply entering the market and a loss of market share. The factors that determine the elasticity of supply in the real estate industry are the barriers to market entry and the contestability of markets.

An example of barriers to entry in the real estate industry is land regulation policy. The
greater the restrictions that land use regulation has on new development the longer it will take to bring a new product to the market. If a firm had a significant market share, and therefore little existing competition, rents could be raised above competitive levels with little threat of new product arriving on the market in the short run. The barrier to entry in this example creates an opportunity for the owner of real estate to exert market power. In this example, supply is inelastic in the short term during the regulatory induced development lag.

Contestability of a market is similar to barriers to entry - in both cases the level of competition is limited. In the case of contestability, the restriction on competition results from a structural characteristic inherent in a given market. A market is considered perfectly contestable if entry and exit are costless. The Manufactured Homes industry is the closest example in the real estate industry in which entry and exit are costless. Manufactured homes can be easily moved from one market to another quickly and with minimal expense. Therefore, in this example supply is elastic.

**Market Power in Real Estate**

Are the market and economic fundamentals in place for market power to be an issue in the real estate industry? Although real estate traditionally has not been viewed as an industry characterized as an oligopoly or one dominated by a few firms, on a market-by-market basis the trend appears to be headed towards consolidation of ownership. The next step in exploring the market power issue is developing an understanding of the economic characteristics of the real estate industry – what are the demand elasticities for various sectors of the industry? What is the character of elasticity of supply? These questions are difficult to answer because the elasticities

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7 Case and Fair, p.368.
differ over time and by geographic market. Therefore, we will use generalities as a context to explore whether real estate firms have the potential to exert market power.

The degree of substitutability of product vary. A consumer in the apartment sector has many product options. Consumers are willing to relocate to other communities if the benefits out weigh the cost. For example, an individual may be willing to commute an additional fifteen minutes to work if the savings in rent out-weigh the cost of the commute.

Space consumers in the office sector vary in their willingness to substitute office product. The executive offices of well established financial firms value a prestigious address downtown. They are not likely to relocate to another market or product type if faced with excessive rents. However, start-up firms are extremely price sensitive and tend to move to office space in markets with the least expensive rents.

The consumers (the tenants) in the retail sector are least likely to look for substitute product. Demographics generally drive the location of regional and super-regional malls. Specialty shops rely on the synergies that result from being in close proximity to an anchor tenant and benefit from a landlords interest in controlling the tenant mix. These synergies rarely occur outside the controlled setting of a mall. In addition, a region can only support a limited number of malls and these malls are found in prime locations to insure their success. Once a regional or super-regional mall is established entry is difficult. Therefore, a specialty store interested in entering a demographic market has few choices.

Restrictions on the ability of consumers to exit a given market enhance a firm’s ability to exert market power. The real estate industry is characterized by contracts and leases. The length of lease terms will have a direct influence on a tenant’s ability to relocate. Residential leases tend to be short-term (one year in length). As such, renters can move between markets relatively
quickly in response to cheaper supply or changes in the community, such as increased congestion or improvements in the school system.

Office leases tend to be five to ten years in length which limits the speed that a particular market can fall out of favor. Often office consumers choose to locate in a market because of the agglomeration value of being in close proximity to related firms or competitors. The length of the lease term has a direct impact on the likelihood of a market with agglomeration synergies, such as a financial district, to relocate to another area of the city. If a market offering agglomeration synergies is controlled by one firm and there are barriers to entry, above market rents can be charged in an amount equal to the present value of the agglomeration benefits. In response, firms may begin to relocate but due to the length of leases in place it could be as long as ten years for a complete transformation of a submarket from one area to another. A firm is also likely to encounter first mover problems, where no one is willing to incur the loss of agglomeration synergies in the short term and they wait for everyone else to relocate. The degree to which real estate consumers are willing to exit a market when faced with above competitive level rents will have a direct impact on a firm's ability to exert market power.

In the short run, barriers to entry can influence the real estate markets. Land use policy, zoning, and the availability of land all affect the length of the development lag. The development lag varies from sector to sector. The development of enclosed malls can take several years and involve re-zoning, infrastructure improvements, extensive design processes, and a lengthy construction period. By contrast the development of an apartment building is generally much quicker, as little as a year. Often existing zoning allows apartment buildings, and the design and construction periods are less intensive. During these development lags an owner in a dominant position can charge above market rents until the arrival of new product
forces a reduction of rents back to competitive levels. In the short run, the current state of the economy becomes a significant factor. If rents are below replacement costs, a dominant firm can raise rents above competitive levels, but below a level at which it is feasible to build new product.

In the long run there are few barriers to entry in real estate markets. Many of the frictions that create barriers to entry in the short run such as the approval/permitting process, land use regulations, and scarcity of developable land can be overcome with time. Land can be redeveloped for its highest and best use, land use policy can be modified or compromises can be reached, resulting in the supply and demand of real estate entering equilibrium.

Barriers to entry generally tend to be action or regulations that act to limit competition, premeditated or unintentional. The contestability of a market depends on the inherent structure of a market. If there are no structural characteristics that restrict competition a market is considered contestable. In general real estate markets are freely contested. Anyone with capital can enter the office or apartment market. The retail sector is an exception. Structurally a geographic market can support a limited number of regional and super-regional malls. Once a market has reached a saturation point with all prime locations occupied it is economically risky for new entrants, thus reducing the contestability of the market. The limited number of malls within a given market allows the accumulation of significant market share to be achieved relatively quickly. This coupled with the fundamentals that limit new entrants, the ability to control markets appears to offer the most potential in the retail sector.

The character of supply and demand in the apartment sector make it unlikely that a firm will be able to exert market power. This sector faces low barriers to entry and can be freely contested. The office sector has the potential for market power to exist in some submarkets
during short term frictions. In the long run there are few barriers to entry and entire submarkets can relocate when faced with above market rents. The retail sector has the greatest potential for market power. This sector is the most difficult to enter because a geographic market can only support so many malls. As such, there is low product substitution and high barriers to entry.

**Market Power Measured - Theory**

Although a market may have the characteristics that allow market power to exist, the challenge for economists and antitrust courts is measuring the magnitude of the market power. The Lerner Index is a measure that relies on knowledge of either a firm’s marginal costs or the firm’s elasticity of demand. The relationship between the two is depicted in the following expression.

\[
\frac{(P - MC)}{P} = \frac{-1}{E_d}
\]

<table>
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<th>The Equation</th>
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<td>[\frac{(P - MC)}{P} = \frac{-1}{E_d}]</td>
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<th>The Variables Defined</th>
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<tr>
<td>P = price</td>
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<tr>
<td>MC = marginal cost</td>
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<td>E_d = the elasticity of demand</td>
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The index yields a value between zero and one. Competitive markets result in an index value of zero, in this case price equals marginal cost, therefore the left-hand side of the expression equals zero. In perfectly competitive markets the demand approaches infinity, thus the relationship holds – the right-hand side of the equation equals zero. In the extreme case of market power the
demand curve is vertical and therefore, the elasticity of demand equals negative one and the monopolist sets a price regardless of marginal cost.\(^8\)

Lerner’s simple measure of market power presents several problems if applied to the real estate industry. The elasticity of demand in real estate, whether it is apartment, retail or office space, is not easily determined. These difficulties are in part due to the fractionalized ownership of real estate, where a firm’s demand curve is not the market demand curve. The variance in supply and demand from short term to long term compound the problems of quantifying elasticity of demand. An index value could be determined if marginal cost was known. Marginal cost is a concept that in practice is easily determined on the assembly line however in real estate determining the cost of an additional unit of production is somewhat challenging. The industry is characterized by development lags that prohibit simply adding a unit of production (i.e. an additional square foot of office space).

Where the Lerner Index measures market power of an individual firm, the Herfindahl-Hirschman Index (“HHI”) attempts to measure the market power within an industry or market. The HHI index sums the squares of the market shares of all firms in the relevant market to arrive at a statistical measure of concentration. The impact of a horizontal merger within a given industry can be evaluated by comparing the HHI pre and post merger.\(^9\) Because the HHI is easier to quantify than the Lerner Index it has been incorporated by antitrust courts in their analysis of market power. The HHI will be discussed further in the antitrust section of this chapter.

The difficult task of determining whether market power exists in practice is the

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\(^{8}\) Landes and Posner, p. 939-941.

responsibility of the Federal Trade Commission and the Department of Justice who are charged with the responsibility of enforcing antitrust laws. These laws were implemented to limit the social costs that is a product of market power. These antitrust laws and their application in the real estate industry is the subject of the next section.

**Review of Antitrust Laws**

Federal antitrust regulation is everywhere, with virtually every business of significance falling within its reach. However, antitrust regulators historically have not found the real estate field and its related transactions of interest. This lack of antitrust regulation in real estate is probably due to the belief that there are many real estate transactions in markets that are generally unconcentrated. However, just because real estate has not raised antitrust concerns in the past does not mean real estate business is exempt from antitrust law. As REITs continue to grow through mergers and acquisitions and the real estate market becomes concentrated for the first time, antitrust regulation and its consequences may become a relevant issue in real estate transactions of the future.

The antitrust laws were instituted to declare monopolies and trade restraints illegal and to regulate mergers and acquisitions that may reduce competition. The most notable antitrust laws are the Sherman Act, the Clayton Act, the Federal Trade Commission Act and the Hart-Scott Rodino Antitrust Act.

In 1890, Congress passed the Sherman Act, which is the basis of all antitrust laws. The two most important provisions of the act are found in Section 1 and Section 2. Section 1 states every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal.
Section 2 states every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty. ¹⁰

It is important to highlight that the Sherman Act focuses on the act of monopolization, not on the existence of a monopoly. The act of monopolization is different because it requires the possession of monopoly power in the relevant market, and the willful acquisition or maintenance of that power. It is possible for a company to possess monopoly power and not be in violation of the Sherman Act, if the monopoly power was achieved through the growth or development of a superior product or business acumen.¹¹ It is the willful acquisition or maintenance of that monopoly power which is deemed illegal.

For example, if a REIT has a high concentration in a market it does not necessarily mean the REIT is in violation of the Sherman Act. The government would have to prove the REIT was acquiring market share with the stated intent to dominate the market and/or maintain its market share to be found guilty of the act of monopolization under the terms of the Sherman Act.

Enforcing the Sherman Act has raised interpretation problems, such as what types of acts were considered “in restraint of trade”. The Supreme Court responded in 1911 when it introduced the Rule of Reason to determine whether a particular action was illegal (“unreasonable”) or legal (“reasonable”) within the terms of the Sherman Act.¹² The court made it clear not every action that restrained trade was illegal, only those that were deemed unreasonable.

In response to the issues surrounding the Sherman Act and the difficulties in its interpretation, Congress passed the Clayton Act in 1914. The Clayton Act was designed to

¹⁰ Case and Fair, p. 380.
strengthen the Sherman Act and to clarify the Rule of Reason. The Clayton Act, as amended by
the Robinson - Patman Act of 1936 and the Celler-Kefauver Act of 1950, prohibits specific
monopolistic behaviors, such as tying contracts, discrimination among customers through prices
or other means, and prohibits mergers or acquisitions of one firm by another, whenever the effect
may be to substantially lessen competition.

At the same time congress passed the Clayton Act it also passed the Federal Trade
Commission Act. This act provided the government with an agency, the FTC, that has the power
to investigate possible violations of antitrust legislation and issue orders forbidding unfair
competition practices. Currently, all antitrust issues are under the jurisdiction of the FTC and the
Antitrust Division of the Department of Justice ("DOJ").

The above mentioned laws effectively outlaw monopolization; however, they do not
address the prevention of mergers or acquisitions of companies that may produce a monopoly.
Congress addressed this issue when it passed the Hart-Scott Rodino Antitrust Act ("HSR") in
1976. The act’s main objective was to institute reporting guidelines for an entity contemplating a
large merger or acquisition. The HSR act enables the government to review a merger before it is
consummated and proactively halt the mergers and acquisitions that may substantially lessen
competition. Under the reporting guidelines instituted by the HSR act, the merging entities must
file premerger reports with the FTC and the DOJ and wait a specified period of time before
consummating the transaction.\textsuperscript{13} It is the government’s belief that it is easier to stop a merger or
acquisition from occurring than undoing one that has occurred.

The FTC, with the concurrence of the DOJ, has the right to exempt transactions or
required waiting periods that are not likely to violate the antitrust laws and to create rules which

\textsuperscript{12} Case and Fair, p. 380.
\textsuperscript{13} "FTC Enacts New Exemptions from Merger Regulations; Plan will Ease Regulatory Burden on Business"
may be necessary to carry out the intent of those laws.\textsuperscript{14} As a result, the FTC has created premerger notification rules which contain exemptions from the reporting requirements and waiting periods outlined in the HSR. However, it is important to note that although the transactions may be exempt from the reporting requirements of the HSR, the transactions are not exempt from the antitrust laws.

**Merger Guidelines**

In 1968 the DOJ and FTC issued merger guidelines to attempt to clarify the antitrust laws. The stated purpose of the guidelines is to identify economic dangers posed by mergers that “may create or enhance ‘market power’ or ... facilitate its exercise”.\textsuperscript{15} Market power is defined as the ability to profitably raise prices above competitive levels for a significant period of time. The guidelines have been amended several times over the years with the most recent rendition being 1992. The 1992 merger guidelines attempt to define and clarify the relevant market, which is often the most crucial issue of an antitrust suit. Briefly stated, the product and geographical market are defined as the smallest group of products or geographical area where a monopoly could raise prices by a certain amount.\textsuperscript{16}

The first step in determining if a company has or will create market power with a merger or acquisition is to define the relevant market. The guidelines specifically define the product market by asking which products would be substituted by buyers in response to a small but significant and nontransitory price increase, usually 5% in a year, in a series of possible markets.


\textsuperscript{15} Mark A. Glick, Duncan J. Cameron and David G. Mangum, “Importing the Merger Guidelines market test in section 2 cases: potential benefits and limitations” *Antitrust Bulletin*, Spring 1997, V41N1, p. 123.

\textsuperscript{16} Patrick A. Gaughan, p. 93.
When a conclusion is reached that such an increase would not add significant substitutes, the product market is defined.17

The guidelines apply the same rational for defining the geographic market. The geographic market is a region where a hypothetical monopolist of a relevant product market could profitably impose a small but significant and nontransitory price increase, usually 5% in a year. If the buyer responds to the price increase by shifting to a product produced at locations outside the region, then the tentatively identified geographic region is too narrow. When a conclusion is reached that such an increase would not result in a buyer going outside the region for a substitute, the geographic market is defined.18

Relevant Markets in Real Estate

As previously stated in the discussion of the horizontal merger guidelines, there are difficulties involved in the definition of markets when determining if market power effects are present. The lack of a clear market boundary leaves plenty of room for dispute. For example, if a market is too narrowly defined one may misdiagnose a high market concentration. The same is true of defining a market that is too large, one may miss the presence of a high concentration in the market and the potential for market power.

In the context of real estate the relevant market is defined by the location of the assets. An example of defining a market in the office sector in Boston, Massachusetts is to draw a hypothetical boundary around a relevant area. An example of a relevant area is the Financial District. Questions raised in response to this hypothetical boundary: Is this market too small? Would a firm in the Financial District be willing to occupy space in another area of Boston like

17 "Executive Summary of the Antitrust Laws", p. 12.
the Back Bay? If the conclusion is the Financial District is the appropriate submarket, then in the short term a real estate company may be able to exert market power in this submarket because a firm is not willing to locate to another submarket of Boston. However, in the long run the response to such market power may be the development of a new financial district on the outskirts of Boston. The tenant then has the option to relocate in response to such market power.

**Who is the Consumer?**

The government generally investigates claims of antitrust when a company is monopolizing a market. This monopolization is usually evidenced by an increase in consumer product prices. Since the real estate industry has not been subject to many antitrust investigations, the definition of the consumer in real estate is not clear. Is the consumer, the tenant paying rent for the real estate or is it the end consumer purchasing a product from the tenant? To illustrate, consider a law firm that leases space in a downtown office building. If the rent for the law firm’s space is increased because the building owner is exerting market power, can an antitrust suit be brought against the building owner? In this example is the tenant the consumer or is the consumer the clients of the law firm? If the former is true, an antitrust suit would have to prove the consumer’s (the law firm) price for the product (the office space) was greater than the price in the market. If it is agreed the consumer is the law firm then the remaining issue in this suit would be the definition of the relevant market. However, if the latter is true, then to prove a violation of antitrust would be even more difficult. In addition to the challenging task of defining relevant markets, it would also have to be proven that the rates the law firm charged their clients increased because of the rental increase and not because of other factors, such as inflation or increased operating costs (excluding rent) of the law firm. Since
antitrust law in the real estate industry is a relatively new concept, the definition of who the consumer is remains to be answered.

**Market Power Measured - Antitrust**

The measurement of concentration in an industry has evolved over the years. Originally, the guidelines used concentration ratios, which are the market shares of the top firms in the industry. For example, an industry was considered highly concentrated if the largest firms, where the number of firms varied by industry, held at least 75% of the total market.¹⁹

In 1982, the HHI was introduced to antitrust policy. The HHI is the sum of the squares of the market shares of each firm in the industry. The HHI is a better measure of merger-related market concentrations than concentration ratios because it increases with the number of firms in the industry and it sums the squares of the firms in the industry so it weighs larger firms more heavily. The DOJ established threshold levels to use in conjunction with the HHI for concentrations in a given industry. The threshold levels are: 1) if the HHI is greater than 1,800 than the industry is considered highly concentrated; 2) if the HHI is between 1,000 and 1,800 the industry is moderately concentrated; and 3) if the HHI is less than 1,000 the industry is unconcentrated.

An example of how these threshold levels are utilized is to consider an industry composed of nine firms with equal market shares of 11.5%. The computed HHI \((11.5^2 \times 9)\) is equal to 1,190.25. This is considered moderately concentrated under the threshold levels established by the DOJ.

The DOJ recognized that the application of the HHI was mechanical and inflexible. As a result, the guidelines were revised to allow qualitative information in addition to quantitative
analysis. Simultaneously, the guidelines introduced the use of the 5% test, which tests the effects of a potential 5% increase in the price of a product in each merging firm.\textsuperscript{20}

Today, the HHI index, the 5% test, and qualitative analysis are all utilized in antitrust suits. In addition, under the 1992 guidelines a merger will be challenged if there are anticompetitive effects, such as through a price increase, even if the firms can prove there are demonstrable efficiency benefits.\textsuperscript{21}

The real estate industry has avoided antitrust investigation and as such has not been subjected to this type of quantitative analysis by the government to determine the industry’s market share. However, the HHI is the government’s standard tool to measure industry concentration and if in the future the real estate industry is subjected to antitrust investigation, the HHI will be one of the forms of analysis the government will utilize.

\textbf{Premerger Notification Rules and the FTC’s Position on Real Estate}

As mentioned previously, premerger notification rules ("premerger rules") list the exemptions from the reporting requirements and waiting periods outlined in the Hart-Scott-Rodino Antitrust Act. While the FTC has historically viewed a real estate company’s acquisition of property as being in the ordinary course of business, and thus exempt from reporting requirements, it was never documented as such in the regulations. However, on April 29, 1996, the FTC amended the premerger rules. These amendments are of interest to the real estate industry because new exemptions for the acquisition of real estate and for the acquisition of voting securities are formally put into effect.

The FTC created these exemptions because they view the exempt transactions as being

\footnotesize{\textsuperscript{19} Patrick A. Gaughan, p. 90-91 \textsuperscript{20} Patrick A. Gaughan, p. 92-93.}
"abundant" and "in markets that are generally unconcentrated." Furthermore, the FTC states:

"these two factors make it unlikely that a transfer of these property types of assets will have anticompetitive effects. It is thus not necessary to examine each individual transaction to determine if it will violate antitrust laws." 23

As amended, the premerger rules exempt the acquisition of eight categories of real property assets because the FTC believes that holdings of these eight categories are "widely dispersed." 24 Additionally, the FTC believes that "transfers of these categories of real property are generally small relative to the total amount of holdings, and entry into regional and local markets for these types of real property assets is usually easy." 25 The eight categories are: new facilities, used facilities, unproductive real property, office and residential property, hotels and motels, recreational land, agricultural property, and rental retail space and warehouses. The new facility exemption allows an entity that has constructed or acquired real estate and assets incidental to its ownership to sell the property. The exemption for used facilities allows a tenant involved in a sale/leaseback arrangement to purchase the facility and be exempt from the reporting requirements. Unproductive real property is real property, such as raw land, buildings or parking lots, that have not produced revenues of more than $5 million during the 36 months preceding the transaction. To qualify for the office and residential exemption, the FTC anticipates that at least 75% of the space must be used for office or residential purposes. The exemption for hotels and motels also includes facility improvements such as golf, swimming, tennis, restaurant, health club, or parking facilities. Exempt recreational land is defined as property used primarily as golf, swimming, or tennis facilities. The exemption for agricultural

21 Patrick A. Gaughan, p. 93-94.
22 FTC document - 16CFR Parts 801 and 802, p. 4-5.
23 FTC document - 16CFR Parts 801 and 802, p. 5.
land includes assets incidental to the ownership of the property. Finally, exempt retail and warehouse space includes property that houses and is leased to retail establishments and includes shopping centers, strip malls, and stand-alone buildings.26

In the amended premerger rules, the FTC has also created an exemption for the acquisition of investment rental assets. The FTC has done this to “exempt most real property acquisitions typically made by institutional investors, real estate investment trusts, or real estate development and management companies that are not exempted” in the eight categories of real property assets.27 Examples of transactions that might be covered by this exemption include the acquisition of industrial facilities, manufacturing facilities, nursing homes, self-storage facilities, net-leased restaurants, and even sports/entertainment complexes.28,29 To qualify for the exemption, the acquisition must consist of real property assets that will be held by the acquirer for rental purposes. The purchaser may only occupy the building to maintain and manage the operation of the investment property and may not occupy the property for their own use.

The FTC has also created exemptions for the acquisition of voting securities of companies that hold assets that are exempt. If the assets of the company whose voting securities are being acquired are exempt from the reporting requirements, then the acquisition of that company’s voting securities are also exempt from the reporting requirements.30

It should be noted that when making acquisitions that include both exempt and non-exempt assets, the non-exempt assets are still subject to the HSR reporting requirements. For example, if a retail chain is purchasing a property that is exempt as well as the retail business that

27 FTC document - 16CFR Parts 801 and 802, p. 25.
operates in the property, the retail property is exempt from the reporting requirements while the retail business is not. Additionally, if acquiring large blocks of an individual REIT’s shares, if that REIT owns non-exempt assets such as third party service contracts, the transaction could still be subject to the premerger rules. The value of the service contracts might trigger the reporting requirements.\(^\text{31}\)

The exemptions created by the FTC clearly show that they are not viewing real estate transactions or mergers and acquisitions of real estate companies to be in violation of the antitrust laws. As mentioned previously, the FTC stated that they do not believe it is necessary to review individual real estate transactions because they believe it unlikely there will be anticompetitive effects from the transactions. The apparent trend towards consolidation in the real estate industry can continue unabated by antitrust regulation in the short term. However, in the future, if real estate firms acquire large market shares, and if market power is exerted, the government could begin to re-examine its current “anticompetitive” stance on the real estate industry. Just because transactions are exempt from the premerger rules does not mean that companies are exempt from the antitrust laws. If the government believes that market power is being exerted, they could pursue an antitrust case at any time.

**Conclusion**

While the FTC is currently of the opinion that transactions of real property are not in danger of violating the antitrust laws, real estate firms are still subject to the antitrust laws. As REITs continue to acquire assets, the possibility of increasing market shares is possible. As market shares increase, REITs may begin to execute the strategy of controlling markets. This

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\(^{30}\) FTC document - 16CFR Parts 801 and 802, p. 21.  
\(^{31}\) Edwards and Jaffe, p. 5.
exertion of market power could cause the government to intervene with charges of monopolization under the Sherman Act. It could also cause the government to revisit the exemption of real property under the antitrust law.
CHAPTER 3
CONCLUSION

To put the discussion of REITs and market power in the proper theoretical perspective, we began with an economic theory section which provided an explanation of the economic concepts of market power as they apply to the real estate industry. In this section, the fundamentals of market power were highlighted, including market share, elasticity of supply, and elasticity of demand. These were elaborated on by using concepts such as product substitution, market exits, barriers to entry, and market contestability. Issues such as lease terms, agglomeration synergies, consumer demographics, zoning laws, and regulated development lags were all discussed in an attempt to apply the economic theory to the real estate industry.

We then discussed federal antitrust regulation policy, by first highlighting the basic acts that make up antitrust law: the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Hart-Scott Rodino Antitrust Act. This review encompassed an examination of the Department of Justice and the Federal Trade Commission merger guidelines which were published to help clarify antitrust laws. The merger guidelines attempt to define the relevant markets, both product and geographic, as well as how market power is measured.

We then discussed how antitrust policy is applied to the real estate industry and the difficulties in defining relevant markets. In real estate, the location of the assets and the lack of clear geographic boundaries cause difficulties in determining relevant markets. Also discussed is the possibility of two different definitions of the consumer in a real estate antitrust suit. The first definition is the individual consumer who purchases the product of a company that is a tenant in a building. The second is the tenant of the building. This distinction is important because it might be possible to prove a violation of antitrust laws if a tenant is paying above market rents;
however, if the individual consumer is the relevant consumer, then proving an antitrust suit could be difficult.

The discussion of antitrust policy concludes with a brief summary of the Federal Trade Commission’s position on real estate transactions. For office, residential, hotels, retail, warehouse, and other property held for investment purposes, the FTC currently views transactions as being unlikely to violate antitrust law. Therefore, these transactions are exempt from the reporting requirements and waiting periods outlined in the Hart-Scott-Rodino Antitrust Act. Although these transactions are currently exempt from the reporting requirements, real estate firms are still subject to antitrust law. As REITs continue to grow, consolidate, and increase their market shares, the government may revisit this exemption of real property transactions under the antitrust laws.
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