

The Viability of the REIT Structure as a Vehicle for Real Estate Development

by
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Submitted to the Department of Urban Studies and Planning in Partial Fulfillment of the Requirements
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ABSTRACT

Little, if any, research has been published on development-oriented real estate investment trusts (REITs), as a category. This thesis examines the viability of the REIT format for the real estate development process. Capital is the life-blood of any development concern, and, as such, particular attention is paid to the processes pertaining to the access of funds, the subsequent allocation of funds, and the underlying logic governing these decisions. This paper reviews industry articles, past studies on the effects of development on REIT performance, and interviews with key personnel of the REITs and private development firms profiled in this thesis. I conclude that the REIT format is an effective vehicle for real estate development although skilled management is vital to exploiting its inherent potential.

Development-oriented REITs are distinguished from their conservative REIT brethren by their objectives. REITs that shun development add value for shareholders through the active management of property holdings, whereas REIT-developers adopt strategies that are focused on creating and adding value through real estate development. Additionally, some of the strategies adopted by development-oriented REITs are unrelated to development but related to value-creation. Development-oriented REITs may engage in development, joint ventures with capital providers or private developers with specific expertise, the disposition or acquisition of assets, share repurchases, and lastly, the solicitation of capital. The REITs profiled in this thesis are manufacturers of real estate assets, which are focused on value creation through development.

This paper will:

1. focus on the application of the REIT structure by development firms and the factors governing their decisions regarding investment and the generation of shareholder value; and
2. investigate the potential of the REIT structure beyond passive real estate ownership and determine its value to development-oriented public companies with aggressive value-creation agendas.

Thesis Supervisor: William C. Wheaton

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I

Introduction

The History of Real Estate Development in the United States

The ownership of land and buildings is more pervasive in the United States than in any other country in the world. Widespread participation in the real estate market has been a common feature of the economic profile of the United States since it was established, and for this reason, land ownership is a symbol of freedom and prosperity. During the 18th and 19th centuries, Americans successfully battled and lobbied for legal reforms that enabled citizens to become landowners. These reforms led to the widespread privatization of U.S. land.

For example, the Homestead Act was enacted in 1862 in response to the mobilization of rebellious settlers who farmed land for their employers and were paid in money and shares of stock for their work. The settlers opposed this arrangement and insisted upon owning the land on which they worked. The Homestead Act of 1862 led to the creation of a fee simple system of absolute property rights through private ownership. As a result, one private party could convey property rights to another party through a sale, lease, or trade. This development produced an exciting real estate market that drew considerable amounts of investment capital. In the 18th and 19th century, the real property market was extremely volatile due to erratic flows of capital. There were large disparities in land prices and frequent land speculation. Almost every time a new settlement was established, land was subdivided and the speculative, boom and bust climate returned.

In addition to the privatization of land, federal, state, and local governments also embarked on the pervasive development of roads, canals, ports and other public facilities in the 1800s in order to encourage population and employment growth. Issuing public bonds financed these capital improvement projects. These bonds were to be repaid from revenues generated through the sale or lease of land, whose value had increased because of the new infrastructure. The public sector's sponsorship through bond issuance was central to making successful development and pervasive ownership possible.

Additionally, other early initiatives such as the institution of building codes, the legal protection of property transactions, land use controls pertaining to the physical environment, the increase in public

safety, and the subsequent growth in property values all served to promote mass participation in the U.S. real estate market.

By the middle of the 19th century, the railroad became the primary mover of people and merchandise around the U.S. In comparison to canals, which were used earlier, the railroad served as a catalyst for development across a wide area. Railroad tracks could be laid almost anywhere, and as such, the amount of land targeted for potential development increased exponentially. Large railroad companies were among the first big businesses in America, and because of their service, they were inseparable from real estate activity. Railroad companies would sell land or mortgage some of their holdings to banks and buyers of bonds in order to raise capital. Today, railroad companies remain among the countries largest private landowners.

Land is still primarily privately owned in the United States and the public sector's role is still critical to the valuation and development of land.

Overview of the Real Estate Development Process

Real estate development differs from other business activities because it involves the production of a capital-intensive product that is fixed in location and requires a long-term investment horizon. Development involves the acquisition of an under-utilized property and converting this property to a higher and better use.

The developer's first task is to select a target market. A developer has an advantage if he is in an area where he has conducted business for a number of years. The success of some projects depends as much on personal relationships as on one's skills. Local developers normally have an advantage over outsiders because of their personal relationships except in the circumstance of large projects (high-rise office buildings, shopping malls, major industrial parks) that draw the attention of national developers. In addition, local developers also have a better understanding of the political and economic structure of an area and are more adept at obtaining public approvals and financing.

After determining a target market, developers turn their attention to product selection. Usually, developers will develop products that they are familiar with. During this phase the developer sells his idea to potential investors and lenders by conducting a market study. This study analyzes the local market to ascertain rent levels, competition, the regulatory environment, local tastes and construction methods, and the types of units or buildings in greatest demand. The challenge is to identify a product that the market lacks because developers obtain a competitive advantage when they design for a specific market. However, market studies rarely bestow competitive advantages on the entity that commissions it. Rather, a developer's perception of the market is what separates him from his competitors. A developer must understand the market well enough to act before other developers find the opportunity and the information becomes public.

The development of real estate products is organized according to specific steps. The sequence of steps to be taken, and even the steps themselves, changes frequently. The rate of change in the development field is a significant dynamic. This condition levels the playing field between experienced developers and beginners. These steps usually include determining a project's feasibility, design, financing, construction, marketing, operation, and management. Some of these steps are taken simultaneously and some are taken sequentially. For example, active pre-leasing of an office building begins as soon as preliminary design drawings are ready to be shown to prospective tenants. Pre-leasing of the office building occurs throughout the development period from financing through construction. On the other hand, apartment projects are normally further along before leasing occurs. In another scenario, the architect may prepare construction drawings at the same time that the developer searches for a loan. The construction of a building will sometimes occur before the architect completes the design drawings. However, at each stage, certain items must be completed before advancing to the next stage. For instance, before lenders will consider a mortgage application, the developer usually must provide conceptual drawings, a boundary survey, title information, information about the site's feasibility, market surveys, personal financial information, and an appraisal.

An excellent example of change took place in the early 1980s. Developers normally secured a commitment for a permanent loan, or takeout loan, before obtaining a commitment for a construction loan. When inflation increased to double digits, lenders ceased to issue takeout commitments. As an alternative, developers patronized construction lenders who in turn issued miniperm loans. This loan device was essentially a five-year loan that covered both the construction period and the operating period. Developers and lenders wagered that interest rates would change, and they did. Lenders were also prepared to roll these obligations into new loans if interest rates did not change as expected. However, when the credit crunch of the 1990s arrived, developers witnessed the return of traditional permanent takeout commitments.

The development and construction processes are similar. Each step in both processes depends on the quality of the previous steps. For example, poorly written contracts with lenders, contractors, tenants, or professionals are detrimental to the continued success of the project. Additionally, development requires a very intensive monitoring system. The developer must depend heavily upon others to complete the project and, as such, oversight is critical. Developers sometimes create a critical path chart for each development phase, which depicts the sequence of events and the length of each step. The early stages of development are especially important, as the initial planning and analysis impacts the final arrangements.

In addition, there are varying levels of risk throughout the development process. Developers identify risk as the total amount of money that can potentially be lost. When the developer conducts a preliminary assessment of the market and the targeted site, the funds at risk are restricted to the cash spent on the feasibility studies pertaining to the soils, floodplains, and the market and conceptual design. Once the earnest money on the land is committed, those funds are also at risk. The developer's risk increases significantly when he closes on the land, purchases financing commitments, and authorizes the generation of working drawings. The developer typically delays the initial stages in order to assess the project's feasibility. Due to the irreversibility of the development process, the developer is unable to recover initial costs if the project is abandoned.

A detailed cash analysis is necessary as development progresses. For example, before the contract for earnest money is consummated, a simple capitalization analysis is conducted to determine whether land costs surmount the required hurdle rate set by the developer. Next, the developer constructs an annual cash flow pro forma pertaining to the operating period, which reflects planned square footage, rents determined from the market analysis, and an estimate of construction costs. After this stage, a cash flow analysis is necessary to give confidence to the lender that sufficient funds exist to see construction through to completion. Construction planning relies on more accurate information about costs and revenues, including detailed design drawings, rent concessions, and tenant improvement allowances. In contrast to the developer-lender dynamic, an analysis for a joint venture or equity syndication requires a cash-flow statement containing information on both the construction and the operating periods to ensure that the timing of equity requirements, distributions of tax benefits, and sale proceeds can be explained. Each deal has its own distinctive characteristics and the circumscription of risk is not always feasible because development is an iterative process, which brings new and more accurate information to the decision-making process and subjects larger amounts of money to risk.

Market Analysis and Product Selection

Following the initial feasibility study and refinement of the conceptual idea by the developer, systematic research is undertaken to verify the practicality of the study's assumptions. The choice of sites depends upon the market that the developer is aiming for. Market information of exceptional quality is necessary to ascertain what to build, who to build for, and how much to build. Market studies are excellent at identifying potential pitfalls. Market analyses are also used to bolster loan applications in order to secure financing. Once a site is acquired, the submarket is examined with greater scrutiny. A comparative analysis of local projects is then conducted to determine competitive strategy. The goals of a market analysis are to:

1. identify potential gaps in the market;
2. narrowly define the target market in order to determine product; and

3. formulate a competitive strategy to determine whether to compete directly or search for niches in the marketplace.

Site Acquisition

The terms of the land acquisition has an effect on all subsequent events in the development process. A site is usually purchased with a three-stage contract. The stages are:

1. a free-look period;
2. a period in which earnest money is forfeitable; and
3. a closing period.

When purchasing land, developers are primarily concerned with their chances of fulfilling their building objectives. Furthermore, developers also want to inspect titles, physical conditions, utilities, market, financing, economics, and design feasibility.

The land purchase contract contains contingency clauses that address certain events that must occur before earnest money is forfeitable and the closing takes place. The most important contingency addresses the subjection of the sale to the developer's attempt to secure financing. If the developer cannot obtain financing then the earnest money is returned. Another important contingency is the subjection of the sale to the buyer's acceptance of feasibility studies. This clause refers to testing involving soils, title, marketing, site planning, and economic feasibility. If the contract gives the buyer discretion to render final approval of all reports then the buyer effectively has an opportunity to exit the agreement. A third contingency that is addressed in the contract is one that subjects the sale to the seller's support of the developer in obtaining zoning and other necessary approvals. This provision aligns the interests of the seller and the buyer. It is designed to induce the seller to lend his support because the final price of the land depends upon the size of the building that is approved.

Regulatory Process, Obtaining Approvals

The increase in government regulation has added to the time, expense, and risk of development. The larger the scope of a development project, the greater the likelihood that it will become the object of regulatory anxiety. It is imperative to conduct a thorough and careful assessment of the political environment in order to control regulatory risk. If the regulatory sector is committed to the developer's concept and engaged in the development process, this mitigates time consuming delays and roadblocks. Regulatory uncertainty impacts developers' desire to buy land.

The price of land is usually bound to the number of units or square footage that can be built on a site. This shifts the approval risk from developers to the sellers because the purchase price is lowered if the developer cannot obtain permission to build the amount of square footage agreed upon. Government approvals are difficult to obtain. Municipalities require developers to build roads and community facilities on an imposed schedule. Consequently, before construction is initiated, the developer's primary focus is on the economic feasibility of the project. Moreover, developers must proceed in phases because of the cyclical character of the real estate industry, coupled with the delays that occur between the approval and construction stage. Despite the fact that the development process is compartmentalized, developers retain the flexibility to work in small increments in order to manage the full array of products that the market specifies.

Economic Feasibility

A financial feasibility study for development is a device used to determine a projects economic viability. The goal of the study is to convince lenders and investors to offer support for the project. The initial analysis is primarily a summary of sales revenues, costs, interest, and a calculated estimate of potential profit. This part of the study is executed before the developer secures the property with an earnest money contract. As the transaction progresses, the analysis grows in depth and complexity. A thorough financial feasibility analysis is a useful regulating device before construction begins. This study

helps the developer arrive at assessments regarding land use, site planning, sales rates, prices, costs, and financing. The information culled from this study forms the basis for succeeding examinations.

The second part of the study builds on the first study and expands the initial summation into a discounted cash-flow analysis, and applies the capital asset pricing model applied to real estate. This cash flow analysis assigns revenues and expenditures from the initial summary investigation to specific periods of time. Subsequent economic studies concern the appropriate return hurdle rates and opportunity costs of capital.

Design, Site Planning, Engineering, and Construction

Understanding architecture and urban design theory is imperative because it provides the developer with clues about structures that are timeless and have weathered social and technological change. The design process involves considerable trial and error. Potential end users and their relationship to every aspect of the site must be considered and studied. During the schematic planning phase the developers main concern is to make certain that the design meets his marketing and financial objectives.

Design begins with the production of a base map. Federal sources are engaged to procure zoning and topographic maps, soil surveys and borings, and previous environmental assessments. Title companies supply data on existing easements, rights of way and other restricted information. After the base maps are set up, and accurate gross and net developable square footage calculations are made, the design process begins.

A developer loses the most money during the construction phase because of the numerous uncertainties. As such, coordination and collaboration between the professional members of the development team is paramount to the successful completion of this phase. These players include the architectural team, which consists of the design architect, interior designers, technical architects, curtail wall consultants, lighting designers, acoustical consultants, and structural, mechanical, and electrical engineers. The general contractor's team of professionals, which includes labor unions, material

suppliers, equipment rental companies, various insurance and financial entities, project engineers, estimators, and a team of subcontractors. In addition there are several players from the public sector: municipal, health, and life safety inspectors. On-site supervision is paramount to the successful management of the construction activity. As the complexity of the project increases so does the probability that problems will occur more frequently and be unusual in nature. The provisions made for the administration and supervision of project construction are of particular interest to construction lenders that inspect the construction work. Institutional lenders and permanent lenders also inspect the construction work. The presence of these fiduciary entities intensifies the periodic reviews of the construction work.

Land Control

This is the first step in the financing of real estate. The developer seeks funds to finance the purchase of the land. This loan is usually a long-term mortgage covering as much as the land cost as possible. In some cases the seller may offer a "purchase money mortgage," which is merely a mortgage loan from the seller to the buyer secured by the transferred property. A substitute for a mortgage comes in the form of the long-term ground lease. The leasing of the land by the developer circumvents the issue of financing the cost of the property at the outset and assumes a liability that can be structured to match the anticipated cash flow. Furthermore, the value of the unimproved land is not depreciable for tax purposes, so it does not serve as the same sort of attractive tax shelter that buildings might be. Moreover, only the interest portions of the mortgage are deductible (the amortization of principal is not deductible), while the entire ground lease rent payment is deductible as a business expense.

Construction / Development Financing

With the exception of the construction phase, securing development financing is essentially the most difficult part of the development process. Construction financing usually originates with commercial lenders who are interested in financing the production of an asset since they understand the process of creating value. Construction financing is usually short in duration. Currently, in order to secure debt financing, developers must contribute equity of their own in addition to personally guaranteeing the notes dispensed by the lender. The funds are borrowed as it is needed to pay for construction costs and is paid in full when the construction phase is complete. The lender makes cash disbursements in increments as the developer furnishes the lender with proof of completion of certain phases of the work effort. No repayments are made during the construction process. The developer's goal in financing a project is to either assemble the capital necessary to purchase land, build any improvements, or prepare a project to generate revenue.

Permanent Financing

When construction is complete and the development is ready to start producing income a permanent lender agrees to refinance or purchase the construction loan after construction is completed. Permanent lenders are usually institutional in nature, insurance companies and pension funds, which are interested in the management of an asset. Permanent lenders also understand the process of managing and maintaining value. Permanent financing, also known as a take-out loan, is a vital component of the development process. This loan product comes in a variety of forms. Besides bullet loans, standard fixed-rate, adjustable-rate, and variable-rate mortgages, lenders sometimes sanction participating loans and convertible loans. Lenders participate in cash flows after debt obligations are satisfied as well as participation in the residual cash flows from sale. The lender's ability to participate in the upside associated with the project raises its IRR above the loan rate by 2 or 3 percent which influences the lender

to provide funds between 80 to 100 percent of project costs.¹ Depending on the region and the state of the economy, most developers are required to guarantee a portion of their loan obligations. Sometimes, these guarantees remain in place until the project reaches a certain level of stabilization or a threshold level of debt coverage is attained. In the 1970s and 1980s, it was atypical for developers to give personal guarantees for development loans. The only recourse lenders had in case of a default was to look to the property for repayment of the obligation. As a result of the pervasiveness of lax underwriting standards in the 1980s, conservative lending practices have prevailed. The current standard practice requires developers to personally guarantee development loans. In order to close on a permanent loan, certain covenants in the loan agreement must be met before the deal can be consummated. The usual requirements call for a certain level of stabilization for a pre-specified period of time. In addition to this, lenders may also demand credit check on tenants. The difficulty of the loan closing depends upon the real estate market at the time of the transaction.

Equity Financing: Joint Ventures and Partnerships

Developers employ the joint venture structure to raise funds, obtain debt financing, and furnish loan guarantees. Equity investors are anxious about these five features:²

- 1. Preferred Return Yields** – The preferred return gives the investor a first call on cash flow. It can be cumulative or non-cumulative. A cumulative preferred return is accrued in any year in which the current cash flow is insufficient to cover the full preferential return.
- 2. Share of Residual Profits** – Privately sold deals, and joint ventures with well-moneyed partners like financial institutions and large investors, profits are divided in a variety of ways. The split of profits is most usually 50/50, 25/75, or 20/80.

¹ Richard B. Peiser, *Professional Real Estate Development: The ULI Guide to the Business*, (U.S.A.: Dearborn Financial Publishing, Inc., and ULI-the Urban Land Institute, 2000), p. 155.

² Peiser, *op. cite.*, p. 180.

3. **Downside Liabilities** – The majority of syndications and joint ventures are formatted as limited partnerships that put a cap on the downside liabilities of investors.
4. **Cash Calls** – Cash calls transpire when a partnership calls for further capital from investors to service debt.
5. **Front-End Fees** – These fees could be construction, management, development, leasing, syndication, organization, and costs associated with raising capital.

Marketing and Leasing

The marketing of the project to prospective tenants before and during the construction process is essential to mitigating risk. Developers seeking financing find that lenders are willing to accept a larger loan-to-value ratio of the project if prospective tenants have agreed to lease space before construction begins. In addition to this circumstance, the successful pre-leasing of the project endows the developer with a significant amount of flexibility. A stabilized asset can be used to secure debt financing that matches the cash flow and terms of the asset's underlying lease agreements thus enabling the developer to pull capital out of the asset for redeployment. What is more, the pre-leasing of the project significantly reduces the uncertainty of future cash flows and most lenders adjust the rate of interest accordingly.

Operations, Management, and Maintenance

Post-construction maintenance is an item that should be given significant consideration. A building may be well designed but it will not reach a profitable state if it is not managed properly. Additionally, effective property management requires proficiency at several levels. The following activities are essential items in the profitable maintenance of property holdings:

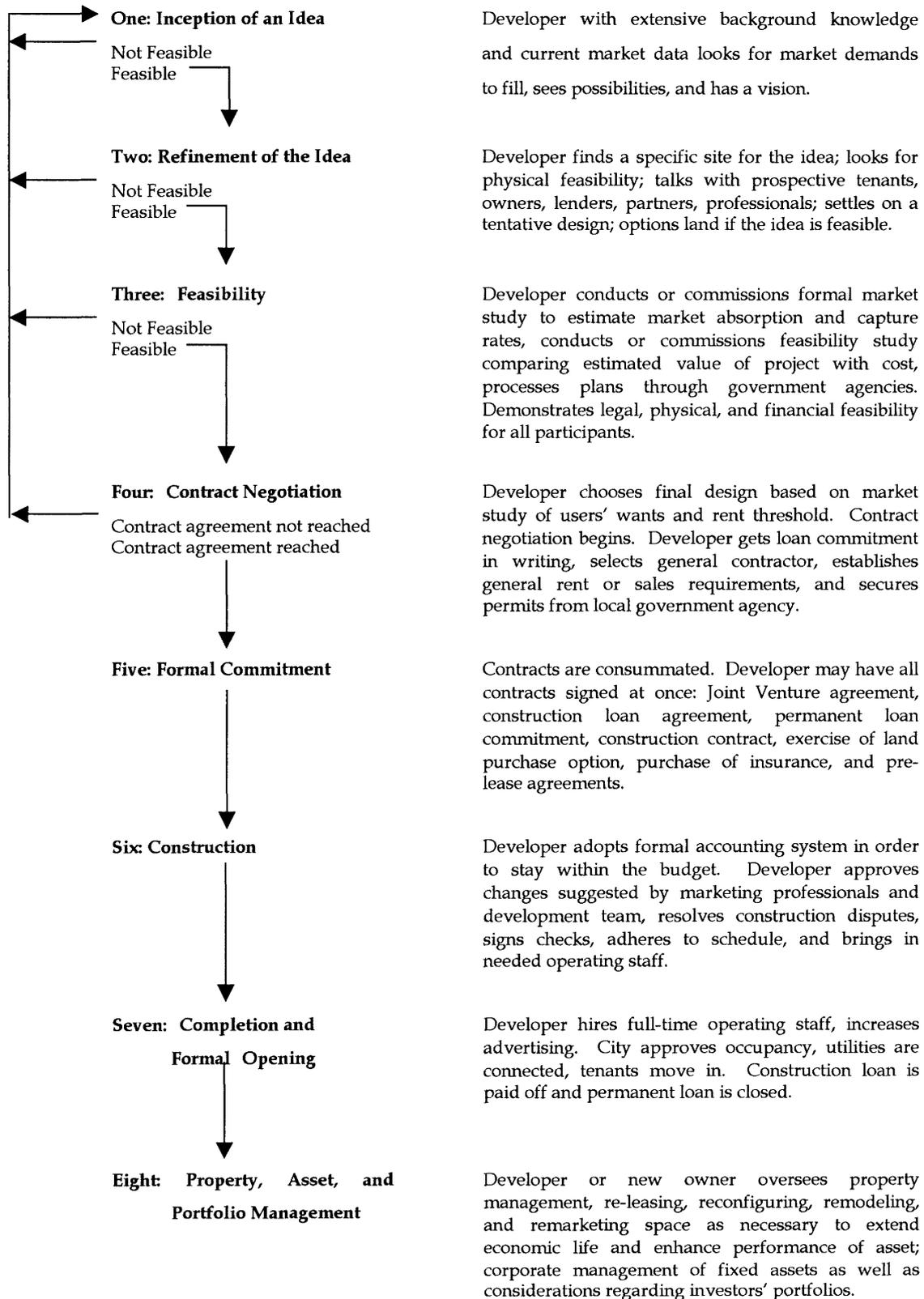
1. Leasing, re-leasing, and controlling tenant turnover; and
2. Rent collection, documentation of activities; and
3. Dealing with tenant grievances; and

4. Preserving affiliations with the brokers, firms, and community organizations; and
5. Establishing lines of communication with the overseers of competing and neighboring buildings to share information on bad tenants and other additional shared problems.

Developers wish to achieve stable occupancy with low levels of turnover and credit quality tenants who promptly pay market rents. In order for a property to continually throw off profitable yields encountered problems must be addressed in a swift and decisive manner. As a result, successful property management is entrepreneurial in nature minus the layers of management that may exist in other areas of the operation. According to the Urban Land Institute, the life cycle of property management has three stages: the leasing of the property, the stabilization income, and the positioning of the property for sale.³

³ Peiser, *op. cite.*, p. 202.

The Eight-Stage Model of Real Estate Development⁴



⁴ Mike E. Miles, Gayle Berens, Marc A. Weiss, *Real Estate Development: Principles and Processes*. Third Edition. (Washington, D.C.: ULI-the Urban Land Institute, 2000), p. 6.

II

REIT Information

Legal Requirements

The National Association of Real Estate Investment Trusts (NAREIT) offers the following description of a REITs legal structure:

A REIT is a company that owns and, in most cases, operates income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses. Some REITs also engage in the financing of real estate. The shares of a REIT are freely traded, usually on a major stock exchange. A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate tax bill. Shareholders pay taxes on any dividends received in addition to any realized capital gains resulting from the sale of REIT shares. Most states honor this federal treatment and do not require REITs to pay state income tax. To qualify as a REIT, a company must distribute at least 90 percent of its taxable income to its shareholders annually. However, like other businesses but unlike partnerships, a REIT cannot pass its tax losses to its investors.⁵

In order to obtain designation as a REIT, a company must be in compliance with the following provisions of the Internal Revenue Code (IRC):⁶

- The company must exist as a taxable corporate entity;
- Managerial oversight must be administered by a board of directors or trustees;
- The company must possess fully transferable shares;
- The company must have a minimum of 100 shareholders;
- The company must have no more than 50 percent of the shares held by five or fewer individuals during the last half of each taxable year;
- The company must invest at least 75 percent of the total assets in real estate assets;
- The company must derive at least 75 percent of gross income from rents from real property, or interest on mortgages on real property;
- The company must have no more than 20 percent of its assets consist of stocks in taxable REIT subsidiaries;
- The company must derive no more than 30% of gross income from the sale of real property held for less than four years and securities held for less than six months or certain prohibited transactions; and
- The company must pay dividends of at least 90 percent of its taxable income in the form of shareholder dividends.

⁵ National Association of Real Estate Investment Trusts.

⁶ Internal Revenue Code Section 856(a), of 1986, as amended.

Developmental - Joint Venture Equity REITs

Development-oriented REITs are companies that package into one entity two very different ventures, exceedingly risky property development and the more conservative acts of property ownership, leasing, and management.⁷ The former, if executed right, can create considerable value, while the latter will generate good inflation-adjusted returns in almost any economic climate.

REITs have the ability to participate in real estate development through joint venture arrangements with private developers. This structured agreement enables REITs to generate higher returns due to their access to development profits. Although these profits lead to higher returns, they usually come at the expense of higher risk due to construction and leasing concerns. One of the patrons of this REIT-type is a developer in search of construction funding. The REIT secures funding through a public offering and then forwards these funds to a joint venture partnership structure that includes a developer and the REIT. The REIT commits to contributing a specific portion of the development costs that it releases in phases throughout the construction process as work progresses. Additionally, during the construction process, any unused funds from the offering intended for the development project must be invested in other projects based on a predetermined formula. Once the project is constructed, the joint venture investment is typically refinanced and this allows the REIT the opportunity to regain a sizeable amount of its investment while retaining some ownership until the project is sold.

From the developer's point of view, a developmental joint venture with a REIT may provide a relatively inexpensive source of capital for construction and development. The initial dividend yield requirement of the REIT's shareholders may be lower than the cost of traditional construction financing. Further, the developer may be able to obtain more financing than would otherwise be available with a conventional loan.

A REIT may also participate in a development project through a land purchase leaseback transaction. Under this arrangement, the REIT purchases the land to be developed and simultaneously leases it to the developer. The REIT earns income from the lease and usually participates in income

⁷ Ralph Block, "The Development REIT's Dilemma," *REITWeek* (September 17, 1999).

earned on the project through an income participation agreement based on a percentage of income from the improved property and a participation in any sale or refinancing of the project. The REIT may also obtain an option to purchase the improvement when the land lease expires.⁸

REIT History

Officially approved by Congress in 1960, the REIT format generated few takers in those early years. The few REITs created in the 1960s were small in both their market capitalization and the size of their real estate portfolios. REIT performance in the 1960s was respectable with average dividend yields of about 6 percent and total annual return greater than 10 percent.⁹ Between 1968 and 1972, most REIT assets were invested in short-term construction loans. REIT managers attempted to leverage their investments in order to enhance returns by capturing the spread between their cost of capital and the rates they charged to their borrowers.

The sudden flourish of mortgage REITs in the late 1960s nearly caused the REIT format to be phased out of existence due to poor underwriting practices regarding the issuance of short-term construction loans.¹⁰ The mortgage REITs borrowed heavily in the short-term markets while lending for longer time periods. These entities neglected to match their assets with their liabilities. When the real estate markets encountered a downturn accompanied by a stiff increase in short-term interest rates, several REITs either collapsed or reorganized. REIT performance in the 1970s reversed course. Inflation increased and REIT's cost of capital swelled. Additionally an economic downturn wiped out any demand for space and overbuilt space markets pulled down rental rates. This moment in history proved to be a major setback for mainstream acceptance of the REIT structure for real estate investment.

However the 1980s demonstrated promise for the real estate industry through 1985, with REITs averaging 20 percent total returns.¹¹ However, the resurrection of REITs was short-lived as competition

⁸ William B. Bruggeman and Jeffrey D. Fisher, *Real Estate Finance and Investments Ninth Edition*, (Irwin: Homewood, Illinois 1993), pp. 665-666.

⁹ PricewaterhouseCoopers, "Special Report-REITs," Korpacz Real Estate Investor Survey, (2nd Quarter 1998), p. 9.

¹⁰ PricewaterhouseCoopers, *op. cit.*, p. 9.

¹¹ PricewaterhouseCoopers, *op. cit.*, p. 9.

for capital engendered by the Economic Recovery Act of 1981 led to the rapid escalation of real estate prices to levels that failed to sustain dividends. More importantly, it also led to an unprecedented building boom that the U.S. real estate markets had ever seen. The passage of the Tax Reform Act of 1986 overturned the investor advantage associated with the Economic Recovery Act of 1981, leading to the intense divestiture of real estate assets.

Factors that Led to the Adoption of REITs in the 1990s

In the early 1990's, the real estate capital markets experienced the financial equivalent of the "perfect storm." The United States witnessed the greatest development boom ever in the late 1980's, which ultimately led to the oversupply of all building types. As new building stock was developed and brought to the market in the early 1990's, the economy as a whole slipped into a recession and demand for space abated. Developers and property owners alike experienced defaults, foreclosures, and bankruptcies. Commercial building values plummeted to the tune of 40-50 percent in the early 1990's.¹² The pain in the real estate industry was evident and pervasive. The 1990s also saw the emergence of the Umbrella REIT Partnership (UPREIT). This format was widely adopted because it allowed an existing property owner to gain relatively low cost equity capital without the tax exposure. The owner would submit the properties to an Operating Partnership in exchange for an interest in this UPREIT. For tax purposes, this was effectively a tax-deferred exchange.¹³ A REIT is admitted as a partner in an UPREIT arrangement in exchange for a cash contribution, which this REIT has raised through a public offering of shares. In a traditional REIT the sale of interest in properties in exchange for shares of stock would engender capital gains tax consequences. Because of this the UPREIT facilitated the acceptance of public status by private developers.

¹² Anthony Downs, "What Have We Learned From the 1980's Experience?," Salomon Brothers, Inc., July 1991.

¹³ Fred Carr, "Overview: The UPREIT Structure," The Penobscot Group, Inc.

The following three factors partly explain the extensive embracing of the REIT structure by real estate companies in the early 1990's.¹⁴ First, banks and insurance companies, traditional sources of capital for real estate development and acquisitions, were subjected to such severe regulatory and stockholder pressure. Consequently, these traditional issuers of capital sought to remove as many real estate assets from their balance sheets as possible, which led to the disappearance of liquidity for private real estate companies because the ability to borrow was effectively wiped out. The credit lines that developers depended on for access to capital suddenly practically vanished. The retreat of commercial debt providers was comprehensive in scope. Debt financing went from the preferred method of choice used to maximize returns on assets to an encumbrance with obscenely high opportunity costs. Private equity was not an option due to the purge of real estate assets from institutional portfolios. A new source of capital was needed because many owner-operators took on debt obligations that matured during the economic downturn of the late 1980s and early 1990s. Coupled with the unwillingness of traditional lending sources to issue debt, many companies faced liquidation. The inability of developers to roll their debt obligations into successive loans and the resultant debt overhang hindered the faculty of REIT management to execute positive NPV investments. The REIT format furnished property owners with the opportunity to access equity capital through the public markets, retire their debt obligations, and pursue market opportunities, which were plentiful at the time. Companies deployed the capital to take advantage of "positive spread" investing that was flourishing at the time. Quite a few abnormally profitable investments were consummated as this proved to be the bottom of the cycle and many companies executed transactions that produced atypical returns. The early 1990's was the quintessential buyer's market.

The second motive for taking companies public was the reverse of the capital access explanation. A considerable amount of property owners took on 5- to 7-year maturity mini-perm loans or bullets. During the building boom of the mid-to-late 1980s, property owners had levered their properties to 90 to 110 percent of the assets' cost. The climate was so severe that the majority of these property owners did

¹⁴ Richard T. Garrigan and John F.C. Parsons, *Real Estate Investment Trusts: Structure, Analysis, and Strategy*, (U.S.A., McGraw-Hill, 1998), p. 10.

not have the equity to refinance 60 to 70 percent loan-to-value, which were based on lower valuations than the original cost. Additionally, commercial lenders seized security in the form of collateral in order to secure past unsecured borrowings. Lenders' demands for debt reduction meant property owners either had to declare bankruptcy or go public. The majority of developers who took their companies public and adopted the REIT structure did not view the REIT structure an ideal way to manage a real estate company, but had little choice because there were no other viable alternatives due to the capital rationing occurring at the time.¹⁵ Their balance sheets were racked with debt and a considerable amount of the real estate companies that were embracing the REIT structure could not survive without the potential funding that a public offering could yield when they needed to reduce their mortgage debt.

The third measure was estate planning and adopting evergreen status.¹⁶ Many real estate developers were concerned about their company's ability to outlive them. Bill Maguire, founder and Chief Executive Officer of Charlotte based REIT-developer Summit Properties, cited an example from his own experience.¹⁷ He explained that at a competing company, one of the founding members, who owned one third of the company, died and his estate wanted its interest bought out. Many private development companies did not have the necessary capital to satisfy estate demands. This engendered a significant capital gain that resulted in the partial and sometimes full liquidation of assets to meet the resulting tax obligation. The REIT format furnished companies with the necessary liquidity without engaging in the sale of assets. It was also tax efficient and it allowed the companies to adopt a form of ownership that enabled them to outlive the founders. It also avoided the disaster of having to possibly sell assets at the bottom of a business cycle for fire sale prices that could bankrupt the company.

A residual effect of the early 1990s' climate was the feeling that development was too risky and no longer a viable option. The preferred method for generating outsized returns was acquisitions. As a result, only those bold or solvent enough made it through the capital crisis of the 1990s that engendered the sudden pervasiveness of the REIT structure nearly 30 years after its creation.

¹⁵ John H. Vogel Jr., "Why the Conventional Wisdom About REITs is Wrong", *Real Estate Finance*, (Summer 1997), pp. 7-12.

¹⁶ Evergreen - When a company is said to have evergreen status, it means that it can exist indefinitely.

¹⁷ Phone interview with Bill Maguire, CEO of Summit Properties, Inc., July 14, 2001.

Current Trends

The overbuilding in the real estate markets precipitated the “point-spread” investing that led to the appearance of opportunity funds that quickly bought distressed properties. As a result, REITs that were able to raise capital and acquire these distressed assets generated considerable returns for their investors. The subsequent growth in the value of REIT share prices led some to believe that REITs were growth stocks. However, the appreciation in share prices resulted from the property markets entering into a period of cyclical recovery. The markets were returning to a state of equilibrium. In the late 1980s and early 1990s, acquisition costs were well below replacement costs; consequently, acquisitions became the preferred method of capturing growth in real estate.¹⁸ During that time, the REIT structure made perfect economic sense. Capital-intensive development was out of economic favor, debt financing was scarce, and developers needed additional capital to remain in business and salvage their portfolios. The REIT format provided access to equity funding and developers were able to stave off attrition. Real estate operators did not mind the passive nature of the REIT model because the acquisition model was attractive and due diligence was an excellent way of mitigating the risk of real estate acquisitions.

During the third quarter of 1997, the capital markets ceased to be a source of funding for REITs. Suddenly the public markets were not as liquid. The fact is, liquidity provided by the public market is circumstantial. Just as economic conditions in the markets shift, strategies must shift in response. As prices in the property market began to rise, the availability of public equity began to smooth out. Acquisition costs once again approached replacement costs again and in some instances surpassed them. Unexpectedly, the passive nature of the REIT format that real estate operators did not object to when debt was a four-letter word was now a hindrance. It was no longer sufficient to passively ride the property market cycle in order to meet growth initiatives. Portfolio growth had to be sourced through development, offering the potential to provide higher returns.

¹⁸ Downs, Anthony. “What Have We Learned From the 1980’s Experience?,” Research Report, Salomon Brothers, Inc. July 1991.

III

The Pros and Cons of Remaining Private Vs. Going Public

Chapter Preface

The topic of this research paper is, “The Viability of the REIT Structure as a Vehicle for Real Estate Development.” Although most real estate investment trusts are public companies and they are most certainly included in this survey, it is especially important to examine this issue through the private developer’s aperture to better understand the range and potential of the REIT format. Scrutinizing the use and effectiveness of the development process from the perspective of both private developers and public real estate operating companies provides a comprehensive view of this issue.

With the aim of obtaining the perspectives from these two camps, the author attempted to obtain both sides of the story by personally interviewing a total of two CEOs, one development director, and a senior vice-president from three well known highly regarded, very successful public real estate operating companies and culling information from an article in which the CEO of a fourth public REIT commented on his company’s unique abilities and how management circumvents structural shortcomings of the REIT format. Additionally, two equally reputable executives of two distinguished and well-established private development companies were interviewed or submitted questionnaires and information contained herein on the third private company was collected from an online publication. The findings of the information gathering are presented in this chapter and clearly outline the cases for both sides of the development picture. At the conclusion of this research report the author will present his views.

Company Profiles

Public Development Firms

Boston Properties, Inc.

Founded in 1970, Boston Properties, Inc. is a self-administered and self-managed REIT that develops, redevelops, acquires, manages, operates, and owns a diverse portfolio of Class A office, industrial and hotel properties. The Company is one of the largest owners, acquirers, and developers of Class A office properties in the U.S., concentrated in four core markets – Boston, Washington, DC, Midtown Manhattan and San Francisco. The Company's primary focus is office space, however its property portfolio also includes hotels and industrial buildings. The company went public company in June 1997 and has since experienced rapid growth by acquisitions of approximately \$4.7 billion of office properties in existing and complementary markets. Boston Properties has been recognized for its significant expertise as a developer, since its establishment in 1970. When the Company staged its initial public offering (IPO), the Company and its management team had directly developed more than 89% of its portfolio. The following information attributed to Ed Linde, President and Chief Executive Officer (CEO) of Boston Properties, was obtained from an interview with Mr. Linde.¹⁹

CenterPoint Properties Trust

Chicago has always been the focal point of CenterPoint Properties Trust and, by maintaining this focus, CenterPoint possesses a tremendous amount of operating leverage in the area. The Company is the largest purchaser of all goods and services related to industrial real estate in Chicago. CenterPoint has very strong relationships with approximately 600 industrial real estate brokers who are critical to the market. CenterPoint also leverages its local sharpshooter status to access the necessary inputs for development such as construction, design, and government entities, which are the components essential

¹⁹ Telephone interview with Ed H. Linde, President and Chief Executive Officer of Boston Properties Inc., July 14, 2001.

for change in their sector. CenterPoint focuses on solving the problems of industrial property users and owners. The company's market is confined to the greater Chicago area because the city's 1.25 billion square-foot industrial property market offers a substantial, diverse and constant array of problems to work out. CenterPoint is a highly integrated organization that benefits from numerous symbiotic relationships, economies of scale, deep market penetration, and most importantly, a very high level of trust and confidence throughout the Chicago industrial community. The Company asserts that these attributes – and not the physical real estate – are the assets that allow them to execute solutions far superior and efficiently and to a higher level of customer satisfaction than their competitors.

Cousins Properties, Inc.

Cousins Properties, founded in 1958 by current Chairman and CEO, Tom Cousins, is an Atlanta-based real estate development company. This Company is unambiguous in stating that they are principally manufacturers of real estate assets. Cousins' favored method of creating value is through development. The Company went public in 1962 and for tax purposes adopted the REIT model in 1987. Cousins' method of operation throughout its history has been to embrace diversification across product lines and markets. During the 1980s the Company was principally focused on office development. In 1992, CPI acquired New Market Development Company, a company involved in retail development. Cousins can be distinguished from its peers for reasons beyond the size of its development pipeline because of the Company's understanding that there are far more effective ways of making money in real estate than simply by holding it. Despite having an aggressive development agenda, during the REIT bonanza of the 1990s Cousins only accessed the public equity markets only three times. George Berry, Senior Vice President, submitted answers to a questionnaire designed by the author of this thesis.²⁰

²⁰ Questionnaire submitted by George Berry, Senior Vice President, Cousins Properties, Inc., August 1, 2001

Summit Properties

Bill McGuire founded McGuire Properties in 1972. In 1985, McGuire Properties formally changed its name to Summit Properties. Summit Properties Inc. is a self-administered and self-managed REIT that conducts its business primarily through Summit Properties Partnership, L.P., a limited partnership (the operating partnership), of which the Company is the sole general partner and an 85.8% economic owner as of December 31, 2000. The Company's property management, certain construction, and other businesses are conducted through its subsidiaries, Summit Management Co. and Summit Apartment Builders, Inc. Summit properties Inc. was formed in 1993 to continue and expand the multi-family development, construction, acquisition, operation, management and leasing businesses of the predecessor entities through which the Company historically conducted operations prior to its initial public offering. Summit Properties is an established leader in the development, acquisition, and management of luxury apartment communities. The company has have built over 20,000 luxury apartment homes valued at well over \$1 billion and is an established leader in the development, acquisition, and management of luxury apartment communities. The Company operates, develops and acquires "Class A" luxury apartments primarily in the Southeast, Southwest, Midwest and Mid-Atlantic States. The Company develops apartments solely for its own use and does not perform development activities for third parties. Summit Properties Inc. adheres to a strategy that advocates the establishment of city-operating offices in the markets in which they have a presence. These city offices have direct responsibility for development, construction, and management of the communities in their geographic markets. The Company maintains an active development program in these areas to ensure a predictable and consistent stream of new revenues. Bill McGuire, CEO, and Rob Kilroy, Executive Vice President and Director of Development, provided information through personal interviews.²¹

²¹ Interview with Bill McGuire, Chief Executive Officer, Summit Properties, Inc. July

Private Development Firms

Congress Group Ventures

Congress Group Ventures, Inc. (CGV), a privately held commercial real estate development company, founded in 1981 and based in Cambridge, Massachusetts, is ranked among the top dozen developers in the Boston area by the Boston Business Journal. Over the years, the Company has completed, or is currently developing, over 5 million square feet of commercial space, over 2,000 multifamily residential units and 550 hotel rooms, in both urban and suburban settings around Boston and New England. The total value of the company's development activities over the years has exceeded \$1.5 billion. Known as a niche developer of high quality projects, Congress Group Venture's attributed its success to its attention to detail, its ability to fuse the finest engineering and design consultants and available and its unique sensitivity to, and understanding of, the relevant real estate and capital market forces in effect at any given time.²²

Dermody Properties

Dermody Properties, a private national industrial development company that is ranked among the top 15 industrial developers in the country, possesses an extensive portfolio of buildings for sale, lease, build-to-suit, and lease-to-own opportunities as well as an inventory of prime land for sale. Industrial development has been Dermody's sole discipline for 40 years, and the Company has focused on its clients and the placement of clients in prime distribution, manufacturing and industrial regions nation-wide. The Company offers a comprehensive range of in-house design, construction and project management, as well as financing and asset management services to create a seamless process for their tenants. Dermody Properties characterizes itself as a broker-friendly developer, working side-by-side in close collaboration with real estate professionals to assist their tenants with Dermody's cost-effective, value-driven, and flexible solutions. Dermody Properties designs and builds facilities on a turnkey basis, for lease or

²² Interview with Dean F. Stratouly, President of Congress Group Ventures, Inc., July 26, 2001

purchase, and also services these properties themselves. Dermody's construction and design services provide client-centered value for extremely competitive prices.

Hines Interests Partnership

Founded in 1957, by Gerald D. Hines, Hines Interests Limited Partnership (Hines) is a private real estate company based in Houston, Texas that engages in the development, management, leasing, and acquisition of real estate. Hines also serves as real estate consultants. With assets totaling more than eight billion dollars, Hines is one of the largest real estate companies in the world. Hines' portfolio consists of more than 530 properties, which corresponds to 170 million square feet of office, mixed use, industrial residential, and retail properties. The firm has formed alliances with individual and institutional investors to create investment vehicles that facilitate the acquisition and development of new buildings in both domestic and foreign markets. The regional offices of the Company function as autonomous units headed by a firm partner. The following information attributed to a Hines "Senior Executive," was gleaned from a senior officer at Hines.²³

²³ Questionnaire submitted by Senior Vice-President/Executive Project Manager of Hines Interests Limited Partnership, who wished to remain anonymous. July 6, 2001.

Public vs. Private Developers

Aaron Paris, Vice President and CEO of Dermody Properties claims tenants prefer industrial developers who are cost-effective, flexible, and reliable. Paris asserts that private industrial developers are not as hindered when it comes to advancing a project in a creative manner without copious time-consuming approvals, regardless of whether the task is a build-to-suit project or a lease for existing industrial space. Paris further states that REITs, because of their size and the oversight administered by Wall Street investors, entail more extensive reviews and approvals as the projects become more complex.²⁴

One public development company that escapes Paris' criticism is CenterPoint Properties. CenterPoint Properties follows a strategic model that enables their Company to address problems that involve discrepancies between the current business needs of the owners and users of industrial real estate and their current facilities. Through relocation, build-to-suit development, re-configuration and a myriad of other executions, CenterPoint adds value to its customers by matching industrial real estate to their current business strategy.

Paris contends that private developers often seek specific opportunities and work to establish long-term relationships. He stresses that private development companies, like Dermody Properties, have more flexibility to be more aggressive and consummate deals. For their tenants, this means private developers can think and act unconventionally as long as they are creating value. He adds that a successful transaction is not determined by its impact on the current quarter's earnings or concerns about public market reactions, but rather on the merit of the real estate transaction. Additionally, public industrial developers may be more motivated by immediate or short-term gains that provide movement in the stock market. Paris emphasizes that REITs tend to be wed to the public-reporting aspects of a transaction, rather than focusing tenant's needs. Because of this tendency to be driven by formula and structure, while being measured predominately by cash flow, REITs may operate more like a bureaucracy instead of a business partner.

²⁴ Paris, Aaron. "Leasing with a Private vs. Public Developer," *Area Development Online* (July 1999)

Dan DuPree, President and CEO of Cousins Properties, Inc., a commercial REIT developer disagrees with Paris' assessments. Dupree cites Cousins' employment of the joint venture structure. Dupree thinks a JV structure is not simply related to the raising of capital but rather the JV also serves to forge long-term relationships. "The joint ventures we're in are not entered into for the sole purpose of finding capital," explained DuPree. "They really are more about creating relationships with our lead tenant on an equitable basis. One thing a tenant gets in a relationship like that is that they get considerably more flexibility for growth and contraction."²⁵

CenterPoint Properties exhibits the same attributes as private industrial developers. The company's strategy is "creating investments, not buying investments," affirms President and CEO John Gates.²⁶ Flexibility is the key to CenterPoint's process of creating investments. Gates likes nothing more than shredding a tenant's lease and developing a new property that more closely meets its needs. CenterPoint is in a position to execute initiatives like this because, unlike many REITs, it has no significant joint ventures that hold property for a significant length of time, and because it has relatively little securitized debt. Paul Fisher, Chief Financial Officer (CFO), explains that the Company is flexible because the company has the capital on hand and it is not necessary to talk to anyone other than the board of directors to obtain company approvals.²⁷

Despite Paris' differing views, private developers do get caught in inflexible situations. According to the Hines' Senior Executive, if a REIT owns all of its properties without joint venture partners, they can move tenants from one building to another very easily. Hines, on the other hand, cannot. The Hines' Senior Executive explains, "If we have a tenant that has 5 years left on its current lease but needs additional space because of its growth and our company does not have any additional space in that building for expansion, we cannot destroy that lease and allow the tenant to move. One of our other tenants has to acquire the first lease because they are separate ownerships, although, this is very rarely an issue. When REITs are 'in favor with the equity market,' meaning their stock prices are

²⁵ Deidra Darsa, "Developing Value," *Real Estate Portfolio* (May 2000)

²⁶ Dan Friedman, "Gates Leverages Local Contacts," *Commercial Property News Online* (April 1, 2001)

²⁷ *Ibid.*

high; REITs can steal deals away from us because they negotiate below market leases and above market acquisitions.”²⁸

Based on his experience, Paris affirms that private developers, like their tenants’ business, must be flexible and creative in order to compete. They should have the capability to negotiate leases on a case-by-case basis, staggering leases to take less return at the outset and consequently reducing the tenant’s up-front costs, enabling them to take a bigger return at the end, when the tenant has achieved a degree of financial solvency. Private developers have another solid advantage – the flexibility to add buildings to a portfolio to close a transaction. For example, Dermody Properties once completed a transaction that allowed one of their customers to exchange the value of their building for a long-term lease. This was effectively a 1031 exchange.²⁹ Through this transaction, exchanging existing property pays the client’s lease payment for the next two and a half years.

Greg Elliott, director of real estate and physical assets at DSC Logistics Inc., offers a different perspective than Paris. He states, "I am very comfortable with CenterPoint Properties. I like their ability to listen to my needs and find solutions that work for both of our companies. Recently they were able to tear up a lease on a building I no longer needed in exchange for my extending my lease on another building. Our business is very dynamic, and we need a landlord who is flexible like Centerpoint."³⁰ DSC Logistics, Inc. is the largest third-party logistics company in the Midwest. CenterPoint also has a 95.5% tenant retention rate.

Paris emphasizes that when tenants conduct business with a private developer and a clear decision-maker, issues can be resolved quickly, leases can be amended, and tenant improvements accomplished on a tight time frame. The issues that are important to tenants are also important to the private developer: efficiency, cost-effectiveness, and the desire to best serve customers while paying close

²⁸ Hines Senior Executive, *op. cite*.

²⁹ 1031 Tax Deferred Exchange: A deferred Exchange is defined as an exchange in which, pursuant to "An Agreement", the taxpayer transfers property held either for productive use in a trade or business or for investment and subsequently receives another property to be held either for productive use in a trade or business or for investment. In order to qualify for tax deferral, it is essential to carefully structure an exchange to avoid actual or constructive "receipt" of proceeds of sale and to prevent characterization of the transaction as a taxable sale and reinvestment.

³⁰ Friedman, *op. cit*.

attention to the bottom line. The traits of the private industrial developer – usually smaller, more flexible, and more risk-oriented, and definitely committed to a long-term relationship with their customers – may be more appropriate for providing the kind of individualized lease agreement a prospective tenant needs to obtain a competitive advantage over its competitors.

CenterPoint Properties is proficient at adapting to marketplace requirements. Their management team has instituted strategies for responding to every stage of the economic cycle, modifying its investment emphasis through the recovery, strong economy, and recession phases. In the event of economic change, the Company is well organized to accommodate its clients, and the reaction time is minimal. The REIT structure does not preclude this Company from effectively serving its tenants. A 95% tenant retention rate confirms this. Regarding risk, CenterPoint is anything but risk-averse. Gates explains that there are properties on the market for sale that are not suitable for CenterPoint Properties Trust because they do not involve sufficiently large problems for the company to solve and subsequently create or add value.³¹

³¹ Friedman, *op. cite.*

Pros and Cons of the REIT Format

REITs are hampered in their ability to retain earnings, this prevents them from supporting growth internally. To facilitate the acquisition, maintenance, and development of properties, REITs must constantly source the public markets for equity while concurrently shelling out dividends. The constant need to raise capital engenders high fees along with the ambiguity surrounding secondary equity placements.³² It is interesting to note that the REITs in operation during the 1990s are self-advised and self-managed. REITs were initially conceived to exist as passive investment vehicles that depended on the counsel of advisors who performed duties akin to portfolio managers in mutual funds.

The contentious issue with REIT restrictions also encompassed management fee structures. Management compensation was not coupled with overall REIT performance and this circumstance created a conflict of interest between management and REIT shareholders. Private developers lamented losing control of their properties when they converted their companies to the REIT format. However, in the latter half of the 1980's, private letter rulings from the IRS authorized REITs to assume responsibility for selecting investment properties and managing assets, giving management the opportunity to direct the destiny of the REIT.³³

The Senior Executive from Hines' affirms, "REIT's are only a form of capital structure for real estate ownership and this capital structure doesn't in and of itself add value. The value that is created is done at the property level in the local market place and not on Wall Street. The REIT structure does not add value to the company; it only allows them to raise money in the public markets. Hines Interests has the ability to access that capital by simply joint venturing with a REIT but we have not done so because we fail to see the value in this practice because there is no lack of capital in the marketplace. What is more, total REIT capitalization is small in comparison with the total amount of capital invested in real estate worldwide. Just as other 'hot financing structures' Hines has disagreed with, REITs, in our view, were just another competitor whose limitations were recognized by the investor market. It appears that

³² Brent W. Ambrose and Peter Linneman. "The Maturing of REITs," *Wharton Real Estate Review*, (1999), pp. 39.

³³ Ambrose and Linneman. *Op. cite.*, p. 39

REIT's are not a growth stock but an income stock similar to a utility company. The prominence of REIT's in the market did affect our objectives towards the end of the last rising real estate market. Our company noticed that REITs were overpaying for assets. In response, we repositioned ourselves in the market and became sellers instead of buyers. Our attitude was, 'If REIT's think that a building is worth the numbers they were willing to pay, then we are going to be a seller.' We had confidence that we could buy the properties back once the market corrected."³⁴

According to Ed Linde, Boston Properties CEO and President, when it comes to raising capital the REIT format gives Boston Properties an additional edge with respect to capital accumulation. Linde contends that the REIT format has made Boston Properties a better organization and a stronger operator of real estate. According to Linde, Boston Properties exists as an ongoing-operating business and not as a deal-by-deal-by-deal business. He states that this circumstance has made his company more appealing in the eyes of capital providers in the public and private markets. Linde asserts that Boston Properties has an easier time sourcing capital. He also states that the disciplined approach to real estate development as a result of going public has made his company a more efficient machine. For example, Boston Properties capital structure has lower leverage levels than it did while it operated as a private concern handling deals on a one-off basis. Linde states that his company's capital structure is oriented towards having the capacity to engage in future transactions. The adoption of the REIT structure has not affected the way he runs the company and he emphasizes that he has been a real estate operator for over 30 years.

Public investors have significant direct and indirect control of both debt and equity real estate capital. The downturn in REIT share prices during 1998-1999 effectively precluded the real estate industry from sourcing equity capital.³⁵ Although REIT developers like Boston Properties have been successful issuing equity in the public markets, adopting the REIT structure does not guarantee access to public market capital, rather the REIT format guarantees a company the *opportunity* to access capital through the public markets. Furthermore, REIT share prices, more often than not, are more volatile than private real estate prices, notwithstanding the carnival of the early 1990s. Stock market conditions change

³⁴ Hines Senior Executive, *op. cite*.

³⁵ David J. Kostin, "Giving Thanks," *Goldman Sachs REIT Weekly* (November 24, 2000), p. 1

faster and with less predictability than private real property markets. For example, REIT share prices tumbled in 1987 and in 1998 while private property prices remained constant. REIT shares may sometimes fall in sympathy with the overall stock market. Ironically, this volatility is caused by the liquidity advantage bestowed by the public markets and is a result of stock market investors' investment horizons being shorter than those necessary for the nurturing of real property.

Hines' representative stresses, "REITs cannot keep cash on hand from net income due to their REIT distribution requirements. REITs are allowed a maximum of 40 percent debt on their portfolio. Therefore, the only way REITs can raise money for development or acquisitions is through the equity markets. If the equity markets are not accessible to REITs due to low stock prices, REITs cannot raise cash so they sit on the sidelines. This causes them to lose their best people because those senior executives can't make money by sitting on the sidelines."³⁶

Linde claims that Boston Properties employs "opportunistic capital sourcing" to circumvent the distribution requirements outlined by the IRC that retards internal growth. Linde has turned this restriction to his company's advantage. Boston Properties is very disciplined and flexible in its approach to raising capital. Linde does not view this as a problematic provision. He asserts that the culling of assets through capital recycling is a good business practice that a company should undertake whether public or private. Boston Properties has been particularly alert to the conditions in the market in order to ferret out opportunities to source capital. Linde is an advocate of capital recycling. Boston Properties has sold \$100 million dollars of assets in the previous 18 months. Boston Properties will sell assets in their portfolio that has exhibited sluggish growth or have reached a level of optimum stabilization where the upside to these assets have been realized and they no longer demonstrate the potential to increase in return over time. Boston Properties sells these assets with the intention of putting the capital to work in projects that will generate more income.

³⁶ Hines Senior Executive, *op. cite.*

Saying “No” to the REIT Structure

Because Hines was building architecturally significant buildings in prime locations in central business districts, Hines’ offshore investors were looking to invest significant real estate funds in the US in extremely safe projects. A bank, thereby ensuring credit access, often anchored these projects. The tenant took the highest leasing risk space, on a long-term lease of greater than 15 years. These international investors wanted to move a significant amount of money into the U.S. real estate market. The content of Hines’ portfolio provided the opportunity these investors were seeking. The buildings had tenants, with excellent credit profiles, that were locked into long-term lease agreements in the best buildings in the regions in which they were located. Moreover, Hines’ partners felt comfortable proceeding with all-equity deals. Hines’ Senior Executive asserts that offshore equity investors had clients, who were the source of their funds, in countries like the Netherlands, Germany, Saudi Arabia, Kuwait, and Japan that were accustomed to receiving a three percent return on their money. Therefore, when the real estate market plummeted, Hines’ buildings remained on leased albeit at lower rents. Although the return on equity was lowered, the buildings did not have mortgage obligations and no foreclosures occurred. According to Hines’ Senior Executive, Hines’ competition, firms such as the Trammell Crow Company and Olympia & York Properties acknowledged that Hines’ approach was worth repeating.

Hines’ Senior Executive illustrates the difference between Hines and their competitors. He asserted that many firms went public, otherwise they would have filed for bankruptcy. Hines manages risk better and avoids the excessive leveraging of its properties. During a slight downturn, an over-leveraged property is lost to its lender because the debt service is too high. However, most of Hines’ transactions are 100% equity financed, therefore the company is better able to withstand differing market cycles.

Stratouly states that in order to transition from a private developer with managed assets to a publicly traded REIT, the developer needs an asset base that is homogeneous, consistent, and controllable. Congress Group Ventures had an equity partner on the majority of their assets and the

partner did not want to go public. This made it difficult for the company to proceed. As such, Congress Group's assets class did not fit the description of controllable. Congress Group Ventures survived the credit crunch of the early 1990's by restructuring loans, delving into the firm's cash reserves, and selling assets to meet remaining obligations. The firm also reduced its staff significantly from fifty people to five.

Although Stratouly points out that a controllable asset base is a necessity for a private firm looking to make the transition to public status, Great Lakes REIT, a fully integrated self-administered and self-managed real estate company, demonstrates that this is not always the case. Great Lakes started as a private REIT in 1992 without money or assets. The Company conducted three private placement offerings between 1992 and 1994. The majority of funds raised came from high-net-worth investors.³⁷

Remaining Private: A Sound Decision

The Senior Executive at Hines stated that the Company's decision to remain a private concern was the correct decision during the early 1990's. At the time REITs were considered as the "hot new financing vehicle." He also asserted that the history of real estate is littered with various trendy financing devices. Twelve months ago it was REIT's. Other historic vehicles that Hines has avoided are commingled funds, tax driven ownership structures, CMBS etc. He claims that these vehicles have one or more of the following:³⁸

- 1) High risk (i.e. Co-mingle funds did very poorly because the interest of the investors was not aligned properly with the interests of the fund managers – fund managers lived off of fees, the investor wanted good returns – the fund managers had a disincentive to sell properties (i.e. lower fees) therefore the managers always held on to property and did not sell at the high value point in the assets life (therefore getting the investor the high returns promised),
- 2) Investment strategies based on loop-holes in tax law that were closed by a change in tax law (i.e. accelerated appreciation tax shelter structures) or

³⁷ Steve Felix, "Great Lakes REIT: Sponsor Interview," *Institutional Real Estate Securities*, September 2000.

³⁸ Hines Senior Executive, *op. cite*.

- 3) High fee structures (i.e. high cost of money structures) like CMBS. The CMBS debt market is the high loan to value market and a very expensive way to place debt on a property due to high investment banking fees. We can finance a large building at 100 to 200 bp less in the Pension Trust/ Life Company debt markets than the CMBS. The difference is almost all fees.

Second, according to this Senior Executive, Hines is successful because they nurture an entrepreneurial culture by maintaining a flat organizational structure. They are well positioned and are able to make critical decisions, thereby securing value in a project due to pricing arbitrage in the market. The public nature of a REIT exposes the company to questioning from the public market and this engenders bureaucratic activity that ultimately delays the decision-making process and leads to lost opportunities. It also prevents doing high value added investments that take more than a few quarters to materialize.

Hines' Senior Executive asserts, "Our organization is made up of less than ten percent accountants that are non-value added staff. While accountants can and do add value, REITs are subject to a considerable amount of reporting because of their high number of accounts. Due to current regulations, and this is an embellishment, but it seems as if REITs are made up of almost 50 percent of accountants!"³⁹

While the Senior Executive explained that REITs are a permanent feature of the market, the downside is a REIT's stock price is subject to the uncertainties of the public market. According to this Senior Executive, Hines is not subject to such intangibles and can spend more time creating value in real estate rather than being worried about external public agents and other related factors. The Senior Executive states, "A REIT's stock price varies because some Analyst on Wall Street thinks they know more about what is happening with rents (i.e. Cash Flow / FFO) at the corner of 'Main St, and Fifth Ave' in some city half way across the country. I consider this to be the best example of the 'tail wagging the dog.' Some of my peers, at the helm of REITs, spend 30 - 40% of their time managing the Analysts on

³⁹ Hines' Senior Executive, *op. cite.*

Wall Street. I am happy to state that I spend 0% of my time dealing with external agents of this nature. I spend the bulk of my time is adding value to the real estate under my management and having fun.”⁴⁰

Why Adopt the REIT Format?

After experiencing the real estate “depression” for at least six years, Boston Properties believed that the economy was about to improve and they were in a position to profit from the available opportunities. Boston Properties wanted additional capital to deploy for real estate acquisitions. Given the depressed prices of real estate assets and the capital available in the public markets, the Company believed it was an unusually good opportunity to go public. The REIT format provided Boston Properties with great “balance” regarding capital access. Boston Properties could go to the private markets when public market capital was too expensive or inaccessible. The REIT format provided the Boston Properties with a strong balance sheet, which is a bargaining tool when the Company decides to approach the debt markets. The REIT structure provides flexibility in a shifting economy. For example: In the Fall of 2000, Boston Properties executed a public offering and netted \$635M, while in this current climate, it would be more difficult to raise that amount of equity in the public markets. However, the Company can negotiate from a position of strength when they enter the debt market because of the quantity of equity on their balance sheet. Boston Properties can leverage this equity in an attempt to produce excellent returns for their equity holders. Boston Properties can also access debt capital that private developers would have hard time accessing. Ed Linde, Boston Properties’ CEO and President, commented that in addition to the capital itself, access to capital is integral to engage in development. Linde states, “In this modern era every development company needs equity to finance their deals.”⁴¹

George Berry, Senior Vice President at Cousins Properties, states that the current REIT structure Cousins currently employs was implemented in 1987. However, in the early 1970’s Cousins organized a REIT, Cousins Mortgage and Equity Investments, Inc. (CMEI). Under the former rules, a REIT had to be a passive entity that simply held assets and passed on to investors the net profits. Cousins Properties Inc.

⁴⁰ Hines’ Senior Executive, *op. cite.*

⁴¹ Linde, *op. cite.*

was a private company that had a contract to advise the REIT. Later, as the REIT laws changed to allow management and development activities, the organization was changed such that CPI became the REIT. Berry stated, "Cousins has taxable subsidiaries through which the Company conducts some of its activities, mainly those that require the sale of assets, such as residential subdivision development. The basic reason for the REIT structure is the favorable federal income tax treatment. With the REIT structure, we can avoid the double taxation levied on profits from real estate activities. Secondly, it offers the promise of raising capital in an efficient and cost effective way. In addition to operating as a publicly listed company, the REIT structure gives us the resources needed to accomplish our mission. We have specific investors who are attracted to us because of their REIT structure."⁴² Berry further stated that the REIT format immediately opened up the public market to Cousins. It allowed the company to grow through equity investment as opposed to corporate debt.

The REIT Format is Unsuitable for Development / The REIT Format is Effective for Development

Even though the REIT status confers upon Cousins the opportunity to source capital through the public markets, they rarely take this course of action. One of the alternative devices the Company employs is the recycling of capital. The company has been recycling capital since the 1970's. In simple terms, they build and lease a building, and then ensure that it reaches a satisfactory level of stabilization. Cousins then places a permanent, non-recourse loan on the asset. Typically, the amount of this loan approaches Cousins' initial capital investment in the asset. The Company uses the proceeds from the loan to complete a subsequent project. In this way, Cousins grows "retained earnings" over time in asset value over the amount of the debt they have placed on their property holdings. Real estate development is what Cousins identifies itself with. This is a REIT that manufactures real estate assets continually throughout all phases of the business cycle.

While Cousins identifies itself with development, the Senior Executive from Hines flatly stated that, "The REIT structure does not work for development." He explained, "A REIT's number one goal is

⁴² Berry, *op. cite.*

to increase its stock price and a REIT's stock price is based on FFO. FFO is equal to cash flow minus depreciation. This is a bit of an over simplification but close enough for comparative purposes. A REIT's stock price varies directly with the amount of cash flow.⁴³ The nature of development is to build something for \$100 that is worth (due to cash flow created by new leases) \$150. But in order to do that, one needs 2 to 3 years to build the property. During that time, no money is coming in. Therefore, development is dilutive to a REIT's stock price because it is consuming cash and increasing the to capitalization of the company while providing no cash flow, or FFO, to the bottom line. The behavior of Sam Zell's company is as an example as to why some REITs will not develop properties. Zell will do forward purchase contracts that say, 'Very well Mr. Developer, once you are finished constructing the building, I will pay for your building based on a "x"% cap rate'. This allows Zell to avoid having the cash flow down time while at the same time accessing new cash-flowing properties. Therefore, Zell matches capital outlay with cash flow/income which increases his company's stock price."⁴⁴

Linde vehemently objects to the notion that the REIT format is sub optimal for development activity. He claims that Boston Properties is the most active developer in the country by a factor of two and exclaims, "So much for the passive nature of the REIT structure."⁴⁵ The REIT format has not inhibited his company's ability to execute development projects. Boston Properties engages in development because they believe they have the expertise to manage risks and that this activity produces excellent returns for shareholders. Linde's company engages in institutional joint ventures where Boston Properties provides a third of the budget for a 50 percent equity stake while the opportunity or pension fund puts up two-thirds of the budget for the remaining 50 percent of equity. Boston Properties benefits from this enhanced return because of their development expertise.

Stratouly believes the REIT structure exacts a price in the form of lost autonomy and a reliance on "public relations," and catering to the whims of Wall Street analysts who know nothing about real estate and value creation at the development level. Startouly's peers who have gone public detest the typical

⁴³ The denominator in the P/E ratio - P/E ratio is what analysts use to compare REIT's stock prices, Hines Senior Executive.

⁴⁴ Hines Senior Executive, *op. cite*.

⁴⁵ Linde, *op. cite*.

REIT “promotion”, or public reporting, including the numerous time constraints. Congress Group Ventures had no intention of going public if it wasn’t in a distressed state. Adopting the REIT structure puts formerly private companies in precarious positions where they are subject to public market oversight. Congress Group Venture is primarily a development company that does not like selling its assets in a balanced market. Stratouly suggests that if Congress Group Ventures were to go public the REIT’s structural restrictions on income retention and the balance sheet ramifications of development would be considerable hurdles for his company to surmount. The one-off project financing with several different equity partners sharing positions in various company holdings would make a transition to public status expensive and cumbersome.

Berry points out that the original intent of the REIT laws limited the trusts to the passive holding of real estate assets. However, this has changed over the years. Today REITs can operate in much the same way as a privately held company. There are some exceptions such as the requirement to pay out 95% of earnings each year and the limitations on selling of assets. However, Cousins does not find these limitations to be onerous, especially given the substantial tax benefits. Berry declares that development is the method through which real estate values are created. Over the years Cousins has made great progress in reducing and managing risk. In fact, Cousins was a risk averse company prior to becoming a REIT. Obviously, the necessity to pay dividends on a quarterly basis and to publicly announce financial results on a quarterly basis, impacts a company’s operations. Berry states that with the various amendments to the REIT act over the years, the REIT structure is suitable for development activity.

Cousins’ continued history of delivering stellar shareholder returns is an advertisement that the REIT structure is indeed suitable for development activity. Cousins has delivered average annual returns of 19 percent since it went public in 1962, and of 29 percent, since 1977.⁴⁶ Cousins is noted for its practice of implementing development initiatives within well-defined risk parameters. Pre-leasing is considered an important part of these parameters. Berry states, “Short-term ‘break-even,’ the point at which a new development, after the capitalization period, is not dilutive to FFO, generally occurs

⁴⁶ Barry Vinocur, “First Cousins,” *Property Magazine* (Winter 2001)

between 65 and 75 percent lease-up, depending on the product and the pro forma yield. We successfully market our projects to prospective users well in advance of actual construction. For example, in three retail projects currently under construction, 64 percent of the space was leased or committed at groundbreaking and is currently 70 percent leased or committed within an average of nine months before delivery of space. Our office projects, now under construction have 76 percent of its space pre-leased. In January 2001, Cousins' development pipeline was valued at \$496 million, and nearly 86 percent of this pipeline is pre-leased."⁴⁷ In conclusion, Berry says, for over forty-years Cousins has established a reputation of the highest quality office environments in this Atlanta. This reputation and any goodwill it generates gives Cousins an advantage over its competitors.

The REIT Structure's Effect on the Real Estate Industry

According to the Senior Executive from Hines, REIT's ability to obtain high returns on their investments, led institutional investors to transfer money from the private market to the public markets in search of REIT stocks. The institutional investor's justification was:

- 1) The returns were good; and
- 2) The stock provided them more liquidity and diversification.

However, when the market does not like a REIT and the stock drops, there are no buyers and therefore no liquidity. According to the Hines' Senior Executive, "Warren Buffet once said, 'I don't know why investors spend so much time on diversification because I only have so many good ideas and therefore I ignore diversification.' If a REIT invests poorly, investors lose money, regardless of whether the REITs

⁴⁷ Berry, *op. cite.*

are diversified. Furthermore, towards the end of the period when REIT's were extremely popular, REIT's started over paying for their investments in order to maintain their stock prices."⁴⁸

Stratouly asserts that the industry has shifted from an entrepreneurial one to one that is institutional in nature. In terms of market conditions and sourcing capital, the market fluctuates continuously, if a company does not have access to a discretionary fund. Stratouly asserts, "I believe that sourcing capital from the public markets puts development companies in a precarious position. In the early 1980's, developers were considered the critical contributors to value. Developers located, permitted, controlled, and packaged sites. By the late 1980's developers were relegated to secondary roles. When the credit crunch of the late 1980's and early 1990's put a strangle hold on developers the most important component of a real estate deal was the capital and not the real estate and certainly not the developer of the real estate. The money manager has the attribute of value creator now and not the real estate developer. The reluctance of banks to carry real estate obligations on its balance sheet hurt private companies like Congress Group Ventures that engages in one-off project financing."⁴⁹ Stratouly further states that when Congress Group Ventures has to deal with the public markets to source capital, the company is at the mercy of the markets since the public market is not a static entity.

George Berry declares that the real estate industry is changing as the percentage of publicly owned assets grows. The industry is not nearly dominated as it once was by the wealthy entrepreneur. Professional managers direct publicly owned REITs in the same manner as their private counterparts. The major difference in managing a publicly owned company versus a privately owned company is, of course, compliance with the SEC rules and the other relations one must constantly nurture within the investing community. The Boston Properties CEO's contends that effective reporting measures can only serve to improve an operation's capacity. Whether a public or private entity, succinct summations possessing clarity and accuracy will improve access to capital for any company.

⁴⁸ Hines' Senior Executive, *op. cite.*

⁴⁹ Stratouly, *op. cite.*

Public Market Oversight and the Inappropriate Business Analysis of REIT Development Activity

The demands of Wall Street impose a new kind of discipline on developers and according to some operators who maintained their private form, not all of it is good. Historically, developers have been very resistant to the type of discipline endorsed by analysts.⁵⁰ The large analytical framework put in place to scrutinize real estate securities in both the equity and debt markets has forced companies backed by public funding to supply in-depth information about all aspects of their business – this includes “same store” performance, capital spending, and sensitive managerial issues. Essentially, what is required is a detailed summary of the economic consequences of the firms’ business strategy from a micro (property) angle as well as a macro (portfolio) angle. Public REITs are constrained by SEC regulations that state that public companies must provide detailed explanations of their portfolio performance on a quarterly basis. In addition to this, they must also disclose their current liquidity and future funding needs. When the REIT is subject to these conditions, the objective is to produce an acceptable if not attractive rate of growth regardless of the economic real estate environment. The result of this dynamic is that transactions are no longer additive to earnings and the typical public real estate company is making a transition from a transaction-oriented business to one that is focused on operations. This portends difficulty for the public company that desires to engage in development activity.⁵¹ The paradox to these circumstances is that despite the distribution requirements that REITs must adhere to, the employment of debt must be treated gingerly because this will affect the cost of equity. However, the low leverage levels circumscribe their return on equity, which in turn precludes REITs from achieving the growth status that Wall Street approves of.

Hines’ representative offers that his company can analyze a REIT’s deals by searching EDGAR and obtaining the past 10K or 10Q’s. If Hines is curious about what a REIT competitor’s activities, Hines has access to this public information, like the rest of the investing public. A company can just call up a REITs latest 10K or 10Q and the entire lease or sale analysis is already complete. Therefore, when Hines

⁵⁰ Hines Senior Executive, *op. cite*.

⁵¹Raiman, Lawrence, May 1999, “The New World Order of the REIT Business,” Donaldson, Lufkin & Jenrette: Equity Research, p. 5.

or any other private development concern competes with REITs, the REITs pricing tendencies are public knowledge. He asserts that this circumstance makes the life of a private company very easy and that REITs are at a competitive disadvantage to well-managed development firms. A REIT's information is easily accessed due to the SEC requirements. Hines Interests on the other hand is stealth.

Linde disagrees with this assessment. Regarding stealth and the concealment of business activities, Linde states that if Boston Properties was a smaller company then it might benefit from being off the public radar screen but since the company is large and operates on the scale that they feel is necessary to operate, Boston Properties couldn't stay below the radar screen even if the company had remained a private concern. He further states that capital recycling keeps his company out of the equity markets at unfavorable times and allows his company to exercise their development expertise and it doesn't occur at the expense of the company's financial performance because the asset base isn't expanding needlessly thus avoiding the reduction in overall return.

Hines' representative contends that the hiring of high value-added entrepreneurs by a REIT is almost impossible because independent minded professionals won't work in a bureaucratic environment that is engendered by analysts being in your hair everyday. They need autonomy (i.e. a license to hunt for good deals) in order to stay on such a team.

Linde contends that Wall Street's influence has made Boston Properties a better operator and he doesn't think that the dynamic between public real estate development companies and Wall Street is a negative. He asserts that Boston Properties operates as a unified business and not a series of individual deals. Linde claims that his company has gotten better at tracking, exchanging, and managing information regarding the condition of their portfolio to a degree unimaginable if Boston Properties has remained a private concern. Linde goes on to add that his company needs to have the facts and figures at its disposal. He believes that private development concerns should submit themselves to this discipline and eschew the looser forms of management that pervade the private sector. Linde goes on to say that the financial information is much more valuable to Boston Properties for the internal management of their real estate holdings than simply because Wall Street demands it. Linde asserts that Boston

Properties would engage in detailed financial reporting even if Wall Street didn't require them to provide it. This discipline is essential to a healthy business, public as well as private. Thorough periodic fiscal assessments are essential for maintaining the level of vigilance necessary to compete effectively.

Stratouly believes that his firm has an advantage over REITs where decision-making is concerned. Congress Group Ventures, as a private rather than a public concern, is faster, more nimble, and is a stealth player since it is not subjected to any strict set of reporting requirements or procedures. The attribute of stealth allows them to remain below the radar of the competitors in the market. Public companies need to engage in administrative gymnastics pertaining to their balance sheet in order to undertake development projects and avoid the balance sheet scrutiny and the subsequent hit on its FFO.

Linde believes that the complaints pertaining to the lurking presence of Wall Street have more to do with personal inconvenience. Although Linde has justify his company's actions to explain to Wall Street, Linde feels this makes him a better real estate operator and in no way hinders his ability to effectively and profitably manage a real estate development company.

Stratouly concedes that the one-off financing model is the not the most cost-effective means of accessing funds. He believes that growth is the direct result of a company's ability to access capital at rates that are commensurate with the market's ability to sustain that rate. Under these conditions growth is achievable. Congress Group Ventures is a project-based company that grows by executing projects instead of increasing FFO like publicly traded REITs. Even though Stratouly's company is afforded the flexibility they desire by remaining private, financing projects on a project-by-project basis is very inefficient when sourcing the public markets. Stratouly and his partners are still providing guarantees for their loans, whereas the REIT format would obviate this circumstance.

Berry asserted that Cousins has better access to capital and that an investor can rely on a staff of proven professionals to create value in real estate assets and to pass the benefit of that added value through to them free of income tax charges. The disadvantages associated with the REIT model include the difficulty of making long-term investment decisions with respect to assets that do not produce immediate revenue. Cousins has to be exercise caution regarding the amount of speculative space they

build as well as investments in unimproved land for future development. Berry also admits that complying with the SEC's disclosure requirements is sometimes burdensome. Despite this cost of doing business as a public company, Berry contends that the benefits far outweigh the costs.

Ed Linde makes a strong argument for the disciplining influence of public market oversight and accountability. However, Wall Street intervention still comes with a few caveats. A typical analysis of real estate assumes stable growth with yearly increases in revenues normally fueled by inflation. Potential revisions and alterations in demand or competition, that is, additional supply in the marketplace, are not anticipated or included in studies. Yet these are the most important factors to consider since no other aspect has as much bearing on a real estate asset's ability to meet projections. Prior to the pervasive adoption of the REIT format, real estate was considered as an investment rather than a performance vehicle. Investment in the development and management of real estate was considered to be a wealth generator instead of an operating business.⁵²

Development-oriented REITs are faced with expectations to deliver performance on a quarterly basis while undertaking investments that yield returns well after the capital has been utilized. The appropriate measures for evaluating investments with future payoffs does not always correspond to the tools employed to scrutinize the rest of corporate America. For example, over the past five years, Cousins Properties has reported annual growth in FFO per share of 31%, 17%, 19%, 21% and 18% respectively, compared to an average 10% annual growth realized by the REIT industry as a whole.⁵³ According to Cousins' 1998 annual report, despite demonstrating exceptional growth, Cousins continues to be evaluated as a property company because the market does not believe the Company can sustain such growth and because no model exists for development companies. The consequence of this dynamic is that Cousins' performance is essentially discounted. Virtually all REITs are moving toward property company valuations, price/earnings multiples are becoming less common. Cousins is also being valued for their assets and not its unique development or "asset manufacturing" ability. As a result Cousins'

⁵² Phone interview with Blake Eagle, CEO of National Council of Real Estate Investment Fiduciaries (NCREIF). August 5, 2001.

⁵³ Cousins Properties, Inc., 2000 Annual Report

price/earning multiple has actually gone down, despite exceptional and substantial growth in earnings. REIT developers must communicate the fact that they are creators of value so that the market better understands their structure and more accurately evaluates their business.

REIT Effects on Financing, Marketing, and Public Relations

Public non-real estate companies typically invest in long-term assets using money that is generated internally. These funds come from the company's depreciation and from earnings that are not paid out as dividends. Shareholders want to see companies invest these funds in positive-NPV investments because the assumption is that this will lead to capital appreciation in the value of their shares. In some years a gap exists between the capital that is needed for these corporate investments and the money that is internally generated. In order to make up this deficit companies must decide to either sell new equity or borrow the necessary funds.

Financing decisions are reduced to two questions:

1. How much profit should be reinvested into the business rather than paid out as dividends?
and
2. What proportion of the deficit should be financed by borrowing rather than by equity?

The first question demands that the firm formulate a dividend policy and the second question addresses the need for a debt policy.⁵⁴ Real estate development is a capital-intensive business with considerable risk, therefore development-oriented REITs are faced with a dilemma. First, as outlined by the IRC,⁵⁵ REIT distribution requirements state that shareholder distributions must equal or exceed the sum of 90 percent of REIT taxable income. A fundamental tenet of corporate finance is that a firm's most basic

⁵⁴ Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance*, (Burr Ridge, Illinois: Irwin McGraw-Hill, 2000), pp. 383-384

⁵⁵ Internal Revenue Code Section 856(c), of 1986, as amended.

resource is the stream of cash flows produced by its assets.⁵⁶ Thus, as a corporate entity engaged in a capital-intensive growth initiative, development-oriented REITs possess a dividend policy that is set in restrictive, immutable terms. Unless investors are sophisticated about the nature of real estate investment and management's ability to negotiate these restrictions, REIT stock prices will trade at discounts to their net asset values (NAV), thus affecting their ability to access capital at attractive rates. Ironically, REITs were extremely popular for in the early 1990s precisely because of this feature. The IRC's tenets regarding dividend policy and the constant surveillance by analysts and rating agencies of the liability side of a REIT's balance sheet affects the REIT's ability to market itself to the public. A company's dividend and debt policies are viewed as marketing decisions because the company is packaging and selling its assets, operations, and growth opportunities to outside investors. To some managers of REIT development companies these circumstances seem nonsensical. Development companies manufacture assets in a similar fashion to a companies like IBM and Xerox. The argument involves the tax benefits that REITs enjoy. Tom Peck, Vice President at Duke-Weeks Realty, a REIT developer based in Indiana, stated that at one point Duke-Weeks seriously considered reverting to private status.⁵⁷ The company commissioned a comparative study illustrating the results under the two scenarios. They concluded that the tax benefits they enjoyed as a REIT outweighed the obstacles that the REIT format presented.

Conflicting Views on Operations and the Use of Leverage

Dr. Yougou Liang published a research report in 1998 in which he asserted the following statements, "Historically, private developers have utilized as much leverage as possible in an attempt to lever up their returns on equity in addition to their low cash balances for development projects. As a result, private operators employed one-off project financing for their proposals. With each deal apportioned, the high risk, high return goals of private developers were best achieved by maximizing the use of leverage. Public equity market analysts disagree with this tactic, viewing it as inefficient because it obscures the big picture of a firm's economic condition. Analysts seek a comprehensive view of a

⁵⁶ Brealey and Myers, *op.cite.*, p. 382

⁵⁷ Phone interview with Tom Peck, Senior Vice-President, Duke-Weeks Realty. July 16, 2001

company's consolidated debt circumstances instead of vignettes of individual projects. This entails determining whether earnings are a result of real estate expertise , which is construed as a recurring event, or opportunistic financing, which is considered a product of circumstances rather than skill. This analysis illustrates the difference between corporate and project finance. Private developers, like typical mavericks, do not contemplate the 'correct' amount of debt but rather how much debt they can potentially obtain for their projects.⁵⁸ With the adoption of the REIT model, the mixture and ratio of debt to equity is of paramount importance to corporate strategy. Management must recognize this shift in focus and administer REIT operations accordingly.

⁵⁸ Dr. Youguo Liang, "A Brief Story About REITs," Research Report, Prudential Real Estate Investors 1998

Loss of Flexibility

REITs have to abide by rules set up in the IRC. The financial flexibility available to owners for managing income and assets is lost when property is placed into a REIT. When development firms go public with the intention of continuing to develop property, they must reconcile long-term growth and appreciation returns from real estate with the requirement for short-term reportable earnings to the public markets. The merchant builder⁵⁹ approach would rectify this circumstance, however, IRC income requirements demand that REITs keep properties in their portfolios for no less than four years unless through involuntary conversion or foreclosure.⁶⁰ This IRC provision prevents the development-oriented REITs from engaging in merchant building activity when the building-for-sale approach could potentially solve this problem. Thus, a development-oriented REIT that develops buildings will book operating losses during relatively long construction and holding periods. The solution of choice for many REIT developers is the structuring of a joint venture agreement between the REIT entity and a private developer. This marriage allows the development-oriented REIT to pursue its unique goals and avoids the problematic issue of combining a cash flow oriented business with an earnings-oriented business.

Public Market Relativity

The downside of exposing real estate to pools of investment capital that traditionally ignored the property markets is that the relative attraction of REIT shares in comparison to stocks of other sectors (including high-tech, internet, large capitalization) plays a larger role in determining the valuation ascribed to underlying real properties of REIT shares. The opportunity to access more diverse sources of capital traditionally has had the effect of lowering the cost of capital but only under favorable stock-market conditions. Today, REITs have to compete more with alternative forms of investments, than they have had to in the past. If an event in the larger stock market community makes REITs less desirable, then the pricing of public market capital might not seem as reasonable.

⁵⁹ Merchant Builder. An initial landlord who is motivated to build and rent a property, sometimes to a pre-specified level of rent stabilization, then sell it immediately for a profit.

⁶⁰ Internal Revenue Code, Section 856(c), of 1986, as amended.

REITs must plan strategically in order to take advantage of market opportunities, they must properly “time the market.” The ideal time to increase leverage levels for investment use is when their stock prices are relatively high thereby promoting more borrowing because presumably the property markets are also high at this time. This in turn makes it difficult to locate acceptable deals based on property returns. Conversely, when the property markets are depressed and real estate companies are seeking to acquire properties at discounted values, REITs are at a disadvantage because they cannot issue equity when their stock trades at a discount to NAV. Besides this fact, an equity issuance under these circumstances would dilute the holdings of current shareholders. Companies who engage in this practice receive harsh punishment from the public market. However, according to Ed Linde, REITs do not have to develop assets nor acquire assets to grow.⁶¹ What stimulates growth, he asserts, is the responsible deployment of capital and assets. Regardless of whether older assets are disposed or shares are repurchased. Bill Maguire, CEO of Summit Properties, agrees with this assessment.⁶² Maguire also believes that the REIT format furnishes a company with an expanded arsenal in which to operate, albeit within certain parameters that require the acumen of competent leadership to maximize its potential.

Potential Effects of the REIT Modernization Act (RMA)

Linde states that the effects of the RMA will mitigate some of the hardships related to distribution requirements and enable Boston Properties to eliminate the convoluted arrangements regarding the ownership of parking garages and hotels. Previously hotels and parking garages were owned in separate business structure and then Boston Properties would lease the hotel from this business structure in order to generate management fees from these assets. The RMA allows Boston Properties to directly own hotel assets and parking garages and directly draw this ancillary revenue to Boston Properties and not through the shell structure.

⁶¹ Linde, *op. cite.*

⁶² MaGuire, *op. cite.*

The enactment of the RMA gives some real estate players optimism regarding the selling of their services to their tenant base.⁶³ Although at present, Linde claims that the RMA is not very important to Boston Properties, it will allow the Company to engage in fee development should it wish to do so in the future.

⁶³ Linde, *op. cite.*

IV

Business Strategies of Development-Oriented REITs

Real Estate Development

During the development stage the developer buys wholesale and sells retail. Developing property is very often more difficult than acquiring a stabilized built asset. However, development may prove to be a more cost effective method of establishing a product with an acceptable investment yield. It is difficult to secure public approvals to alter the status quo and obtaining funds for a development project with no proven history of revenue generation. In order to solicit funds, real estate developers must coordinate the efforts of various skilled professionals. Why do firms insist on engaging in this precarious practice? Higher risks engender higher rewards.⁶⁴

Advantages of Real Estate Development

By investing capital in new development, value is created and a premium over development cost is achieved. This is not possible simply through the acquisition of assets at retail prices. Development is prohibitively expensive and fraught with risk and the ability to keep costs low is essential to the successful completion of a project. Replacement costs, which include more than construction costs, are the ultimate barriers to access. Firms that have a history of successful development and significant development expertise have an edge over firms with less experience. These firms are better positioned to experience greater yields on their investments, allowing them to compete more effectively on rents. Although it is extremely risky, development affords a particular class of capital providers the opportunity to receive higher returns for their investment objectives, than they would otherwise have access to in other forms of real estate activity.

Real estate performance is an indication of past levels of activity and is not a reliable indicator for future levels of activity. The most significant factor influencing real estate future value is competition. Real estate performance is what advances new development. In the absence of barriers to new development, the superior performance generated by real estate assets draws the interest of competing

⁶⁴ William J. Poorvu and Jeffrey L. Cruikshank, *The Real Estate Game* (New York, New York: Simon & Shuster Inc., 1990), p. 146.

developers eager to gain access to profits that may be available in the market. Barriers to access protect the investment from competition.⁶⁵ Commercial lenders make it a priority to review a company's financials in comparison to industry conditions in order to gauge the company's current worth and also to ascertain the company's future performance. Bars to access are an excellent form of protection for monopoly-like profits.

Disadvantages of Real Estate Development

Development activity increases the risk profile of a company among capital providers. This has the potential of lowering yields. Additionally, yields are low during development periods and development projects can encumber revenue targets. Not surprisingly, this eventuality draws negative attention from stock market analysts. At times, REIT management will engage in empire building and also lose sight of the overarching goal of profit generation. Instead, they pursue the needless expansion of the REIT's asset base. The return on invested capital is the most accurate measure of performance, rather than the number of assets that are added to the company's portfolio holdings.

Competition from developers seeking profits in the same vicinity or locale can significantly lower current and future yields. The market conditions that make development permissible for one firm also makes it permissible for other firms as well. Land and construction costs may increase in response to increased demand for products and services, thereby increasing the vulnerability of the developer to new competition. Overhead associated with development, at times, will influence investment decisions. If a company has in-house development expertise, management may be tempted to execute deals simply to keep its personnel busy rather than focus on the relative merits of the investment. Development departments are akin to machines that require constant feeding. The financial commitment to move progress with a project is established on the basis of a pro forma, whose cost assumptions are not yet committed to in a contract. This engenders the potential inflation of construction costs. Additionally, construction costs are difficult to control because of the fragmented nature of the construction industry.

⁶⁵ Samuel Zell, "Modern Sardine Management," *Real Estate Issues* (Spring/Summer 1986), pp. 1-5.

Development is also a time-consuming business and few projects can be planned and executed within a year. Many projects take several years to complete. Moreover, the development process is not a linear route and is subject to constant repositioning. The decision to move forward with development is irreversible. As previously mentioned, the initial cost of investment is at least partially sunk and it is not possible to recover the entire cost of the investment once the project has begun. Development activity engenders a higher cost of capital due to the increased risk and uncertainty. Unless executed in-house, development entails the coordination of multiple disciplines external to the REIT. In order to successfully complete development a solid network of professionals, including contractors, architects, and lawyers, is paramount because of the complexity and the myriad of skills necessary to execute a project. The developer may provide oversight but has very little control over the other consultants' performance. These inevitable circumstances amplify the project's risk.

Value in real estate is usually created over a long period of time and the ability to survive downturns is crucial. The development process takes several years, and a decade or more may pass before the operating income stream is maximized. The pay-off in real estate investment arrives late in the life of the project. Although development is extremely risky, the level of risk throughout the life of the project is not constant. Because of this circumstance, a myopic evaluation of development deals is inappropriate. Development-oriented REITs are expected to deliver performance on a quarterly basis while managing assets that deliver performance over a long period of time. The appropriate measures for evaluating investments whose payoffs come years down the line do not always correspond to the tools employed to scrutinize the rest of corporate America. James E. Hodder and Henry E. Riggs assert that traditional devices and techniques used to evaluate risk suffer from three drawbacks.⁶⁶ They are as follows:

1. Inappropriate view of inflationary effects especially in long-lived projects;

⁶⁶ James E. Hodder and Henry E. Riggs, "Pitfalls In Evaluating Risky Projects," *Harvard Business Review* (January-February 1985), pp. 128-135.

2. Disproportionate risk adjustments, chiefly when risk declines in later phases of a project; and
3. Reluctance to recognize how management can reduce project risk by diversification and other responses to future events.

The disparity between the inflationary assumptions regarding cash flows and hurdle rates is most pronounced for projects with payoffs that occur years after a project is started.⁶⁷ The inaccuracy that results from neglecting to include inflation in cash flow estimates compounds with time as long as inflation is positive. Investment in real estate can suffer from understated present values and this inaccuracy may distort a project's evaluation.

Real Estate Acquisitions

The acquiring concern begins with clear and explicit expectations of the benefits to be gained. The attractiveness of an asset targeted for acquisition is measured by the expected return on investment (ROI). If the expected ROI of the acquisition is sufficiently high to justify the effort and equal to or higher than the expected ROI associated with internal growth, the acquisition is potentially worthwhile. Goals of "increased sales" or "improved profitability" are only part of the picture. An acquisition itself will not improve profitability. Only the well-executed combining of complementary corporate resources will create value for the acquirer.

Acquirers typically seek one or more of the following benefits:

1. A stronger market share in a key geographic region;
2. The introduction of a new building type into an established portfolio;

⁶⁷ *Ibid.*, p. 129.

3. Improved economies of scale, such as improved capital pricing, and operating costs spread over a larger number of assets; and
4. A cost-effective way to expand the company's ability to generate profits and increase shareholder value.

REITs have entirely different considerations than a typical private investor. As previously stated REITs are driven by a compulsion to constantly grow, thereby increasing FFO, their multiples and their stock value. Martin S. Katz calls this phenomenon the "LSD Factor," which is the excess, non-real estate value paid by a REIT for liquidity, securitization and diversification.⁶⁸ The greater the market perception of security in a REIT stock and the lower the dividend expectation, the lower the capitalization rate that can be employed to purchase new properties. This may allow a prominent REIT to acquire at a 5% or 6% capitalization rate. Smaller, less prominent REITs can only acquire properties at higher capitalization rates because of greater anticipated dividends by investors.

Advantages of Real Estate Acquisitions

Although complex in its execution, due diligence is an essential tool employed in the acquisitions process to mitigate and eliminate risks. Due diligence is a structured, systematic research effort used to accumulate the facts necessary to make an informed decision regarding an acquisition candidate. This process increases the chances of the acquisition's success both during and after the transaction. The acquirer must begin with clear and explicit expectations of the benefits of the acquisition. After gaining a clear understanding of expected benefits at the outset appropriate due diligence procedures can be identified and efficiently carried out.

Acquisitions allow the purchasing entity to profit from potential mispricing in the market and to quickly build market share and establish a market presence.⁶⁹ It also allows the acquiring company the

⁶⁸ Martin S. Katz, "REITs Signal Appraisers to Refine Valuation Approach," *National Real Estate Investor*, (January 1, 1998)

⁶⁹ Interview with Rob Kilroy, Director of Development, Summit Properties, Inc., May 24, 2001.

opportunity to add a new building type to its portfolio, that it has no experience developing. If the target market has high barriers-to-entry in the form of government regulations restricting new development or high replacement costs, the ultimate barrier to entry, then acquiring properties is a viable alternative.

Disadvantages of Real Estate Acquisitions

Acquisitions provide scarce opportunities for value creation. Purchases of real estate provide rare opportunities to capture value because buying assets at retail prices means paying another entity the development profit.⁷⁰ Exceptions occur when the property in question is distressed, meaning it is generating negative cash flows or when the seller is distressed, meaning the seller lacks the funds to service debt and is desperate for cash. The due diligence essential to mitigating the risks associated with purchases requires considerable time to investigate legal issues pertaining to the transfer of ownership, (including title issues) and the physical condition of the asset (including building inspection). During this time, market conditions could shift and the acquisition may no longer be feasible or profitable.

The numerous acquisitions and constant bidding up of the purchase prices of commercial properties by REITs in 1997 had a significant and unwanted impact on property tax assessments. The prices paid by REITs were much higher than the then existing fair market value determinations used by assessors to establish taxes in proportion (*ad valorem*) to the value of the assessed properties. Tax assessors used this perceived increase in value to levy enormous increases in commercial real estate taxes, which reduced REIT operating cash flow and profits. This kind of development is frustrating to tenants who usually pay a pro-rated share of all real estate taxes assessed against a property.⁷¹ The acquisition of commercial properties is sometimes complicated by the application of franchise, going-concern, enterprise, or goodwill values of the businesses conducted in the acquired space. Appraisers may include the value of non-real estate items such as licenses, concessions and personal property instead of real property valuation, which is based on historical cost or current market value. REIT managers contend

⁷⁰ Kilroy, *op. cite*.

⁷¹ Martin S. Katz, "REITs Signal Appraisers to Refine Valuation Approach," *National Real Estate Investor*, (January 1, 1998)

that such non-real estate items should be excluded from the calculation of value for real estate taxation purposes.

Joint Ventures

In 1997, REIT owners searched for alternative ways to raise capital because the public market ceased to yield funds for growth. They began to establish joint venture relationships. REITs that enter into these relationships must be mindful of several considerations.

Advantages of the JV Structure

The joint venture structure is an excellent way to source capital for development. It enables the company employing it to remain out of the equity market at inopportune times. REITs can also draw ancillary income from the JV structure through management, leasing, and acquisition fees in order to increase the overall yield of the venture. This circumstance allows for the evasion of the IRC (prior to the enactment of the RMA⁷² 1/2001). JV arrangements also enable REITs to contain construction risk through structured agreements with merchant developers that give the REIT the right but not the obligation to purchase the developed property upon the satisfaction of certain contractual conditions. REIT owners are not exposed to the uncertainties of whether the property is completed, whether it is built to specifications, or whether it is lien free.

⁷² **REIT Modernization Act: Taxable REIT Subsidiaries** - The RMA will allow a REIT to own up to 100% of the stock of a taxable REIT subsidiary ("TRS") that can provide services to REIT tenants and others without disqualifying the rents that a REIT receives from its tenants. The RMA contains size limits on a TRS to ensure that a REIT remains focused on core real estate ownership and operations. To ensure that a TRS is subject to an appropriate level of corporate taxation, the amount of debt and rental payments from a TRS to its affiliated REIT will be limited. Further, a 100% excise tax will be imposed to the extent any transaction between a TRS and its affiliated REIT (or that REIT's tenants) is not conducted on an arms' length basis. A TRS may not operate or manage lodging or health care facilities, but a TRS may lease lodging facilities from its affiliated REIT at market rates so long as an independent contractor operates and manages the facilities. After the 2001 effective date, a REIT will not be able to own more than 10% of the vote or value of the securities of a non-REIT C-corporation (other than securities of a TRS, certain debt securities, and securities of "grandfathered" entities described below). The RMA restrictions on TRSs will not apply to arrangements in place (including third party subsidiaries) as of the date of introduction so long as the subsidiary does not engage in a new line of business, its existing business assets do not increase, and the REIT does not acquire any new securities in the subsidiary. **Distribution Requirement** - The RMA will return the REIT distribution requirement from 95% to the 90% level currently applicable to mutual funds and that applied to REITs from 1960 to 1980.

REITs can also protect their income statements and shield their balance sheets from the dilutive impact of development through the use of JVs. Unusable depreciation expenses that belong to a JV partner may be allocated to the REIT. JVs with institutional investors allows companies to further their relationships with current and potential tenants and hone their acquisition and development skills. Additionally, the JV model provides a partnership structure that could provide future financing flexibility.

Disadvantages of the JV Structure

REIT joint ventures complicate the efforts of analysts and investors in assessing the REITs actual condition. First, the main concern about the mechanism is that REITs can mask the true extent of their leverage. Rating agencies such as Moody's, have expressed concern that by borrowing off balance sheet at the JV level, REITs may understate their overall leverage.⁷³ Additionally, rating agencies point to the fact that by considering JV interests as akin to wholly owned properties, REITs can "double-leverage" these interests by incrementally increasing off-balance sheet leverage through the use of higher debt and contingent liabilities from take-out guarantees of private developers. The third consideration involves the complication of debt-maturity schedules by JVs, which conceals a REIT's proper liquidity requirements. At the property level, analysts must take into account the eventual fate of the JV and the track record of the JV partner, whose quality may vary considerably from one JV partner to the next (does the REIT have the obligation or the right to acquire the properties involved at the end of an agreed upon period?).⁷⁴ JV covenants may limit operating flexibility, as they often require the approval of partners in order to add capital or re-position properties. A potential moral hazard exists since it is probable that joint venture relationships engender the risk that deals are completed for fees instead of the economic merit of the overall transaction.

⁷³ Paul Reeder, "Are REITs Needlessly Complex?," *SNL Real Estate Securities Weekly*, (June 28, 1999).

⁷⁴ *Ibid.*

Capital Recycling / Self-Funding

Firms embracing this capital raising method continuously review their asset portfolios in order to identify capital sources. Given a dearth of equity capital and the presence of high leverage ratios, substantial value can be created by selling off "mature" or less desirable assets and reinvesting the proceeds in value-creating activities. Firms that engage in this type of behavior believe that most of the value generated from real estate investing comes either from buying assets cheaply or developing new products. As real estate markets are in equilibrium today and offer no fantastic values, these companies question the value of holding onto fully priced properties when these "bonds" can be sold to pension funds at a profit. They believe that they can get spreads of up to 300 basis points by trading at 8% capitalization rates for 11% development yields, and that investors will reward them for doing so.⁷⁵

This model is effective in bull and bear markets. Although firms may not expand their asset portfolios by selling assets and recycling capital it is still a superior method of creating value because rapid expansion would lower the rate of return on capital and reduce the impact that IRC distribution requirements have on the capital budgeting decisions of REITs.

Advantages of Capital Recycling / Self-Funding

The recycling of capital reduces the dependence on the capital markets. Raising capital through the disposition of assets assuages investors' fear of secondary offerings and enables the company to take advantage of development opportunities. As the company's capital revolves and funds for development are extracted from sale proceeds, development can occur without incurring substantial levels of debt and needlessly expanding the asset base. This contributes to the retention of development expertise within the organization. This is an important attribute because the more development expertise a firm possesses the greater the likelihood the company can execute development initiatives that create value for shareholders. The recycling of sale proceeds breeds accountability and engenders a great deal of discipline. The willingness to dispose of mature or even obsolescent assets eliminates a pull on earnings

⁷⁵ Ralph Block, "Of Raiders and Saamis," *REITWeek Electronic Newsletter*, (July 23,1999)

and prevents internal growth rates from declining. There are also intangible benefits derived from culling stabilized properties that may have no positive growth remaining. For example, asset sales can boost external growth rates, improve company morale and capture the attention of performance-minded investors. Opportunistic divestment can be executed. This enables the firm to take advantage of a temporary high capitalization rate environment through the sale of assets.

Disadvantages of Capital Recycling/ Self-Funding

The disposition of assets is can be problematic because it may be difficult find institutional buyers willing to pay reasonable capitalization rates. FFO growth may be diluted because as sales proceeds are recycled, they sometimes exert a pull on earnings. REIT management must guard against managing their properties, or even their building standards for short-term profitability. Potential tax burdens can result from the occasional payment of capital gain taxes or property exchange encumbrances. The structural limitations particular to the REIT format restricts the ability of a company to sell assets. If a REIT sells more than seven properties a year or disposes of a property held for less than four years, it cannot qualify for the "safe harbor" and is at risk of becoming a "dealer" – and such a classification would require it to pay a 100% excise tax on any gains.

Share Repurchases

For non-real estate concerns, share repurchases have serious implications. Companies repurchase shares when they have accumulated more cash than they can profitably invest or when they wish to increase their debt levels.⁷⁶ The logic behind share buyback programs implemented by REITs are simple to execute and elegant in principle. REITs repurchase stock to enhance FFO and increase shareholder value. When a REITs share price is trading at a discount to the NAV of its underlying assets, it is provided with an opportunity to extract value for shareholders through a public/private market arbitrage. It can sell properties at full value and subsequently execute a share buyback in order to

⁷⁶ Brealey and Myers, *op. cite*, p. 446.

capture value in the form of the spread between the sale price of the assets and the REIT share price. For instance, imagine a scenario in which a REITs share prices are trading at a discount of approximately 25%. Essentially the REIT could potentially invest more funds in its existing real estate portfolio at say \$0.75 on the dollar, for example, and finance this arbitrage with sale proceeds from assets sold in the private market. REIT management may find that their development or acquisition business initiatives are hampered by sluggish market conditions, however the opportunities to extract value from assets still exist. REIT shares that are punished by the public markets due to overall market uncertainty and turmoil present REIT management with the prospect of buying shares at a deep discount to underlying asset values. This is a great as well as a low-risk investment alternative that a REIT has access to. While an approach like this is familiar to American corporations, any strategy advocating even the partial culling of assets, or even staying the same size, is difficult to acknowledge for many owner-operators who are more comfortable consummating transactions like the deal “junkies” they were before going public.⁷⁷

Advantages of Share Repurchases

A strategy that employs share buybacks is a flexible one. This initiative can be executed during a bear or bull market. The conditional measure is the price of REIT shares relative to NAV. The share buyback provision gives investors a confidence boost. Stock repurchases also signal management’s confidence in the future. Investors assume that the company believes the stock is a good value at the price the buyback is announced. A study by Comment and Jarrell analyzing the announcements of open-market share buyback programs, ascertained that these announcements resulted in an abnormal price rise of 2 percent.⁷⁸ A share buyback provision may be an indication of lack of opportunities to make positive NPV investment opportunity. A company would not repurchase shares if they were presented with a prospect to profitably invest their cash. In my opinion, this is a huge advantage that REITs have over

⁷⁷ Interview with Eric Schlager, CEO and President of Bulfinch Companies, Inc.

⁷⁸ R. Comment and G. Jarrell, “The Relative Signaling Power of Dutch-Auction and Fixed Price Self-Tender Offers and Open-Market Share Repurchases,” *Journal of Finance* 46 (September 1991), pp.1243-1271

private developers. Instead of sitting on the sidelines when development is not economically feasible, REITs can put their capital to work in an effective and efficient manner.

Aptness of REIT Structure for Development

The Influence of Development on REIT Performance

During the winter of 2000, Dirk Brounen, Piet M.A. Eichholtz, and Patrick M. Kanters published conclusions from a study of the effects that development activities had on REIT performance.⁷⁹ Employing data from the Dutch independent research firm, Global Property Research, the group examined the U.S. equity REIT market, made up of 211 publicly traded companies with a total market capitalization of \$139 billion. After eliminating self-liquidating REITs from the study, they had a sample of 174 U.S. equity REITs, which they studied for the period of 1993-1999. The authors then implemented an analysis that examined whether participating in development activities improves REIT performance.

An initial cross sectional analysis demonstrated that the majority of development activity is performed by large REITs. The performance of developing REITs was higher than the returns of REITs that did not engage in development. However, when the authors inserted risk into their analysis the distinctions disappeared. According to their findings, development activity increased the systematic risk in their sample considerably. To account for these risks the returns for the observed companies were adjusted by applying the risk adjustment model (RAM) of Litt and Mei.⁸⁰

⁷⁹ Dirk Brounen, Piet M.A. Eichholtz, and Patrick M. Kanters, "The Effects of Property Development Activities on the Performance of REITs," *Real Estate Finance* (Winter 2000), pp. 17-22.

⁸⁰ J. Litt and J.P. Mei, "Risk Adjustment Model for REIT Evaluation," *Real Estate Finance*, (Spring 1999), pp. 9-19.*

*This model decomposes all the factors affecting REIT returns into two major sources—macro-factors (systemic factors) and firm-specific factors (unsystemic factors). The sample used by Dirk Brounen and company was homogeneous and they felt that the systemic factors would be harnessed by the NAREIT index. Unsystematic risks, the variance in REIT returns that cannot be explained by changes in the return of the market, are included separately in the risk adjustment model (RAM). As a consequence, this condition yields the following cross sectional model:

$$E(r_i) = a + b(\beta_i) + c(\sigma_i)$$

Expected return, $E(r_i)$, is a function of both systemic risk, β_i , and unsystemic risk, σ_i . This RAM model allowed the study to accurately ascertain whether significant differences in performance exist between REITs that are involved in property development activities and those that are not.

Estimates of systemic risk were determined by regressing the monthly excess returns of each REIT on the NAREIT portfolio. Specific risk is determined by calculating the standard deviation for each individual REIT. The mean excess returns were then regressed onto the beta and the standard deviation. They employed this cross-sectional regression to derive the parameter estimates for the RAM-equation, which yields the following:

$$E(r_i) = 0.00399 + \beta_i(0.0044) - \sigma_i(0.0431)$$

The authors employed this model to calculate the required return for each REIT individually and conducted a comparison with its actual return.

After identifying develop-oriented REITs, the next step was to determine if development was worth the risk. This was accomplished by conducting a non-risk adjusted return comparison between the REITs comprising the NAREIT index and the REITs in the assembled sample. The results of this analysis are captured in Exhibit 1.

E X H I B I T 1

Returns per Category for the Period 1993-1999

Category		Number of REITs	Mean Annual Excess Return	Out-/Under- Performance	% REITs Out- performing
Developing REITs					
	> 10% of Total Assets	17	9.53%	3.36%	76.5%
	5%-10% of Total Assets	24	7.45%	1.28%	91.7%
	2.5%-5% of Total Assets	17	8.74%	2.57%	70.6%
Total		58	8.44%	2.27%	81.0%
Semi-Developing REITs		22	6.12%	-0.05%	62.5%
Non-Developing REITs		73	6.16%	-0.01%	65.8%
NAREIT Index		174	6.17%	0.00%	

Using the amount of development activity as a gauge, development REITs were divided into three subclasses. The results contained in Exhibit 1 show that REITs that engaged in property development outperformed the NAREIT index by an average of 2.27%. Non-development REITs failed to outperform the index. According to the study, particularly the last column, 81% of development REITs in the sample outperformed the index.

Risk Adjustment

Brounen and company conducted another analysis to see if higher risks accompanied these higher returns. They wanted to ascertain whether the higher return is compensation for additional risk or whether it results from the additive effects of development activity. After employing the RAM model of Litt and Mei⁸¹, Exhibit 2 shows the results of the risk-adjusted study.

After adjusting the returns of development REITs in Exhibit 1 to account for the added risk attributed to their behavior, the margin between the performance of the NAREIT index and the

⁸¹ Litt and Mei, *op. cite.*, pp. 9-19.

performance of the REITs contained in the sample shrinks noticeably. The adjustment yields an outperformance measure of .64% (8.44% minus 7.80%) instead of 2.27%. In addition to this, columns 4 and 5 illustrate that the comparison of outperformance measures between developing and non-developing REITs no longer possess the same degree of separation in performance (0.64% vs. 0.71%). The results indicate that the higher returns in Exhibit 1 are contingent upon the proportional increase in risk. The risk parameters for development-oriented REITs are different from those of non-development entities. Column 1 of Exhibit 2 shows the distinction between the betas of the two groups. Property developing REITs are more sensitive to changes in the NAREIT index than non-developers. The R² is an indication that the betas of the developing REITs (38%) explain more of the variances in returns than the betas of the non-developers (25%).

EXHIBIT 2

Risk-Adjusted Performance per Category for the Period 1993-1999

Category	Beta	R ²	Firm Specific Risk	Mean Annual Excess Return	Demanded Excess Return	% REITs Out-performing
Developing REITs						
> 10% of Total Assets	0.89	39%	4.08%	9.53%	7.67%	58.8%
5%-10% of Total Assets	0.91	39%	4.18%	7.45%	7.77%	50.0%
2.5%-5% of Total Assets	1.05	38%	5.10%	8.74%	7.96%	58.8%
Total	0.94	38%	4.42%	8.44%	7.80%	55.2%
Semi-Developing REITs	0.85	32%	4.83%	6.12%	6.94%	41.7%
Non-Developing REITs	0.77	25%	6.01%	6.16%	5.45%	52.1%

Brounen, Eichholtz, and Kanters conclude that this study demonstrates that the grouping of property development and investment does not yield an enhanced combined effect. The higher returns ascribed to developing REITs are due to the high level of systemic risk that these firms tolerate. Conversely, when the RAM model of Litt and Mei is applied to these results the developing REITs yield results that barely outperform the demanded returns. Participating in property development increases

both the risk and return of a real estate company, thus altering a company's risk-return characteristics rather than improving them.

Public Valuations Vs. Private Appraisals

The public market prices a REIT as a collection of real estate assets, with positive or negative adjustments to account for the quality of REIT management. The public market price reflects the combination of asset values and franchise value, whereas the private market assets are priced individually and not as a portfolio, and management's ability is not priced as an intangible asset. In addition, a private market asset is priced based on potential growth in internal cash flow, not on the expectation of additional new assets or new cash flow. Unlike private, appraisal-based pricing, public market prices tend to move with the broader stock market as well as with their underlying real estate fundamentals. This gives REIT shares a moderately positive beta value relative to a zero or negative beta for appraisal-based returns. In theory, institutional and small investors should pay less for an asset with a higher beta; thus, the expectation is that privately held real estate assets command a premium relative to REIT pricing.⁸²

With few exceptions, it is now, theoretically, easy to provide REIT managers with the correct incentives to make decisions about purchasing, selling, holding, and managing real property. Stock options, share ownership, and public market oversight should ensure that managers do not engage in the practice of empire building that achieves growth at unsustainable rates and serves to increase the debt in the capital structure.

An additional advantage the private market developers have over their Wall Street counterparts is their superior understanding of the real estate industry.⁸³ Historically, Wall Street has not had access to systematic information about real estate markets. In most instances, a local understanding is extracted from market information available to local sharpshooters, but not widely available to others. Companies

⁸² CB Commercial/Torto Wheaton Research, "Wall Street Vs. Main Street: Real Estate Pricing and New Development," *Market Watch* (Spring 1997), p. 2

⁸³ Hines Senior Executive, *op. cite*.

with access to such information can profit handsomely if they can mobilize the capital. Wall Street REIT analysts and REIT managers with little or no development experience can never command the same type of local knowledge as experienced local developers or private owners.

The private real estate market is considered to be inefficient, while economists believe that the public market is a more practical entity due to the availability of public information. The impacts of anticipated inflation, monetary policy, and economic or demographic trends are quickly reflected in publicly traded share prices. The theory of an efficient market assumes that strong competition among Wall Street analysts, together with widely available information, means that any price in the marketplace incorporates all the information known to investors at the time. Price changes occur as a result of new information. While Wall Street analysts may not have all the information the contention is they will better utilize the information that have in the pricing process. Previous research demonstrated that public market prices are predisposed to precede changes in cash flow for real estate, whereas private market pricing follows cash flow.⁸⁴

The difference between the public and private pricing mechanisms sometimes leads to periods of price divergence between the markets. For example, in early 1997 office REITs were priced at high multiples to FFO, or low, implied capitalization rates.⁸⁵ Buy-side analysts and investors were pricing these REITs based on expectations of growth from acquisitions of additional properties, as well as management's ability to carry out such acquisitions. Also, by bidding up the price of the shares of office REITs, the capital market gave these REITs an accretion advantage. They were able to sell their public equity capital at a low capitalization rate and purchase private equity at higher capitalization rates, thereby creating a public/private arbitrage opportunity. The capacity to issue equity provides REITs with an additional strategy to grow earnings and position their company for future cyclical changes. Private developers do not have the same flexibility.

⁸⁴ CB Commercial/Torto Wheaton Research, *op. cite.*, p. 3

⁸⁵ Anthony Downs, September 1999, "The Future Role of REITs in Real Estate Finance," The Brookings Institution.

VI

Conclusion

Summation

The REIT structure is an effective facilitator of real estate development. The companies profiled in this thesis bolster this assertion through the descriptions of their operating strategies. Although a REIT's business and its operating strategies are subject to certain external factors, including the vagrancies of the stock market, it is possible for real estate developers to achieve their goals within the confines of the REIT regulatory and legislative structure. Despite the criticism of the REIT model by private developers who resisted and continue to resist the transition to public status, REIT developers have demonstrated that a public company's execution of development is not only possible, but also profitable.

However, property development, by itself, cannot satisfy the obligations of public ownership. Development must be one component of management's comprehensive strategy. Besides its suitability for real estate development, the REIT model also eliminates a company's dependence on development activity for growth and profitability therefore abolishing development as the "default" option for profitable activity. Consequently, the REIT format enables the owner-operator to engage in other profitable non-development measures during stages of the business cycle when development activity is not economically feasible.

In addition to maintaining vigilance in the property markets, owner-operators must acknowledge the investment community's shift in attitude towards the real estate industry regarding the sourcing and allocation of capital. As Dean Stratouly aptly noted the practice of real estate development was becoming more institutional and less entrepreneurial.⁸⁶ Stratouly further explained that the "value creator" label that was normally ascribed to the manager and developer of real estate is now used to describe the agent responsible for the sourcing, placement, and allocation of capital.⁸⁷ This shift corresponds to the negligent lending and underwriting practices of the late 1980's and early 1990s that led to an upheaval in the capital markets and how real estate transactions were financed. Real estate markets will continue to be cyclical and real estate operators will continue to depend on reliable sources of cash flow and

⁸⁶ Stratouly, *op. cite.*

⁸⁷ Stratouly, *op. cite.*

financing to fund their operations. REIT developers are adjusting their approaches to operation by conducting market assessments and then acting accordingly. For example, traditionally, private development firms were loath to sell any of their portfolio holdings especially if the company developed the asset in-house. Slowly, this attitude is changing as more REIT developers scan their portfolio for liquidation candidates. This is evident in the recent practice of selling assets in order to generate capital to fund development activity, acquisitions, and share repurchasing initiatives.

An owner-operator's managed assets are no longer only the physical holdings of a company's portfolio. Managed assets have grown to include the "latent capital" contained within the portfolio. Recently, REIT managers have been reviewing their asset portfolios to identify potential capital sources. For example, a stabilized property represents an opportunity to match the maturation terms of a potential debt obligation with the terms of an underlying lease agreement in order to extract and redeploy any potential capital. Another example is the creative use of joint venture arrangements in which REITs contribute stabilized assets to a partnership with an institutional entity in exchange for capital that is invested using the REITs development expertise. This partnership is a cost effective way of extracting value from existing assets under management in order to enhance shareholder wealth.

Development has always been a capital-intensive endeavor. Additionally, the regulatory requirements regarding a REIT's distribution of earnings magnify the importance of prudent financial positioning by management. This concept of "positioning" is directly relevant to the exploitation of development opportunities. It is an immutable truth in real estate that development activity, on average, creates more value than any other business initiative of real estate concerns. As a result of this, capital access, and the proper management of that capital is essential. Recent innovations in REIT financing provide a plethora of alternatives for REIT managers. As REITs have grown in their size and complexity, they have experimented with more intricate financial securities. Over the past few years, REITs have broadened their capital sources from simple common equity and mortgage indebtedness to include perpetual preferred stock, unsecured corporate debt, medium term notes, convertible preferred shares, convertible debentures, and other more complicated securities.

Lastly, the relationship between Wall Street and owner-operators is continually evolving. The development process is detail-oriented and the influence of the public markets is disciplinary in nature. The REIT format requires public accountability and as such, benefactors of the REIT paradigm must appreciate the increased level of public scrutiny that potential transactions are subjected to and become intimately familiar with their company's fiscal and operational health. Coincidentally, companies benefit from this burden. The assembly of information pertaining to the inner workings of an organization and its relationship to the financial structure (including property holdings) is an invaluable informational tool. The financial data that is collected can be used to develop strategies lower capital costs, instill fiscal discipline and add relevance to the firm's projections and forecasts.

Owner-operators must expand their management scope in order to maximize the value of their inventories. It is no longer prudent to hold on to assets simply because they were manufactured in-house. This is not a sound business practice especially when an opportunity exists to use sale proceeds to fund an investment that will produce a higher yield net of transaction costs and fees. Owner-operators should indeed take advantage of the wealth of opportunities presented to them within the diverse and complex corporate financial market.

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