A COST BENEFIT ANALYSIS OF INITIAL PUBLIC OFFERINGS OF EQUITY REITS AND PROSPECTS FOR GROWTH IN THE INDUSTRY

by

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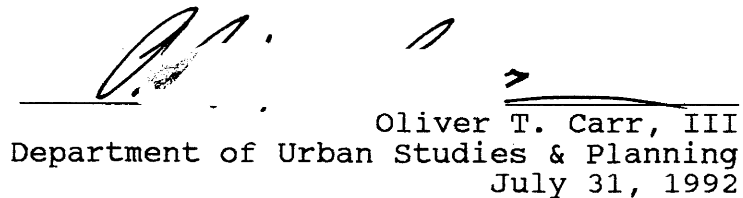

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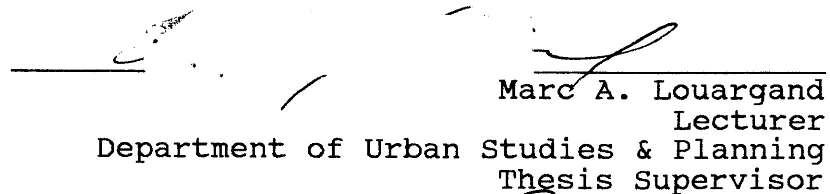

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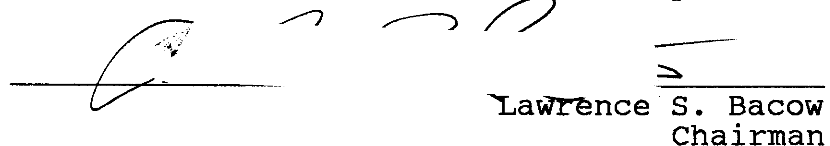

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Submitted to the Department of Urban Studies & Planning on July 31, 1992 in partial fulfillment of the requirements for the degree of Master of Science in Real Estate Development at the Massachusetts Institute of Technology

ABSTRACT

This thesis examines the costs and benefits associated with initial public offerings of equity real estate investment trusts (REITs) and attempts to determine the prospects for growth in the equity REIT industry. In today's commercial real estate marketplace, which is struggling with illiquidity and a lack of access to capital, the equity REIT vehicle has received a great deal of attention as a potential solution for many of the current problems. Both private developers and institutional owners of real estate are considering the equity REIT as a way to access much needed capital and offer the tradeable, liquid real estate vehicle which investors are demanding. However, the benefits associated with equity REIT ownership do not come without costs. There are substantial impediments in the market today limiting the entrance of new equity REITs. Growth in the industry will primarily depend on the ability of the private owners of real estate to overcome the impediments to equity REIT formation, and will depend on the role of the traditional financing sources.

To offer a full perspective on the state of initial public offerings of equity REITs, an attempt was made to gather information from different aspects of the industry including a private developer working through the offering process for a public equity REIT, the former chairman of a public real estate operating company, an investment bank, institutional real estate advisors, and consultants to the REIT industry. The insight of these individuals, in combination with viewpoints from the extensive literature written on the REIT industry, has contributed to the content of this thesis.

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CHAPTER 1: INTRODUCTION

Purpose and Methodology of Thesis

The purpose of this thesis is to examine the costs and benefits of initial public offerings of equity real estate investment trusts (REITs) and to determine the prospects for growth in the equity REIT industry. In my opinion, this is a timely topic, as the commercial real estate industry today is struggling with illiquidity and a lack of access to capital. In addition, the industry is currently undergoing a transformation to a closer relationship with the capital markets, primarily driven by the advent of real estate securitization. Many private and institutional owners of commercial real estate are looking to securitization, and equity REITs in particular, as a panacea to solve all of their problems. However, the benefits associated with equity REIT formation do not come without their costs. There are substantial impediments in the market today limiting the entrance of new equity REITs.

William Newman, the Chairman of the National Association of Real Estate Investment Trusts, Inc., and the Chairman of New Plan Realty Trust, accurately described the outlook for the REIT industry in the following statement:

> Securitized real estate, as represented mainly by the REIT vehicle, is virtually the sole means of raising capital today for the real estate industry. We expect our industry to grow and prosper in the '90's and to provide some of the liquidity missing from the real

estate industry today.[1]

Mr. Newman's statement offers an optimistic view for the REIT industry which is well founded. Over the past three to four years, the traditional sources of non-recourse real estate financing have evaporated from the marketplace in the face of over-built markets and the severe valuation decline of commercial real estate. In addition, private sources of debt and equity financing have retreated from the marketplace as well. These private sources have learned the painful lessons that real estate values can decline and that real estate can experience volatility as an asset class [42]. Liquidity is gone, even for investment vehicles which promised to honor reasonable withdrawal requests, and the performance of most institutional real estate portfolios now falls short of cash equivalent returns [45].

In the face of the dire state of the commercial real estate industry, a rush is currently underway from both private developers and institutions to take private holdings public through the equity REIT vehicle. One author stated that 1992 could see the biggest wave of new REIT offerings since the mid-Eighties [48]. However, there are significant impediments to equity REIT securitization. This is evidenced by the fact that the initial public offering (IPO) of Kimco Realty Corporation in November of 1991 was the first

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[1] **Coopers & Lybrand, REITs: The Future is Now, Perspectives of Industry Experts, 1992, p. 6.**

successful equity REIT IPO since August of 1988 [10].

In brief, the impediments to equity REIT formation include the public market's lower valuation of property, the hard dollar costs of an IPO[1], the cultural changes to take a private company public, and the individual partner issues (if a partnership is being converted to a REIT). This thesis focuses on equity REITs in particular because they are receiving the most attention from investment banks and owners of commercial real estate as a potential investment vehicle.[2] In addition, investor interest in equity REITs is growing as they have generated total returns comparable to the S&P 500 since 1978 with approximately 11% less volatility (See Figure 1).

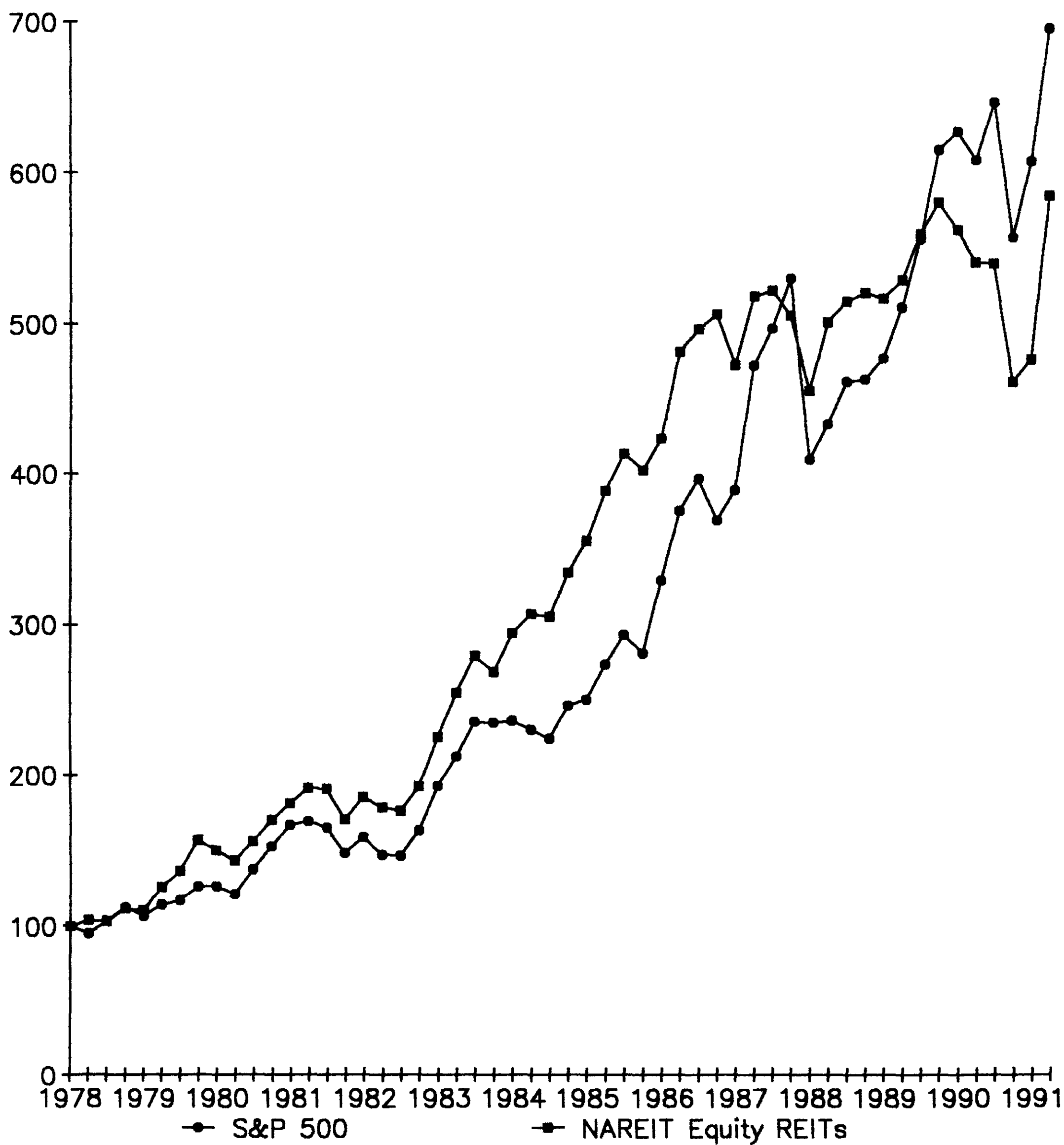
The methodology involved in preparing this thesis was a combination of literature research and interviews with professionals in the REIT industry. Literature was reviewed to access the state of the equity REIT market and to research the existing views from the industry concerning the costs and benefits of equity REIT formation. Interviews were then conducted to test existing theories and to gain first hand knowledge of the current state of the equity REIT IPO market.

---

[1] Hard dollar costs include any cash expenses involved with a public offering such as underwriting fees, appraisal costs, accounting charges and legal fees to name a few.

[2] Mortgage REITs acquired a bad reputation in the mid to late 1970's when the rapidly rising cost of funds turned earnings negative. During this time period, share values of mortgage REITs fell precipitously. Mortgage REITs have continued to be out of favor since that time [8].

Figure 1.



12/31/77 = 100

Data From 12/77 to 3/91

Source: NAREIT, S&P Corp

An attempt was made to gather information from different aspects of the industry including a private developer working through the IPO process for a public equity REIT, the former chairman of a public real estate operating company, an investment bank, institutional real estate advisors, and consultants to the REIT industry. The insight of these individuals, in combination with viewpoints from the extensive literature written on the REIT industry, has contributed to the content of this thesis.

Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts are essentially pooled ownership vehicles for investment in real estate assets. Similar to stock ownership in any corporation, the shareholders of REITs may enjoy a liquid investment with negligible liability. In technical terms, a REIT is a corporation (or a business trust or other association taxable as a corporation) that is able to pass its earnings through to shareholders free of corporate tax. This "conduit" treatment is available provided that the REIT distributes virtually all of its income to shareholders and complies with various requirements designed to compel it to specialize in real estate ownership or finance [40]. Traditionally, REITs were viewed as passive real estate operators which would merely manage existing portfolios. However, REITs are increasingly being viewed today as operating companies with significant capacities to add value to holdings through active management, acquisitions, and redevelopment.

REITs take several different forms including equity REITs which invest directly in commercial property, mortgage REITs which invest in or originate commercial mortgages, and hybrid REITs which have a combined portfolio of debt and equity real estate holdings. As of June 1991, the REIT industry had total assets of $45.42 billion which was made up of $16.34 billion of equity holdings and $25.87 billion of debt instruments (other assets totaled $3.21BN at 6/30/91).

Total equity capitalization of the REIT market as of June 1991 was just over $15 billion (See Figure 2) [41]. The majority of REITs are publicly traded on U.S. stock exchanges while the private REIT industry had a market capitalization of approximately $4 billion as of June 1991.[1] Private REITs can be exchanged only between qualified investors and are typically placed with pension fund investors [22]. "Such private REITs may illustrate the application of the REIT structure as a form of commingled fund for pension plans."[2] However, private REITs may not offer the liquidity and transferability desired due to the limited number of investors.

The concept of the real estate investment trust goes back to the 1880's when the trusts were originally created to avoid taxation at the corporate level. At that time, the trusts were not taxed if income was distributed through to the beneficiaries. However, in the 1930's the Supreme Court ruled that all passive investment vehicles that were centrally organized and managed like corporations be taxed as corporations [3]. With this ruling, the early trusts lost their advantageous tax status.

The modern REIT was born in the post World War II era

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[1] **A REIT qualifies as being public if it has been registered with the SEC.**

[2] **Robinson, Thomas E., "REITs Revisited: Growing Prospects in the 1990s," Real Estate Accounting & Taxation, Winter 1992, p. 35.**

Figure 2. The REIT Industry in 1991

As of June 1991, the National Association of Real Estate Investment Trusts, Inc. (NAREIT) reports the existence of 187 companies that qualify as REITs under the federal tax laws. Of these, 123 have stock that is listed and actively traded on the New York and American Stock Exchanges or on NASDAQ/NMS. REITs that engage primarily in the ownership of real estate ("equity REITs") number 118, while 37 emphasize investment in mortgages and mortgage-backed securities ("mortgage REITs") and 32 have balance sheets that reflect a combination of the basic investment strategies ("hybrid REITs"). Approximately 21 % of the public equity REITs are healthcare REITs. Industry analysts typically view healthcare REITs as a separate type of asset because of their reliance on the healthcare industry [41].

Industry Balance Sheet
(June 1991, $ Billions)

Assets		**Liabilities**	
Equity Investments		**Liabilities**	
Property Owned (net of deprec.)	$14.54	Mortgages	$ 4.26
Other	1.80	Mortgage bonds	16.36
		Convertible Debt	1.03
		Nonconvertible Debt	1.79
Total	$16.34	Bank Debt	4.64
		Other	2.14
Mortgages			
First Mortgages	$ 6.23	**Total Liabilities**	**$30.22**
Mortgage Pools	18.41		
Other	1.23		
Total	$25.87	**Shareholders Equity**	**$15.20**
Other Assets	$ 3.21		
Total	**$45.42**	**Total**	**$45.42**

when the increased demand for real estate equity and mortgage funds sparked renewed interest in a pooled real estate investment vehicle. A campaign was begun to achieve special tax considerations for REITs which had already been afforded to mutual funds. In 1960, legislation was passed which treated REITs as a conduit to pass taxable income through to beneficiaries avoiding tax at the corporate (trust) level if certain set requirements were met [3]. This new legislation was further refined by legislation in 1976 and 1986 which modernized the REIT regulations to their present form.

The requirements put in place by Congress to govern REITs were clearly aimed at limiting REITs to a passive real estate ownership role. Typical development activities such as developing property for sale, third party property management and land sales are restricted by the legislation. A summary of the tax code requirements to which REITs must conform to maintain their tax free status follows:

1. A REIT must be organized as a corporation or business trust which is taxable as a corporation.

2. The REIT must have fully transferable shares (either privately or publicly held).

3. REITs must have a minimum of one hundred shareholders and may not be closely held.

4. No more than 50% of the REIT shares may be held by five or fewer individuals during the last half of each taxable year. For the purposes of the tax code, "individual" is defined to also include U.S. pension funds, private foundations and charitable trusts.

5. At least seventy-five percent of total assets must be invested in real estate assets which include real property, loans secured by real estate, mortgages, shares

of other REITs, cash or government securities. REITs may not hold other non-real estate assets which constitute more than twenty-five percent of total assets.

6. At least seventy-five percent of a REIT's gross income must be derived from rents or mortgage interest and gains from the sale of property. In addition, ninety-five percent of gross income must be from these sources plus dividends, gains from the sales of securities and interest income. Rental income will be disqualified if derived from a tenant in which the REIT directly or indirectly owns a ten percent or greater interest.

7. No more than thirty percent of gross income can be derived from the sale of properties held less than four years, securities held less than six months or other prohibited transactions.

8. A REIT must distribute at least ninety-five percent of its ordinary income as dividends to shareholders. It has the option to retain or distribute capital gains, but undistributed gains are subject to entity level tax [22,41].

The current market for REITs is primarily driven by retail investors who have invested in REITs for their income producing attributes.[1] Although institutional interest in REITs is growing, pension fund investment has been limited by the five or fewer rule and by the relatively small total capitalization of the REIT market [8].[2] However, REITs do offer tax-exempt investors exemption from unrelated business income tax (UBTI) and liquidity.

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[1] **Retail investors include individual investors buying shares through retail brokerage firms. Institutional investors, on the other hand, typically include mutual funds, pension funds and other corporate investors.**

[2] No more than 5 individual investors can own more than 50% of the outstanding stock of a REIT. This requirement is commonly referred to as the "five or fewer rule."

Most of the publicly traded equity REITs have at times traded at a substantial discount to net asset value.[1] This phenomenon has been driven primarily by the difference between appraisal based and public market valuations of commercial property and the market's negative perception of real estate as an asset class. The public markets tend to base valuations primarily on the income streams of properties and severely discount any residual value of the assets. However, some equity REITs have traded at premiums to net asset value as the market has rewarded competent management and income producing acquisition strategies.

The outlook for dramatic growth in the industry, such as that held by Alex. Brown & Sons which forecasted an expansion in the industry from $40BN in assets to $400BN by the end of the decade, is primarily driven by the supply side of the equation [11]. The assumption has been made that private developers, and institutional advisors with extensive real estate holdings under management, will take these assets public and thus grow the industry substantially. However, very little discussion has been focused on the buy (demand) side. At present, institutional investment in REIT's has been limited with public pension fund investment totalling approximately $2 billion [38].

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[1] This experience has been recorded with corporations and publicly traded partnerships as well as REITs. Discounting of partnership prices has been especially severe in the wake of tax legislation in 1987 and 1988 designed to limit the use of publicly traded partnerships [17].

CHAPTER 2: OVERVIEW OF EXISTING LITERATURE

The Demand for Liquidity as a Catalyst for REIT Growth

The majority of authors who have written about the current state of REITs, and the demand for securitized real estate in general, have focused on the prospects for growth in the industry. These growth expectations for REITs, and equity REITs in particular, are driven by the demand of the private owners of real estate for liquidity. Several authors, including Giliberto, Robinson, and Frank, have suggested that REITs will fill the financing void left by the retreat of the traditional sources of financing [22,40,11]. These traditional sources include commercial banks and insurance companies, which have virtually cut off all means of financing for commercial real estate. In addition, syndicators are almost completely out of the picture. Due primarily to the lack of other financing sources in the market, Alex. Brown & Sons forecasts that the REIT industry will grow by tenfold by the end of the decade [11]. Although this estimate appears a bit optimistic on the surface, the REIT industry has grown from $9 billion in assets in 1985 to $45 billion today [14]. The catalyst for this growth was the passage of the Tax Reform Act of 1986 when owners turned from partnerships to REITs as a way to raise capital. Today, the catalyst for REIT industry expansion is the lack of other capital sources in the market.

The idea that REITs will fill the current financing void for commercial real estate may be valid. It is evident

that a new source of liquidity is needed in today's marketplace and as Robert Frank pointed out, "historically, the most efficient way to transfer capital from surplus areas to deficit areas has been through the securities markets."[1] In addition, the need for capital will force the recognition of the public market's implicit pricing of virtually all commercial real estate assets [22].

In a recent interview, David Shulman, the Managing Director of Real Estate Research and Economic and Market Analysis with Salomon Brothers, indicated that the growth in the REIT industry should be long-term due to the fundamental changes which the real estate industry has undergone in the last six years [8]. Specifically, Shulman believes that real estate has been a private business due to the availability of non-recourse debt financing and tax benefits [8]. In today's environment, the tax benefits are gone, primarily due to the passage of the Tax Reform Act of 1986, and the ability of private real estate owners to obtain non-recourse financing has been severely diminished. It is likely that these changes will have some permanence, so it is logical that a new financing vehicle will emerge. Shulman believes that the REIT structure will fill the long-term capital needs of commercial real estate primarily because of the tax transparency of the

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[1] Creswell, Catherine C., Frank, Robert A., Hillers, Samuel T., The Regional Equity REIT: The Growth Segment of the U.S. Real Estate Capital Markets, March 30, 1992, p. 4.

REIT as an investment vehicle [8].

In addition to the fundamental changes in commercial real estate which Shulman has pointed to as a catalyst for equity REIT growth, the growth of the tax-exempt, unlevered pension investors' real estate position argues for a new ownership vehicle. Pension investments in commingled funds and separate accounts have not delivered the liquidity or returns originally intended. Pension plans are looking much more critically at their advisors and their holdings today, and are demanding a real estate investment which offers liquidity and market valuation. This demand may cause a tremendous conversion of private institutional holdings into public ownership vehicles, namely equity REITs. However, the conversion of real estate holdings from private to public has its own set of impediments at the institutional level as well, including valuation and cultural issues. It is unclear at this point whether advisory firms will be willing to accept the public market's valuation of their assets under management. Even if only a portion of an advisors portfolio is securitized, it will likely cause a revaluation of all of their comparable holdings.

Other industry practitioners, such as Jon Fosheim of Green Street Advisors, have stated that growth in the equity REIT industry will be heavily dependent on the private owners' of real estate willingness to accept the lower valuations offered by the securities market [48]. The public market sets

the price for the property, and that pricing may bear no relation to the original cost, or to a current appraisal [48]. REITs have typically traded in the public markets at a discount range of ten to fifty percent of current asset value since 1981, with an average discount close to twenty-five percent (See Figure 3) [44].[1] As of July 1991, these discounts were closer to thirty percent as the public markets tend to overreact to particular downtrends or uptrends in the real estate economic cycle [45]. However, several public equity REITs have traded at premiums to current asset value primarily due to the sustained income growth of their portfolios and favorable earnings projections. For many institutional and private owners of commercial real estate considering going public, the valuation discounts offered by the public markets have been difficult to accept and have served as one of the barriers to securitization [34].

The Benefits to the Owner of an Equity REIT I.P.O.[2]

Most authors have pointed out that the primary benefit of the equity REIT structure to a private owner of real estate is access to liquidity and the capital markets [8,11,15]. This liquidity can benefit the private developer who needs

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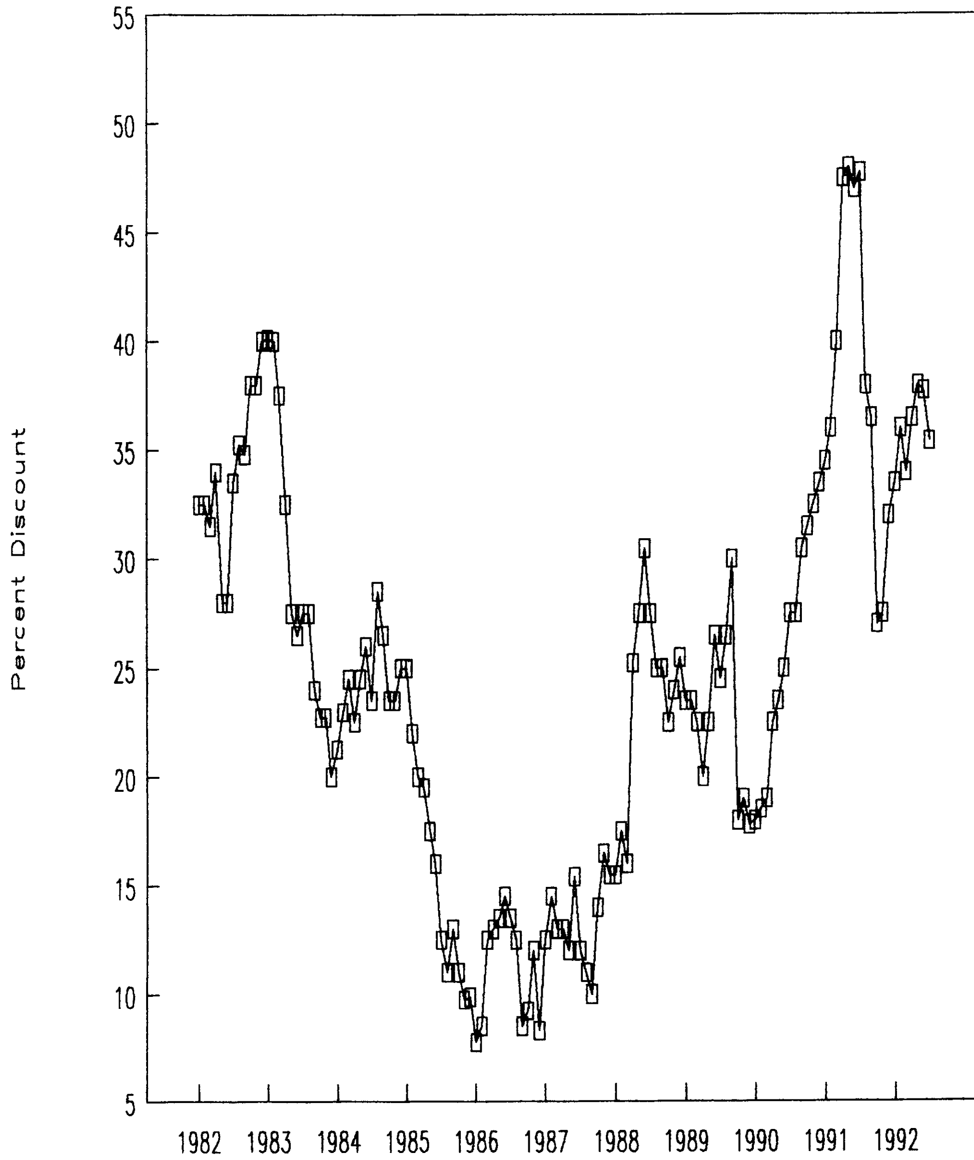
[1] Current asset value refers to a valuation of the commercial properties by a current appraisal. Historically, there has been a difference between the appraisal based value of the assets held by REITs and the valuation assigned to those same assets by the public markets.

[2] I.P.O. stands for Initial Public Offering.

Figure 3
REITs % Discount to Current Value
(Scale Inverted)



Source: Ken Campbell, Audit Investments, Inc.

access to capital and can benefit advisory firms which are trying to meet investors redemption requirements. As Milton Cooper, the Chairman of Kimco Realty Corporation[1] stated:

> We (Kimco) didn't want to rely on traditional lending sources. We were looking to see how we could create another form of ownership where capital would be available on a regular and continuous basis.[2]

Another benefit associated with access to capital is the ability of private owners to reduce outstanding debt. This benefit is crucial in today's marketplace.

Thomas Robinson, the head of REIT Advisory Services for Coopers & Lybrand, has stated that liquidity should not be the only reason that a private owner should choose the REIT as an ownership vehicle [14]. Instead, the owner should focus on the long-term growth opportunities associated with REITs and not just look for a quick fix. REITs have a unique opportunity in this market to raise capital for acquisitions, gain market share, and provide solid long-term growth for owners.

An additional benefit for private owners of real estate that take their holdings public is the discipline associated with public ownership [8]. Due to the disclosure requirements associated with public ownership, expenses must be controlled and REITs must be run efficiently to gain market

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[1] Kimco Realty Corporation is a publicly traded equity REIT which went public in November of 1991.

[2] Coopers & Lybrand, REITs: The Future is Now, Perspectives of Industry Experts, 1992, p. 15.

acceptance. While these requirements may appear to be a burden, several private owners have stated that the discipline required of a public REIT forces the companies to operate efficiently which is obviously a positive [1,8].

Another benefit of the equity REIT to private real estate owners is the ability of the REIT vehicle to attract tax-exempt investors (pension funds). Although the REIT industry's capitalization at present is too small to attract the larger institutional investors, the equity REIT does offer some obvious advantages to pension funds. These advantages include a more efficient valuation of real estate assets than has been the experience with direct investment. Appraisal smoothing has been well documented and investors have accepted the fact that appraisal-based valuations are not currently realizable [42,48,9]. In addition, equity REITs have outperformed direct real estate investments (as measured by the Russell-NCREIF Index[1]) by 53% on a total return basis from 1978 through the 1st quarter of 1991 (See Figure 4).

One author stated that REITs can also offer institutional investors much needed liquidity and corporate governance [8]. However, real liquidity will only be attained through a widely held-public REIT vehicle. Private REITs

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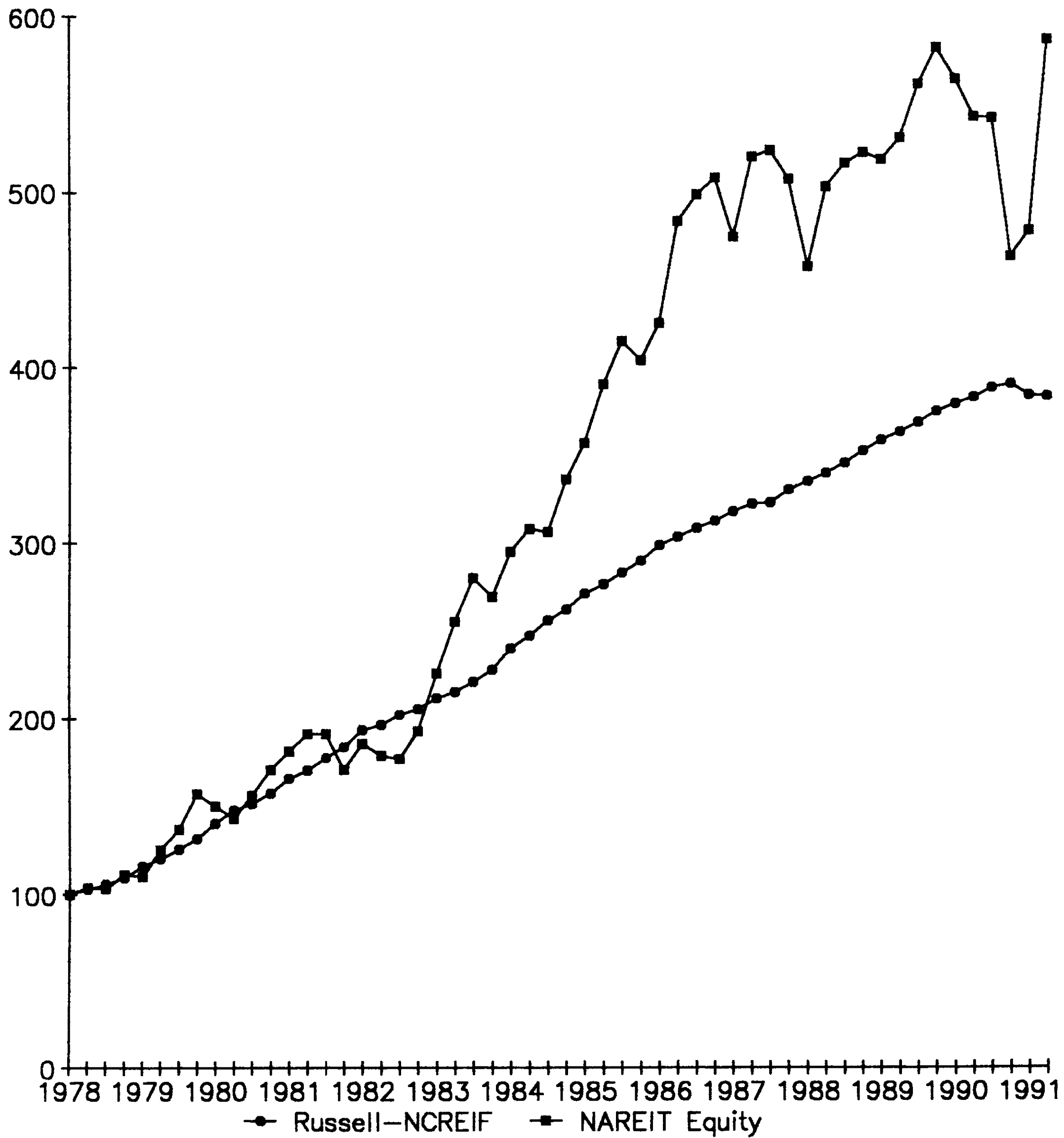
[1] The shortcomings of the Russell-NCREIF index including the issues of appraisal smoothing and lagged valuations, in addition to an inconsistent property index over time, have been well documented. However, this index remains the industry standard for measuring the returns of institutionally owned real estate.

Figure 4.



12/31/77 = 100

Data From 12/77 to 3/91

Source: Russell NCREIF, NAREIT

offer more liquidity than direct ownership of a property, but will offer much less liquidity than a public REIT depending on the number of shareholders. The ability of an institutional investor to achieve corporate governance (control) is limited to some extent as well by the current REIT legislation precluding five or fewer "individuals" from owning more than fifty percent of the outstanding shares. This legislation is currently being challenged in Congress to allow pension plans to own larger shares of REITs.[1]

Another advantage which equity REITs can offer tax-exempt investors is an exclusion from Unrelated Business Income Tax for investment in leveraged assets. Currently, tax-exempt investors are taxed on any investments in levered assets. Ultimately the acceptance of equity REITs as an investment choice for institutional investors should improve the ability of private owners to raise capital.

The Foreign Precedent

A good deal has been written on securitization in foreign countries as a precedent for REIT growth in the U.S. Real estate securitization is much more prevalent in foreign countries where non-recourse lending and large tax benefits

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[1] Foreign pension fund ownership in REITs is not currently limited by the "five or fewer rule." The original REIT legislation did not include foreign pension funds as "individual investors" under the tax code. Instead, foreign funds are considered to be a group of investors. U.S. pension funds are considered "individual investors" under the tax law.

were not common; the United Kingdom, France, Japan, Hong Kong and Australia all have large property share markets [22] (See Figure 5). An example of the extent of securitization in foreign markets is that a single public real estate company in Japan, Mitsubishi Estate, has a greater stock market capitalization ($14 billion) than all publicly traded U.S. REITs ($11.1 billion) (data as of 11/91) [37]. Real estate stocks represent 1.3% of the Japanese stock market, as measured by the Salomon-Russell Broad Market Property Index, versus 0.3% in the U.S. The authors imply that based on the tax law changes and the lack of financing available, the U.S. REIT market should grow to the point that its value is in line with the global property market.

Conclusion

The precedent for securitization which currently exists in foreign markets and the demand for liquidity in the marketplace are compelling arguments for the growth of equity REIT securitization. However, outside of the valuation issues involved in taking private real estate holdings public, relatively little has been written on the impediments to securitization in today's marketplace. These other impediments, which include the cost of the transaction, the psychological impact of going public, and the size of the asset base required to name a few, are significant. The basis of this thesis is to look at the true costs and benefits of

Figure 5
GLOBAL PROPERTY UNIVERSE
As of 12/31/91

Country	No. of Companies	Approx. Cap. ($B)	Total Market Cap.	% of Total
Far East				
Japan	31	$40.0	$2,900	1.38%
Hong Kong	19	26.0	99	26.26%
Singapore	9	5.4	42	12.86%
Malaysia	7	4.3	53	8.11%
Australia	12	3.7	170	2.18%
	---	---	---	---
	78	$79.4	$3,264	2.43%
Europe				
United Kingdom	39	$14.2	$881	1.61%
France	29	11.6	319	3.64%
Netherlands	8	5.8	NA	NA
Spain	15	3.7	NA	NA
Germany	5	1.7	344	0.49%
Other Europe	28	12.4	NA	NA
	---	---	---	---
	85	$49.4	$2,600	1.90%
North America				
United States	103	$12.0	3700	0.32%
Canada	15	4.0	242	1.65%
	---	---	---	---
	118	$16.0	$3,942	0.41%

Note: To be included in these totals, a firm must be an investment-oriented equity holder of real estate. Non-U.S. companies with market capitalization below $70M are not included.

Source: Alex. Brown Kleinwort Benson, GT Global

an initial offering for a public equity REIT based on the insights of leading professionals in the industry.

CHAPTER 3: THE COSTS AND MARKET DRIVEN REQUIREMENTS FOR AN EQUITY REIT IPO: A LEADING UNDERWRITER'S VIEW

On June 12, 1992, I interviewed William Byrnes, a Managing Director of the Corporate Finance Division of Alex. Brown & Sons, Inc. Alex. Brown is a leading underwriter of equity REIT offerings in the U.S.

Byrnes has put together a model which outlines the expenses and desired parameters for initial public offerings of equity REITs from the underwriter's perspective (See Figures 6). It is evident from the costs and market driven requirements outlined in the model that an initial public offering is a process which few private owners of real estate can successfully undertake. The IPO process involves prohibitive transaction costs and the market requires a specific deal structure. The following is a discussion of the costs and parameters outlined in the Alex. Brown & Son's model:

OFFERING SPECIFICATIONS:

1. <u>Minimum Equity Offering - $60 Million</u>:

According to Byrnes, the minimum offering size requirement of $60 million is driven by a combination of subjective and objective criteria. From the subjective perspective, a minimum offering size is needed to generate sufficient liquidity for the REIT investors. If the market capitalization of a REIT is too small, shareholders will not enjoy adequate liquidity due to the small size of the

Figure 6
IPO REIT Expenses and Offering Parameters
May 14, 1992

Offering

Minimum Equity Offering:	$60 Million
Underwriters Overallotment: (Green Shoe)	15% (Specified Properties)
Ownership by Principals:	10% +
Underwriters Discount:	7% Range
Offering Expenses[1]:	Printing SEC & Blue Sky Fees NYSE Listing Legal Fees Accounting Fees Underwriters Advisory Fee Appraisal Fees Total Cost $1 Million
Initial Yield to Investors:	8 - 9%
Initial Dividend Payout Ratio[2]:	80% - 90%
Debt to Equity Ratio:	0 - 50%
Estimated Annual G&A Expense:	$500,000

Source: Alex. Brown & Sons, Inc.

[1] The majority of these expenses would be incurred prior to SEC filing.

[2] Based on Funds from Operations which is operating income of the properties less interest expense and REIT operating expenses. This calculation excludes any capital gains or non-recurring income.

tradeable market. In addition, a minimum market capitalization (in the range of $60MM[1]) is needed to attract institutional interest.

An objective determinant of the $60MM offering is that $60MM is the minimum offering that can be listed on the New York Stock Exchange. Not only does an NYSE listing add prestige to the offering, but less underwriting is required to clear state Blue Sky laws for NYSE registered offerings as well. Initial public offerings below $60MM can be listed on the American or Over the Counter (NASDAQ) exchanges.

All equity REIT IPOs involve substantial pre-offering expenses including the underwriter's advisory fee[2], legal fees, accounting fees, printing fees and appraisal charges among others. In addition, an underwriter's discount in the range of 7% is also charged if the offering is successfully brought to market. A minimum offering size is necessary to justify these expenses. Otherwise, the transaction may become economically unfeasible due to the level of hard costs involved. Based on the costs and parameters outlined in the

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[1] M - Symbol for thousand. MM - Symbol for million.

[2] An advisory fee is charged by the underwriter to cover all of the pre-offering consultation expenses. Private entities converting to REITs typically require advisement on forming a new operating company, structuring the transaction, and dealing with the partnership roll-up issues. Real estate offerings are contrasted with typical corporate offerings which do not require the same level of advisement in most cases. Kimco Corporation's IPO in November included an advisory fee of $600M on a $128MM offering.

Alex. Brown offering model, a $60MM offering would generate hard costs of $5.2MM which constitutes 8.7% of the total offering.

In addition, an asset pool of a certain size is needed to justify the in-house advisory services and management which the market currently demands. Self-administered and self-managed equity REITs tend to trade at higher market prices relative to current asset values compared to REITs which have third party advisors and property management [28]. The market appears to value the exclusive focus of management and the lower cost which is typically associated with in-house management.

Other industry specialists have discussed different minimum capitalization requirements for equity REITs ranging from $50 to $250 million. Stanford Alexander, President and C.E.O. of Weingarten Realty Investors, claims that a minimum market cap. of $200 - $250 million is required for a REIT to be viable today [8]. This belief is based on the fact that larger REITs are rated and can attract institutional money more easily. Bruce Garrison of Kidder Peabody & Co., Inc. claimed that the size requirements of the marketplace, which is primarily driven by the needs of institutional investors, limits the number of potential initial public offerings. REITs that can be formed from large existing pools of real estate holdings, such as commingled funds managed by advisory firms, will be favored by institutional investors [8].

2. Underwriters' Overallotment (Green Shoe) - 15% (Specified Properties):

This is a provision included in an underwriting agreement which allows the syndicate (investment bank) to purchase additional shares from the offeror at the same price as the original offering. In this way, the underwriting group can cover shares sold short without financial risk.[1]

Unlike a typical short selling transaction, the greenshoe is a way for the investment bank to maintain a stable market for the new offering in the volatile early days of trading (30 - 40% of Kimco offering traded the first day). Typically, new REITs have traded at a discount to the offering price on the first trading day. When the green shoe provision is exercised, the offeror issues additional shares for the exclusive purchase of the underwriter. The underwriter then purchases the shares to offset selling pressure and stabilize the share price. The underwriter's overallotment is limited by NASD regulation to 15% of the offering. A greenshoe is typically used in combination with a naked short which is another way for the investment bank to maintain market stability. According to Byrnes, "the goal of the investment bank is to walk away from an offering at a breakeven price (at the offering price). However, it is typical for the investment banks to lose money even after using the greenshoe

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[1] Definition of "Greenshoe" from: Pessin, Alan H., Ross, Joseph A., Words of Wall Street, p. 101, Dow Jones-Irwin, 1983.

and naked short to stabilize the share price." From the perspective of the offeror, the issuance of additional shares further dilutes existing equity holders. However, the dilution is minimal and any stability which can be added to the share price is beneficial [2].

3. Ownership by Principals - 10%:

Potential investors in equity REITs value insider ownership for a number of reasons. First, the market views substantial ownership by the principles as a surety that management is committed to the future of the REIT. Second, insider ownership tends to mitigate conflicts of interest from the investors' point of view as management is evidencing it's commitment to enhancing share value. According to a Merrill Lynch executive:

> Investors are essentially looking for commonality of interests between the operators of the company and the investor through undivided management focus and management compensation in the form of dividend yield and appreciation through mutual stock ownership of the company.[1]

Alex. Brown's ten percent insider ownership requirement is based on the percentage of ownership held by principles in the more successful equity REITs.

The perception in the marketplace is that substantial insider ownership will benefit the share price, and

[1] Berquist, Jack, "It Takes More Than Just Sizzle to Sell a REIT Today on Wall Street," The Institutional Real Estate Letter, April 1992, p.13.

intuitively this makes sense. However, Green Street Advisors, a well-established REIT research firm, developed a statistically based pricing model in 1989 which attempted to quantify what factors cause REITs to trade at premiums or discounts to current asset value.[1] The level of insider ownership was tested as a factor which influenced share price (among eight other factors), and according to the results, it offered little explanation of why the discounts to current asset value exist. Instead, factors such as value added management, geographic and property focus, and level of overhead expenses explained most of the discount or premium. However, Green Street added that the small sample size may have been responsible for the poor explanatory power of insider ownership as a determinant of share price [18].

4. <u>Underwriters' Discount - 7% Range</u>:

An underwriting fee of approximately 7% of the total equity offering, as determined by the pricing set by the underwriter, is charged to the offeror if the issue is successfully brought to market.

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[1] The statistical study involved a sample of 19 equity REITs and attempted to forecast the effects of 9 factors on REIT share price in relation to current asset value. The model explained 65% of the variations that are actually seen in current value discounts. The level of insider ownership was one of the factors included and was found to be statistically insignificant by the model. Insider ownership ranged from a high of 25.5% to 0.1% in the companies surveyed.

5. Offering Expenses - $1 million:

Offering expenses include printing charges, SEC & Blue Sky fees, NYSE listing fees, legal fees, accounting fees, underwriter's advisory fee and appraisal fees. The $1 million fee is based on a sample offering size of $60 million in equity. The majority of these fees constitute pre-offering expenses which will be incurred whether or not the offering comes to market. The possible exception is the underwriter's advisory fee which may be contingent upon a successful offering, however, some minimum fee will be charged by the underwriter in any case to cover costs.

Typical equity REIT IPO's require updated appraisals on all of the properties which will be included in the REIT. This is necessary to establish current asset value. In addition, three years of audits by a "Big Six" accounting firm are required for all of the properties going into the REIT as well as for the parent company [2]. Legal fees will be substantial as well, especially if a number of individual partnerships are being rolled-up into a master limited partnership for REIT formation. Under the Alex. Brown model, the law firm chosen by the private owner will be subject to the underwriter's approval.

5. Initial Yield to Investors - 8.0% to 9.0%:

The market is currently demanding a dividend yield in the range of eight to nine percent for new equity REITs. This

yield has been derived based on the typical yield provided by equity REITs in the current market plus a small risk premium in the range of 50 to 100 basis points for a new issue. New issues tend to be priced at a slightly higher yield primarily because they do not have track records as public companies [8]. REIT dividends are paid out of Funds from Operations which is the industry benchmark for evaluating a REIT's cash flow.[1] Typical dividend payout ratios of equity REITs are in the range of 80 to 95% of Funds from Operations.

Specific REITs which are going public will likely be priced at a small yield premium to the existing REITs in their peer group. For example, the initial public offering of Kimco Corporation was priced at yield of 8.8% based on the current yield of similar regional shopping center REITs plus a small risk premium [8]. Milton Cooper, Chairman of Kimco Corporation, stated that their initial yield was targeted in a range from 7.8% to 8.8% and that Kimco came out at the higher end of that range due to a one hundred point drop in the stock market the week before the offering [8].

The yield demanded in the market today for a new equity REIT offering may present a significant impediment to the private real estate owner. However, as the chart on the following page shows (Figure 7), there is a wide range in the

[1] Funds from Operations is defined as net operating income from the properties less interest expense and REIT operating expenses. This calculation excludes any capital gains or non-recurring income [5].

discount to property value offered by the public market based on the pricing of the offering. For example, at a conservatively priced dividend yield of 9%, and a conservative dividend payout ratio of 80%, the market based discount to appraised value will be in the range of 22% (See Restrictive Pricing Scenario Figure 7). However with a less restrictive offering structure priced at a yield of 8.0% and a dividend payout ratio of 90%, the market discount to value is only 1.68% (See Open Scenario Figure 7). A more reasonable discount to current appraised value is between these two extremes in the range of 12-15% (See Moderate Pricing Scenario Figure 7).

Based on these results, it appears that the lower valuation offered by the stock market is primarily associated with the 50 - 100 basis point risk premium for a new offering and the capitalized value of the incremental expenses associated with running a public company. For example, if the Moderate Pricing Scenario is used, a 75 basis point reduction in the yield and the addition back of the capitalized value of the operating expenses (at the new yield of 7.75%), explains 107% of the valuation reduction offered by the public market. Assuming that the risk premium associated with new companies dissipates over time, one may look to the value of the incremental expenses associated with being public as the primary reason for the valuation discount offered by the stock market.

Figure 7. IPO Equity REIT Property Valuation Discount

Appraisal Based Valuation	Restrictive Pricing	Open Pricing	Moderate Pricing
NREI Cap. Rate for Los Angeles Retail (1)	9.20%	9.20%	9.20%
Assume: Property Net Operating Income	$10,000,000	$10,000,000	$10,000,000
NREI Property Value (NOI/Cap. Rate)	$108,695,652	$108,695,652	$108,695,652
IPO Equity REIT Valuation			
Properties NOI	$10,000,000	$10,000,000	$10,000,000
Less: REIT Operating Expenses (2)	(500,000)	(500,000)	(500,000)
Funds from Operations (3)	$9,500,000	$9,500,000	$9,500,000
Dividend Payout Ratio	80.00%	90.00%	85.00%
Dividend	$7,600,000	$8,550,000	$8,075,000
Required Investor Yield	9.00%	8.00%	8.50%
Market Based Property Value (Dividend/Yield)	$84,444,444	$106,875,000	$95,000,000
Stock Market Based Discount to Value	22.31%	1.68%	12.60%
Stock Market Indicated Cap. Rate	11.84%	9.36%	10.53%

(1) National Real Estate Index capitalization rate for Los Angeles based on real estate transactions completed fourth quarter 1991.

(2) Assume that property NOI already includes management expenses at 4% of NOI. An additional 5% in expenses has been added for incremental REIT costs such as public relations and annual investment banking fees. The combined expenses are in line with industry averages.

(3) Assuming there is no debt on the properties.

In addition, the valuation discount offered by the stock market may be partially attributable to the different valuation methods used by appraisers and the public markets. The stock market values an income stream based on the property market today and the expected volatility of that income stream. Unlike an appraisal based value, there is no lag in the valuation due to the timing of comparable transactions, nor is there the associated smoothing which has been well-documented in appraisal based performance data. In addition, because of its orientation to cash flow and the open-ended nature of equity REIT holdings, the stock market tends to attribute negligible value to the property residuals.

Although the market's valuation of REIT holdings may be considered restrictive by some private owners, Bruce Garrison, the head of real estate research for Kidder Peabody, stated:

> The REIT vehicle provides a pricing mechanism for real estate which I believe is superb. It's instantaneous, it comes from a variety of sources and it's not inherently biased by one party in the appraisal process. As a result, I've always espoused the view that one of the beauties of REITs is offering the world an alternative pricing mechanism for real estate.[1]

However, no matter how efficient the capital market's pricing of real estate may be, it still may represent an impediment to private owners in a restrictively priced market.

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[1] Coopers & Lybrand, REITs the Future is Now, Perspectives of Industry Experts, 1992, pp. 94-95.

6. <u>Initial Payout Ratio - 80% to 90%:</u>

The initial payout ratio refers to the percentage of Funds from Operations which is paid out in dividends. A payout ratio in the range of 80% to 90% indicates that there is a 10% to 20% cushion in the cash flow of the REIT. In other words, Funds from Operations could decline by up to 20% and the REIT would still be able to meet its dividend payment. The market values a cushion in the cash flow of REITs and historically REITs with more conservative dividend payout ratios have traded at higher earnings multiples [8]. The reasoning behind the higher share price is that by having a conservative payout ratio, the REIT is retaining earnings and can invest those earnings at a higher rate than shareholders receiving dividends [8].

Although retaining a percentage of cash flow does provide a cushion to investors, it also reduces the dividend payment initially which effectively reduces the offering price to the private owners. This restriction of cash flow may appear to be an impediment to new offerings, however, if the private owners maintain a substantial ownership position a conservative cash flow will be rewarded with a higher share price.

7. <u>Debt to Equity Ratio - 0% to 50%:</u>

The market today tends to view leverage as a source of risk. This view is based on the current problems in the

commercial real estate market which have been caused in part by the excessive use of leverage. It follows then that the publicly traded equity REITs which are trading at the high-end of the spectrum today carry leverage well under 50% [28]. For example, Washington REIT was trading at a dividend yield below 5% at 2/18/91 and had a debt to total capitalization ratio of 2.6%. New Plan Realty also trades at a dividend yield in the 5% range and has debt of only $15 million on a market cap. of over $1 billion [28].

The downside of the market requiring low leverage for new equity REITs is that equity is a much more expensive source of funding in today's market. If an equity REIT could carry debt below it's cost of equity at up to 70% of market value, for example, the returns to the shareholders would be improved and the offering price would be higher (I am assuming that a debt to equity ratio in the range of 65-70% would not create a prohibitive cost of capital). Although I am not an advocate of leverage and the risks it entails, it is possible that the stock market is too critical of REITs with debt to equity in excess of 1:1. As Bruce Garrison pointed out, "the better stories from a stock point of view are those that encompass the judicious use of leverage because you can get better returns if done right."[1]

[1] Coopers & Lybrand, REITs the Future is Now, Perspectives of Industry Experts, 1992, p. 97.

8. Estimated Annual G&A Expense - $500,000:

The market requires that the operating expenses of REITs are maintained within a certain range. Excessive management expenses will result in a devaluation of the share price as the REIT is not maximizing the return to the shareholders. The $500,000 estimate for general and administrative expenses is based on an offering in the $60 million range. A more general guideline for operating expenses is that they should constitute approximately 0.6% of assets (stock market value) or 9% of Funds from Operations [19]. These expense guidelines are based on the average expenses of the Garrison Brothers Index of twenty publicly traded equity REITs.

Private owners who convert their holdings into equity REITs typically have to reduce operating expenses significantly to meet REIT industry standards. Many owners actually see this expense reduction as a positive because the companies involved are forced to maximize their profitability. As Milton Cooper of Kimco Corporation stated:

> The discipline required of a publicly traded REIT has a positive aspect. People trusted us with their money; while it's an opportunity it's also a responsibility. For instance, we found that as good as we might have been before, we got much tougher with respect to expense control because we were dealing with other people's money.[1]

Although expense reduction can be looked at as a positive for

[1] Coopers & Lybrand, REITs: The Future is Now, Perspectives of Industry Experts, 1992, p. 17.

private owners converting to REIT ownership, implementing the expense controls and downsizing the organizations are other hurdles which must be overcome. A sophisticated management team is needed to bring expenses in line with the industry and control expenses once the REIT has been formed.

Sample REIT Offering (See Figure 8 next page)

Based on a sample offering size of $94 million, the offering costs associated with an equity REIT IPO, as outlined by Alex. Brown and Sons, Inc., would involve an incremental cost of capital of 1.49% over the market dictated return on equity. In my offering example, outlined on the following page, if the market required a total return of 17% (dividend yield + appreciation), the total cost of capital to the issuer would be 18.49%. Based on this example, the expenses associated with the offering should not be prohibitive at only 1.49% of the total offering.

Figure 8. Sample REIT Offering

Assume: Funds from Operations	$10,000,000
85% Payout Ratio	$8,500,000
Offering Value @ 9% Yield	**$94,444,444**
Less: Underwriter's Discount @ 7%	($6,611,111)
Offering Expenses	($1,000,000)

Total Offering Proceeds to Issuer	**$86,833,333**
Assume: Less Stock to be held by Principals @ 10%	($8,683,333)

Cash Proceeds to Issuer (1) (2)	**$78,150,000**
Assume 10 Million Shares Issued:	
Offering Share Price	$9.44
Offering Proceeds per Share	$8.68
Cash Proceeds per Share	$7.82
Assume Market Required R.O.E:	17.00%
Required Total Return per Share	$1.61
Cost of Capital to Issuer	**18.49%**
Incremental Cost of Capital to Issuer	**1.49%**

(1) Assumes there is no debt on the properties.

(2) Worksheet based on Alex. Brown & Sons, Inc. offering model.

OTHER MARKET DRIVEN ISSUES & CONVERSION TIMETABLE:

In addition to the market driven requirements for the actual offering, the market also prefers certain underlying property characteristics and ownership structures. The following is a discussion of the issues which Alex. Brown & Sons, Inc. includes in its specifications for a successful equity REIT:

1. Fully Specified Offering:

In today's marketplace, investors and analysts prefer to see an existing pool of specified properties (ie: 5 regional malls in St. Louis) rolled into REIT ownership rather than a "blind pool". The term "blind pool" refers to raising a pool of capital in advance of acquiring properties. The investors are "blind" as to what those investments will eventually be and are putting all of their faith in REIT management.

The market's distaste for blind pools stems from the historically poor performance of blind pools in the 1970's. During the 70's, there was a feeding frenzy on wall street for REITs and hundreds of millions of dollars flowed into blind pools in the form of both mortgage and equity REITs. Underwriting quality for investments was often poor with some inexperienced managers placing money. In addition, there was just too much money flowing into real estate at the same time [15].

The overwhelming attitude on wall street today is that a blind pool cannot be raised. However, a $165 million blind pool mortgage REIT was offered just recently (July 1992) by Allied Capital Commercial Corporation. It appears that blind pools may be acceptable based on the expected total return of the offering and the management team involved.

Another interesting point is that once an equity REIT is established, it is able to raise additional equity without specifying what the equity will be invested in. Essentially, the market has enough comfort with existing REIT management to allow capital to be raised for "blind" investments. Perhaps the market will allow more proven management teams to raise blind pools of capital for equity REIT offerings in the future.

2. Preferred Property Type - Retail or Apartment:

Presently, retail properties and apartment properties are the desired asset classes for new REITs. This attitude is based on analysis that these two asset classes will outperform the commercial office and industrial markets over the next few years. According to Alex. Brown & Sons, Inc. May 1992 Real Estate Stocks Monitor, apartments are expected to be the first property type to show improvement coming out of the recession primarily due to the significant decline in multi-family housing starts since 1986 [12]. Other analysts have added that the production of new multi-family units

reached a ten year low in 1990 and the level of new starts was down over 40% in 1991 [19]. In addition, apartment vacancy rates, currently in the range of 10%, are expected to decline with the depressed level of construction and pent-up demand building for all forms of shelter [19].

Retail forecasts are driven by the retail sales on the demand side and new construction on the supply side. Like all other real estate asset classes, retail construction has dropped off to a virtual standstill in the past two years. With little new construction and the continuation of the current credit squeeze, analysts are hoping that a rebound in the national economy will spark consumer confidence and thus retail sales. Increased retail sales volume will bring down vacancy rates and lead to higher rents in the sector. One analyst indicated that his focus on retail was driven by the redevelopment opportunities available in the market as well. Existing assets can be purchased cheaply and repositioned in the market [19].

While the benefits of retail and apartments over other asset classes make sense on a national level, local markets may vary substantially. For example, the office market may be stronger than retail in certain cities or an owner may have a local product niche (such as A+ office) which has consistently performed with less volatility than the broader market. It is my contention that the property holdings of potential equity REITs should be reviewed based on historical

performance and the underlying local real estate market more than national trends.

3. Geographic Concentration:

Investors and market analysts are most receptive today to new REITs which are focused both by product type and geographic area. The market is looking for a focused management team which is very good at operating and acquiring a specific product in a geographic region. This reasoning is based on the idea that real estate is inherently a local business and that local knowledge and expertise can provide above market returns.

Opponents of this strategy believe that focus by property type and geographic area opens up REITs to specific risks associated with a region or asset class. Some institutional players have noted that equity REITs should apply modern portfolio theory and diversify by product type and region to provide market returns with less volatility [26]. However, the risk diversification achieved through the application of modern portfolio theory may be offset by the risk of operating in unfamiliar markets.

4. No Conflict of Interest Issues:

In order to avoid conflicts of interest between REIT management and shareholders, the market prefers new equity REITs with a certain structure. First, the market wants all

of the real estate activity of the principals to be associated with the REIT. For example, management should not be splitting its time between the REIT and another separate operating company. Second, the market prefers self-administered and self-managed REITs. Again, this preference is based on the idea that shareholders interests are better protected when the REIT ownership is actively involved in the operation of the REIT and management of the properties. Self-administered REITs tend to trade at higher premiums to book value than their externally advised counterparts [28].
Finally, the market wants the REIT to have a 100% interest in the properties. If multiple partnerships are converting to a REIT, the partnerships should be rolled up into a master and the REIT should take over the general partner position with 100% ownership in the underlying properties. The market does not want a situation where the REIT does not have full control over the properties. The much publicized failure of the Taubman Cos. equity REIT offering in June was partially due to conflict of interest issues. As the deal was structured, the Taubman REIT would not hold a general partnership position in all of the properties and that lack of control was not acceptable to the market.

On the issue of self-advised and self-managed REITs, the market may be mistaken in making a blanket judgement of REITs which have third party property managers and/or advisors. If a REIT can lower its expenses by contracting out

for these services, or if the third party managers are more qualified than the management of the REIT, the REIT should be rewarded for being externally advised or managed. The advisory and management capabilities of individual REITs should be looked at on a case by case basis.

5. <u>No Ground Leases:</u>

Underwriters are not accepting ground leases as assets which can be converted to REIT holdings. The market perspective is that a ground lease does not provide the same level of control as outright fee simple ownership. This is based on the premise that a ground lease constitutes ownership of an income stream for a defined period of time only and not the underlying property.

Conversion Timetable:

A typical equity REIT offering will take in the range of 26 to 40 weeks to complete, according to Alex. Brown & Sons, Inc. The majority of this time will be spent on the pre-offering due diligence and structuring the transaction. If a partnership roll-up is necessary, a great deal of time will be spent working through the partnership and legal issues [1]. All inclusive, the due diligence and deal structuring phase of the conversion should take 16 to 26 weeks. The final 10-14 weeks will be spent on the actual offering which includes drafting the documents and allowing for SEC review

and marketing.

From the offeror's perspective, the time that must be dedicated to the REIT conversion is a large impediment. Not only are the costs of the transaction substantial in real dollars, but there is a huge opportunity cost involved in the conversion as well [2]. The offeror has to shift focus off of his underlying business for up to ten months and concentrate on the REIT conversion. This is time which could be spent on pursuing other forms of restructuring or focusing on bringing in new business. In addition, both the capital and time invested is all at risk because there is no assurance that the transaction will ever make it to market [2].

Additional Points from Interview with William Byrnes:

1. <u>View on Growth in the Equity REIT Industry</u>

By the late 1990's, REITs will emerge as the dominant real estate (financial) structure. REITs provide both liquidity and the opportunity to diversify real estate holdings. In the future, growth in the industry will be spurred by pension fund investment. Directors of institutions (pension funds, insurance companies and advisory firms) are currently involved with cleaning up their problems. Once that process is finished, institutionally owned properties will be converted into REITs and the tax-exempt investors will pay more consideration to REITS as an investment vehicle.

2. Two Biggest Impediments to Securitization at Present

1. Partnership tax issues (See Chapt. 4, part 2).
2. Valuation/Conceptualization - It is hard to swallow the valuation offered by the stock market.

At the partnership level, many private developers have to struggle with the tax issues associated with the individual partners and with bringing all of the individual partners from different properties together. At present, the master limited partnership structure presents some problems. There needs to be a way to shelter the tax liability of the individual partners when they exchange their master limited partnership interests for REIT shares.

3. The Success of the Kimco Corporation Offering

Kimco is a good case study of an equity REIT IPO. The offering was successful primarily due to the following reasons:

1. The properties were valued at a cap rate of 10 -12%.
2. Initial yield to investor of 8.8%.
3. No conflicts of interest - Aligned owner's and investor's interest.
4. Individual partnerships were successfully rolled-up.

4. Stock Market Valuation of Real Estate

In the short term, the market will discount the value of the

real estate holdings. However, in the long run values should improve as the market rewards successful management. The public markets pay a premium for a good management team. Examples of the premium which the market will pay for strong management include Kimco Corporation and Washington REIT. Kimco was originally offered at $20 per share and has now moved up to $26 per share largely as a result of the confidence which the market has in Kimco's management. Washington REIT is currently trading at an effective cap. rate of 4-5%, however, the properties aren't worth that much. The market is rewarding Washington REIT for its solid management and is paying a premium for it.

5. Primary Benefit of Converting to a REIT in Today's Market

In addition to the liquidity associated with the REIT vehicle, REITs today have the ability to raise additional capital. Currently there is a positive yield spread in the marketplace between equity REIT dividend yields and property capitalization rates available to established REITS (cap. rates in the range of 12-15%). Examples are Federal Realty with a current dividend yield in the range of 7.5% and Washington REIT with a current dividend yield in the range of 5.2%. In this type of yield environment, REITs will be able to grow current income which will result in share price appreciation.

However, the true cost of capital for equity REITs

(Return on Equity: dividend yield + appreciation) is close to or above property all-in equity yield rates from net operating income and price changes. To maximize wealth to existing shareholders, REITs would be better served by the judicious use of leverage. For example, if debt could be raised in today's market at a cost of 7% (prime + 1%), and a property could be acquired at a cap. rate of 12%, that spread would be passed on to shareholders without the dilution associated with raising additional equity (This is assuming that leverage would not rise to the point at which it would significantly increase the cost of capital to the firm).

Figure 9. Summary of IPO REIT ISSUES

Additional Specifications for a Successful Offering

- Fully Specified Offering
- Preferred Property Type: Retail or Apartment
- Geographic Concentration
- No Conflict of Interest Issues:
    - All Real Estate and Real Estate Activity of Owners Must Be Handled Through REIT
    - Self-Administered
    - Self-Managed
    - 100% Interest in Properties (Partnerships Must be Rolled Up)
- No Ground Leases
- List on NYSE
- Accounting by "Big Six" Firm
- Law Firm Subject to Underwriter Approval

Conversion Timing

Due Diligence and Structuring Phase: **16 - 26 Weeks**

- Creation & Analysis of Historical Operating Performance
- Projections & Creation of Business Plan
- Agreement on Properties
- Creation of Company
    - Article of Incorporation, By-Laws
    - Selection of Directors
- Resolution of Conflict of Interest Issues
- Tax Issues
- Partnership Roll-Up Issues
- Appraisals
- Audits (3 years of historical property information required)

Offering Phase: **10 - 14 Weeks**

- Drafting Document
- SEC Review and Marketing

Total **26 - 40 Weeks**

Source: Alex. Brown & Sons, Inc.

CHAPTER 4: OTHER PERSPECTIVES ON THE INITIAL PUBLIC OFFERING PROCESS AND THE EQUITY REIT INDUSTRY

Part One

The Private Developer Engaged in the Offering Process

On June 11, 1992, I interviewed a Senior Vice President and the Chairman of Development Company X[1] which is currently working through the initial public offering process for an equity REIT. Our conversation focused on the costs and benefits of taking private holdings public from the offeror's perspective. The following is a distilled version of our conversation:

Costs of the Transaction:

1. Underwriting Fee

A 6.5% fee is charged on the sale of the securities. An additional $500,000 feasibility fee is charged if the REIT is successfully brought to market. If the transaction does not go through, the investment bank receives a flat kick-out fee of $250,000 to cover their costs.

2. Legal Fees

Substantial legal fees are involved in structuring the transaction and working through the roll-up of the individual

[1] The name of the development company must be kept confidential while the company is working through the offering process.

partnerships into a master limited partnership. A myriad of different interests are involved and must be represented.

3. <u>Accounting Fees</u>

Three years of audits by a "Big 6" accounting firm are required for all holdings being put into the REIT and for the parent development company.

4. <u>Opportunity Cost</u>

There is an opportunity cost involved with not being able to carry on normal business. Potential income generating transactions must be passed up to concentrate on the REIT IPO.

Excluding the underwriter's 6.5% discount on the sale of the securities, the offering costs will total $2 - 4 million plus the opportunity cost associated with lost business. In addition, during the underwriting period, the offeror is bearing the entire risk of the transaction. No one will warrant that the transaction will go through.

The Partnership Conversion Process:

Trying to pull all of the limited partners from different properties in one direction is an incredible task. The partners need to be educated about the REIT conversion process and convinced that the transaction makes sense and that their rights will be protected. Psychologically, the

partners have to get comfortable with the transaction as well. Some of the investors have been involved with the development company for a great number of years. There is a fear on their part that going public will diminish the relationship and reduce the level of service which they are receiving. The developer's job is to allay their fears and work to protect their interests.

In this particular offering, the REIT will purchase a general partnership position in the master limited partnership which will effectively dilute the equity interest of the partners (the new equity will be replacing outstanding debt). At that point, the value of one diluted share in the master limited partnership will be equal to one share of REIT stock. The income distributions will be the same for partners and REIT shareholders, as will any property appreciation or depreciation.

If a limited partner wants liquidity, he must exchange his partnership interest for shares in the REIT. This exchange constitutes a taxable event. For partners with a very low or negative property basis this exchange creates an enormous tax liability. Converted shares are not taxed based on their diluted ownership value, but rather on their original cost basis. Limited partners end up receiving a diluted income stream yet their tax liability is not diluted. Once a master limited partnership share is converted to a REIT share, and the tax liability is paid, the investor's basis

steps up.

This tax liability for the limited partners is one of the biggest barriers for a private company forming a REIT. First, it is difficult to persuade the partners that the tax liability is offset by their greater liquidity and the potential for future appreciation. Second, according to the Chairman, "these investors are people that we have built relationships with. It is in our interest to protect the rights of these partners to the fullest extent possible."

(Although the developer's interest in protecting their relationships with partners may imply that forming a REIT is a short term strategy (ie: Look to the partners to invest in future deals), I believe that the developer's efforts are driven more by a sense of responsibility. According to the Chairman, many of these partners literally helped to build the business.)

Other Impediments to Going Public:

1. <u>Quality of Life</u>

Taking a private firm public adds needed discipline, however, confidentiality and many of the freedoms associated with private ownership are lost. All in all, the benefits associated with the REIT vehicle in the current market outweigh the costs, so one is willing to sacrifice some of the luxuries associated with private ownership.

2. Loss of Control

Not only is control lost just by going public, there is the ultimate risk of being taken over through the public market. That risk is not there for a private company.[1]

3. Valuation

Although the valuation issue is a big one (REITS demand a higher yield which equates to lower values), it may be more perception than anything. It appears that values should rebound somewhat once the IPO has gone through and the market gets comfortable with management and its track record.

Benefits of Going Public:

1. Risk Mitigation

Overwhelming sentiment is that forming a REIT is the best way to deal with risk in today's market. It's an effective way to deal with the debt and equity risk associated with private development. In effect, control is traded for liquidity and risk mitigation. Personal risk is escaped as well. It is hard to avoid personal risk with direct ownership.

[1] Historically, public REITs have protected themselves from hostile takeovers by adopting "poison pills", also known as rights plans, which can significantly dilute the ownership positions of potential bidders. Poison pills are activated by an unsolicited takeover bid and effectively allow shareholders to increase their ownership in the firm by purchasing shares at a substantial discount. Poison pill securities are typically adopted without shareholder approval. Studies have shown that REITs with poison pill protection have traded at lower prices than their unprotected counterparts [38].

2. Expense Control

Going through the process (of conversion from private to public) makes a company really focus on operating expenses. While it's a gut wrenching process, it's beneficial to have the company lean and running efficiently.

3. Access to the Capital & Competitive Advantage

In addition to gaining access to capital and liquidity in a market with little conventional credit flowing, forming a REIT should provide a competitive advantage in the local market. Few competitors will have the same access to capital while we will have the ability to grow our portfolio.

[NOTE: A critical determination for any potential REIT offeror is to analyze their all in cost of capital. Based on the Alex. Brown offering model, the all in cost of capital to an offeror today would fall in the range of 15-20%. All potential offerors should consider whether less expensive capital is available through the private markets. The current cost of capital for RTC pools is in the range of 25-30%, so it would appear that owners of better performing properties should be able to access capital at a lower cost.]

Part Two

The Legal Perspective

On July 8, 1992, I interviewed William B. King, Esq. of Goodwin Procter & Hoar. Mr. King is one of the leading real estate investment trust lawyers in the nation. Our conversation focused on the challenges and issues involved in converting individual partnerships into a REIT. The following is a summarized version of our conversation:

Main Barriers to REIT Conversion:

There are essentially three major issues facing private owners who are working through the REIT conversion process. The first issue is simply persuading the partners to enter into the transaction. The partners need to be convinced that their interests will be better served through REIT ownership than through the individual partnership format. Oftentimes partners will resist entering into the transaction simply because they don't fully understand it. Partners need to be educated about REITs and the benefits associated with REIT ownership.

Another sticking point for new offerings has been the negative publicity surrounding partnership roll-ups. The majority of roll-ups which occurred during the 1980's received unfavorable media coverage and suffered equally unfavorable economic results [6]. The criticism of roll-ups was focused

on the diminution of limited partner equity due to excessive fees to the general partner and poor valuation methods [6]. However, with the publicity surrounding roll-ups today, and the recent SEC regulations, roll-up issues should not be as much of a problem.

A second impediment to REIT conversion which relates to the partnership issue is the new regulatory environment surrounding partnership roll-ups. The SEC has already put regulations in place which require roll-up sponsors to provide more disclosure concerning the impacts on valuation of a roll-up and potential conflicts of interest. In addition, the new SEC regulations require the general partners to provide at least sixty days for limited partners to approve restructurings.

Congress is also taking a hard look at roll-ups and legislation is currently under discussion in the Senate which would require roll-up sponsors to compensate any limited partners who vote against the transaction. Effectively, limited partners would have the right to cash in their interest prior to the roll-up taking place based on an independent appraisal [17]. According to King, Congress is basically "bolting the barn door after the horses are out." The SEC regulations have already gone a long way in protecting partners' rights. If the new congressional legislation goes through it will make the whole process too tedious and will kill alot of transactions.

The third, and biggest, impediment to converting partnership interests into REIT ownership is the potential tax liability of the individual partners. If the partners have a low or negative basis in the property, there will be a significant tax liability due upon REIT conversion. To any investors who were planning on holding these investments indefinitely, the conversion tax liability is not acceptable. However, there are certain tax planning strategies to work around the conversion tax issues.

Three Different Approaches to REIT Conversion for Partnerships:

Structuring the REIT conversion to minimize partner tax liability is the most costly and time consuming undertaking from the legal perspective, and may serve as a major impediment to REIT conversion. The following are three different approaches to structuring the transaction according to Mr. King:

1. Individual Partnerships

In the case of an individual partnership converting to a REIT it is a fairly simple process. Under section 351E of the tax code, the conversion of an individual partnership into a REIT is not considered a taxable event because the owners (investors) do not gain any diversification. Tax would only be due upon the sale of the REIT shares. However, if more than one partnership is involved in the conversion, through

a roll-up for example, the conversion will constitute a taxable event. In this case, the individual partners will be responsible for taxable gains on the exchange of their partnership interest into REIT shares.

The straightforward process of paying tax on gains realized in the REIT conversion is not the worst alternative according to King. It is beneficial for the partners to put the tax liability behind them and step up their basis in the newly formed REIT. However, it is typical for underwriters to restrict the sale of insider stock in a newly formed REIT for a year or two. Partners would want the transaction structured so that they could at least sell enough REIT shares to cover their conversion tax liability.

2. <u>Multiple Partnerships - Delay REIT Status Election</u>

Another approach to the conversion process, when multiple partnerships are involved, is for the individual partnerships to consolidate their interests into a master limited partnership (MLP) two years prior to electing REIT status. Under this scenario, the MLP will have satisfied the necessary preference period, and will constitute a single partnership upon election of REIT status. The individual partners would not recognize a taxable gain until REIT shares were sold.

3. <u>Multiple Partnerships - Immediate Conversion</u>

A final strategy involves rolling-up the individual

partnerships into a master limited partnership and simultaneously forming a REIT as a separate entity. Once capital has been raised in the marketplace, the REIT will purchase a majority position in the MLP. In most cases, the equity raised by the REIT will replace existing debt in the MLP. Under this scenario, one share of ownership in the MLP would be of equivalent value to one share in the REIT, and partners would receive income and appreciation benefits indefinitely. However, to gain liquidity (ie: sell a portion of their interest), partners would have to exchange their MLP interest for REIT shares. That exchange would constitute a taxable event.

[Final Note: According to King, the process of simply exchanging partnership interests for REIT shares is the least complicated approach from a legal perspective. His recommendation would be for the partners to simply convert their interest to REIT shares and pay the tax. At that point, the partners have liquidity and no looming tax obligations. From the offerors perspective, this is the least complicated and costly route to follow as well.]

Part Three

The Independent REIT Advisor

On June 15, 1992, I interviewed Thomas E. Robinson, Director of REIT Advisory Services for Coopers & Lybrand. Our conversation focused on the barriers facing potential IPOs in today's marketplace as well as the changes needed for industry growth. The following is a distilled version of our conversation:

Biggest Barriers to REIT Formation:

There are numerous barriers to equity REIT formation in the marketplace today. These barriers include the hard dollar costs associated with the transaction such as the underwriting fees, legal fees, audit costs and local transfer taxes to name a few, as well as other less perceptible barriers. For example, the valuation discount which is typically involved with taking private holdings public into a REIT can be substantial. Typically, a 200 basis point premium will be added to the cap. rate on the privately held properties. So for example, if a private property is valued at a cap. of 10%, the public market will probably value that same property at a cap. in the range of 12%. Many owners do not want to take those kind of write-downs on their portfolios. (The valuation model in Chapter 3 presented a typical increase of 130 basis points to the cap rate)

Another less perceived barrier associated with equity REIT formation is the psychological effect of taking private holdings public. This is a difficult transition for many private companies. Many of the freedoms associated with private ownership are lost once you are reporting to equity analysts and are under the scrutiny of the public marketplace.

The critical mass needed to bring a public equity REIT to market today is substantial as well. In Robinson's opinion, you need assets of at least $100 million to justify the costs of the transaction and to attract institutional investors.

Finally, the partnership issues involved with REIT conversions are a major sticking point today. The focus is really on sheltering the tax liability of the individual partners. Partners with a low or negative basis will have to pay the piper upon REIT conversion unless a new way of structuring the conversion to avoid the tax liability is proven. It will be very interesting to see if the new master limited partnership format, which several potential offerors are working on today, will succeed.

Changes Needed for REIT Industry Growth:

In order for the industry to grow substantially, some changes will be needed. A key issue right now is how to value real estate. We need more of an institutional trading philosophy in the REIT industry in which the public market

gives some value to the property residual. In addition, private property owners and the public markets need to come closer together on what the real estate is worth to get transactions moving.

Another issue facing REITs today is the discount which the market is applying to externally advised REITs. There needs to be a way to structure external REIT management so that the market's interests will be protected. It isn't cost effective for REITs under a certain size to internalize management, and until the market accepts some external advisory structure those REITs will not be formed.

Institutional investment will also be needed for the industry to grow substantially. The industry needs to attract equity mutual fund investors as well as pension fund investment. At present the market capitalization of the REIT industry is too small to attract the larger investors, and the institutions want the kind of control over their investments that they receive with direct ownership. However, the smaller pension funds should generate some growth in the industry. One institutional advisor suggested that pension plans allocating $150MM or less to real estate should consider REIT investment [38]. Based on a recent Coopers & Lybrand study, there are approximately 45,000 qualified retirement plans around the country.

A final question that should be asked is what will the role of the traditional sources of real estate financing be

in the future. If cheaper sources of capital are available, private owners of real estate will be much more hesitant to form REITs.

Outlook for Growth in the Industry:

According to Robinson, "Bruce Garrison originally believed in public REIT capitalization of $40 billion by the end of the 1990's. Now I think that the impediments may be stacking up too much to reach that level, and in the short run, I am somewhat pessimistic on growth in the industry. The costs of forming an equity REIT today are severe. However, in the long run, I think that there will be significant growth in the industry because REITs provide a needed source of capital."

Part Four

Perspective of a former President & CEO of a Public Real Estate Operating Company

The following is a highlighted version of a speech which was presented by Tom Steele to the NAIOP Conference in February of 1992. Mr. Steele is currently the Chairman of M.I.T's Center for Real Estate. Prior to assuming this position, Steele was the President and CEO of Perini Investment Properties[1] which is a publicly held real estate operating company closely resembling an equity REIT. His speech titled Publicly Traded Real Estate Companies : An Owner/Manager's Perspective focused on some of the impediments to operating a quasi-equity REIT.

Perspective on Public Market Valuation and a REIT's Ability to Raise Ongoing Capital:[2]

Public real estate operating companies and REITs tend

[1] Perini Investment Properties was formed to own and operate income producing properties previously held by the parent company, Perini Corp. The properties were spun out from the parent primarily for accounting reasons as the negative net worth of the income properties (due to accelerated depreciation) was negatively affecting the parent's share price. The properties were generating a healthy cash flow after debt service.

[2] Note: This issue is being focused on from an internal managers perspective and not whether the market valuation is appropriate.

to trade at significant discounts to net current value[1] primarily due to the difference between appraisal based and public market valuations (See Figure 3). Appraisals tend to rightfully look at longer trends and not be overly influenced by current market fluctuations, while the stock market tries to value long run trends instantaneously. The stock market also tends to overreact during particular economic cycles. Based on these valuation issues, my [Steele's] conclusion is that it is difficult to use the equity market as a source of capital for many REITs because REITs will frequently trade at a substantial discount from what their management teams perceive is a reasonable proxy for liquidation value. Unless the market's valuation of the properties, in comparison to net current value, closes to the 10-15% range, most management teams will not accept the dilution of net current value that issuing additional shares at market price will entail. This problem is exacerbated during adverse economic and industry conditions. So, in many cases, outside of providing initial capital, the market does not provide an ongoing opportunity for liquidity. [Based on the model in Chapter 3, current stock market valuations are in the range of 10-15% of appraised value.]

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[1] Net Current Value refers to the value of the REIT assets based on current appraisals. This value is contrasted to book value and the public market's valuation through share price.

Other Issues:

1. Reporting of Results to Shareholders

At Perini Investment Properties, we believed that cash flow and appraised value were the most relevant tracks for our investors to follow. However, Dow Jones and the Wall Street Journal would never carry our results because they had a policy of only reporting earnings per share under GAAP.[1] This meant that as quarterly and year-end results became available, ours were not carried by the traditional wire services.

2. Impact of Limited Float

Only about 1.5 million of our 4 million shares was readily available to trade, and this restricted interest in our stock to smaller investors. We weren't large enough or liquid enough to attract the larger institutions. However, this may have been a benefit ultimately. Due to their small capitalization, REIT share prices can get hit hard by institutional selling pressure.

3. Takeover Issues

Being public, and being perceived as undervalued subjected the company to unwanted attention by takeover firms who were taking advantage of the availability of junk bond financing. Whether this was efficient or not from a market point of view is debatable. However, it did threaten to take control of the

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[1] Generally Accepted Accounting Principles.

future of the company out of management's hands, and required enormous diversions of attention to what was ultimately unproductive effort.

4. Responding to Equity Analysts and Industry Specialists

Being public creates a whole new level of constituencies that require attention and feeding. In addition to the usual constituencies we all have by being in the business, i.e; employees, partners, lenders and tenants, there is a whole raft of analysts and shareholders that need to be serviced by the company. Analysts and industry specialists require personal attention by top management. If you can't use the market for additional equity, I question the value of these efforts.

5. Incremental Cost of Being Public

The incremental cost of being public was somewhere in the range of $250-400 thousand annually, and we were not extravagant in hiring financial public relations firms. These costs do not include the incremental costs of legal and investment banking help in dealing with take-over threats. If the company can't access the market, are these costs justified merely to provide liquidity for our shareholders?

CHAPTER 5: The Future Role of Pension Fund Investment in the REIT Industry: Perspectives of Two Institutional Advisors

The increase in initial public offerings of equity REITs will be driven in part by the demand for securitized real estate from tax-exempt investors. At present, tax-exempt investors account for only $2 BN of investment in the REIT industry out of a total market cap. of $15 BN. One of the primary reasons for the lack of pension investment in REITs is the small relative size of the REIT industry. There is a lot of discussion in the industry at present that many of the advisors will be forming REITs from their assets under management which would substantially expand the industry. As of 9/91, real estate advisory firms had $120 BN of tax exempt funds under management.[1]

However, these public offerings also involve impediments to the firms which are involved. I interviewed two institutional advisors to get their perspective on the demand for REIT investment from the pension funds and what the prospects are for advisory firms creating equity REITs from existing pools of managed assets.

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[1] Source: September 1991 issue of Pensions & Investments.

Part One

The Institutional Advisor Specializing in REIT Investment

On June 10, 1992, I met with Keith Pauley who is a Vice President with Alex. Brown Kleinwort Benson Realty Advisors Corporation. Mr. Pauley manages approximately $150 million of pension assets which are invested solely in REITs. Our conversation was centered on the role of pension fund investment as a catalyst for growth in the REIT industry. The following is a summary of our discussion:

Role of Institutional Players in the REIT Industry:

The small capitalization of the equity REIT market is a major impediment to REIT investment by the largest pension funds. However, for funds which are allocating $150 million or less to real estate investment, REITS provide the best investment vehicle. Conceptually the public plans have not decided about REITS. The public funds only have $2BN invested in real estate securities at present. The REIT market needs to grow substantially to attract more institutional investment.

The institutional owners and managers of real estate, such as the insurance companies, banks and advisory firms, can rapidly expand the REIT industry by taking their holdings public. Specifically, Hancock, LaSalle Partners, G.E. Capital, PRISA, and JMB have all looked at converting holdings to REITs. However, all have shied away from going public for

the meantime. In my opinion, the primary reason for this is that the institutions don't want to accept the value that the stock market is currently offering for real estate. In addition, they are still too involved with trying to get a handle on their existing problems.

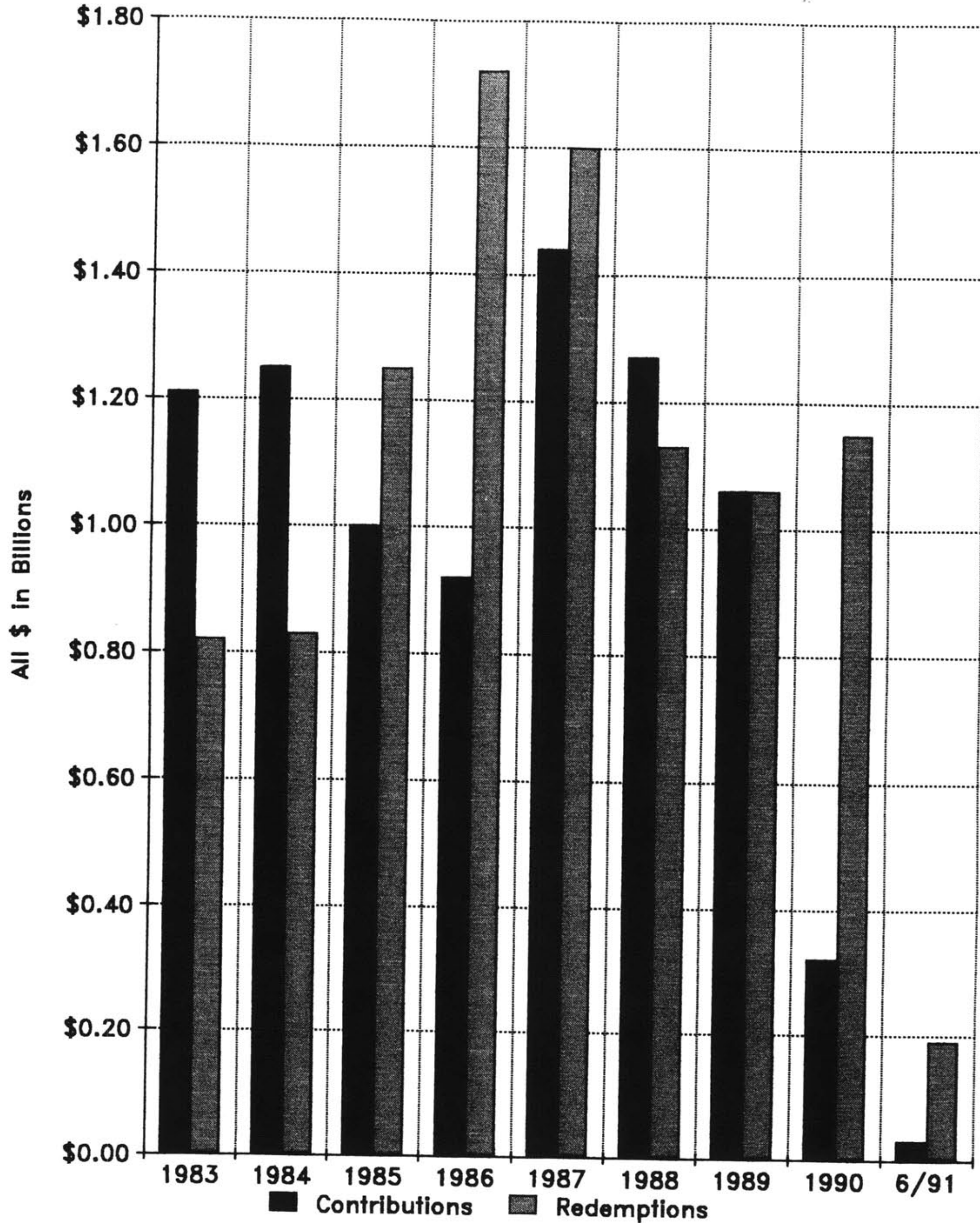
(Another explanation put forward to explain why some advisory firms have not converted their assets under management to REITs is that the cultural impediments involved are too great. Specifically, the institutions have not been willing to allow a separate REIT management team to have full control over the assets. In addition, institutions have not wanted to lose the expertise of a few successful managers which would be needed to run the REIT. A related issue is that managers running the REIT would be compensated far above the level of their contemporaries in the institution, which has created friction [46].)

Primary Benefits of REITs for Pension Fund Investors:

1. <u>Liquidity & Diversification</u>

REITs offer both liquidity and diversification. A smaller pension fund is able to create a diversified real estate portfolio with liquidity that would not be available through direct property investment. In terms of liquidity, REITS are a liquid investment whereas today, many commingled funds can't meet their redemption requirements (See Figure 10 on next page which shows the decline in redemptions and contributions).

Figure 10



Source: Frank Russell Company

2. Flexibility

REITs offer the investor the ability to change investment strategies. For example, an investor could sell off his holdings in office REITS and buy into apartment REITS if the forecasts for the apartment market are more favorable. A commingled fund does not offer the same flexibility.

3. Control

REITs offer pension funds (any investor) more control over their investment than an investment in commingled funds. One of the benefits of public ownership is the voting authority which is given to each investor. (However, the ownership limitations imposed by the five or fewer rule limit the amount of control that any one investor can have in a REIT.[1])

4. Access to Capital

In today's market, REITs have access to additional capital to grow their portfolios through acquisitions. This will benefit existing investors in a positive spread environment. REITs are also able to secure corporate loans from banks where traditional real estate investment vehicles may be unable to obtain financing. In addition, tax-exempt investors are not subject to unrelated business income tax for investments in REITs which are leveraged.

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[1] The 5 or fewer rule stipulates that five or fewer REIT shareholders can't own more than 50% of the outstanding stock or the REIT will be subject to tax at the corporate level.

5. Fees

Pension fund advisory fees are typically charged based on a percentage of total assets under management while REIT fees are charged on a transaction basis only. Over a long holding period, REIT fees would be lower in most cases.

Current Impediments to Pension Fund Investment in REITs:

1. Small capitalization of the REIT market.

2. Five or Fewer Rule

The five or fewer rule restricts the size of the positions that U.S. pension funds can take in REITs. Typically, REITs impose a 10% individual ownership restriction as well. This constrains the market even more.

3. Perception of Real Estate

Current psychology of the marketplace towards real estate investment in general. Many of the pension plans have reduced their real estate allocations substantially or are pulling back from real estate period.

Part Two

Another Institutional Advisor Perspective

On July 16, 1992, I interviewed Susan Hudson-Wilson who is a Director of Aldrich, Eastman & Waltch (AEW). In the interview, we primarily discussed the outlook for new REITs created by the advisory firms and the type of REITs which pension plans would be most interested in investing in. A summary of our conversation follows:

Pension Fund Advisors' Interest in REITs:

According to Hudson-Wilson, the majority of the advisory firms are presently working on some type of REIT vehicle and she expects to see some advisor REITs successfully brought to market by the end of the year. Essentially, the advisory firms are looking at REITs as a way to bring in new business and augment existing business. This is critical in today's market when the bulk of pension plans are holding back on their real estate allocations. Today, plan sponsors are demanding liquidity, and forming a REIT is the best way to provide that liquidity. However, there will still be a huge market for the traditional form of real estate investment, primarily in the separate account form. Ms. Hudson-Wilson expects the capitalization of the REIT industry to more than double to approximately $100 BN by the end of the decade primarily due to the entrance of the institutional REITs.

Attractiveness of REITs for Pension Investors:

According to Hudson-Wilson, the primary benefits associated with REIT investment for pension funds are liquidity and accurate valuation. REITs offer pension investors the liquidity which has been lacking from both direct property investment and co-mingled funds. In addition, REITs offer a precise value daily, and unlike appraisal based valuations, the pricing is derived from a variety of capital market sources.

Historical Performance of Advisory Firms:

With all of the negative publicity which advisory firms have received in the past few years, I was curious as to why the plan sponsors would want to continue their relationships with the advisory firms. In addition, I questioned why pension investors would invest in institutional REITs versus the type of smaller equity REITs which are already in existence. After all, the performance of institutionally managed real estate, based on the Russell NCREIF Index, has substantially under-performed equity REIT investment on a total return and annual yield basis since 1978 (See Figure 4).

According to Hudson-Wilson, pension plan sponsors are still interested in working with selected advisory firms. This is primarily because, in her opinion, advisory firms can offer the institutional quality product that existing REITs

can't offer. Hudson-Wilson believes that institutional investors want a long run creation of value based on a portfolio of geographical and property type diversified assets. These investors are not as interested in the existing "mom and pop" type REITs which are very focused by both region and property type. In addition, the majority of REITs do not hold properties which can be considered "institutional quality". The advisory firms can deliver REITs with a diversified asset base and institutional quality real estate.

An argument to the acceptance of advisor REITs by institutional investors is the return performance which the advisors have provided in the past in comparison to equity REIT returns. On a total return basis, the NAREIT equity index has outperformed the Russell-NCREIF index by 53% since 1978. This historical performance does not bode well for advisors attempting to repackage the same assets and management teams which delivered those results.

Impediments to Securitizing Existing Managed Assets:

Ms. Hudson-Wilson explained that the major impediment to forming the advisor REITs today is getting management and the existing pension investors to accept the valuations offered by the public market. Real estate has to be priced based on a market derived yield, not based on appraisals, and that can create some valuation shortfalls. According to Hudson-Wilson, "there is a steep learning curve facing the

institutional side of the business concerning how REITs need to be structured and priced." She does not see the cultural issues involved with converting assets under management into REITs as playing that big of a factor. "Essentially the entire process comes down to pricing and structure, and the relatively minor cultural issues should not get in the way of an otherwise solid transaction."

According to Hudson-Wilson, the five or fewer rule also presents a substantial impediment to the formation of REITs geared towards institutional investment. At present, the regulations consider U.S. pension plans to be individuals, not a collection of investors, and that is why the plans are restricted. Attempts have been made to get the designation changed so that individual investor would apply to the members of the pension plan. Chris Lucas of NAREIT[1] has indicated that new legislation has been proposed which would create a new level of standards for pension funds. The proposed 10%/25%/50% rule essentially proposes that a pension fund can own up to 25% of a REIT, but no two plans combined could own more than 50%. Individual investors (excluding pension funds) would be restricted to 10% ownership. Violation of any of these regulations by a REIT would result in taxation at the corporate level [33]. Although ultimate passage of the bill is expected, it is doubtful if the legislation will be passed during the current election year.

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[1] National Association of Real Estate Investment Trusts

CHAPTER 6: Conclusion: The Prospects for Growth

The equity REIT industry is positioned for tremendous growth primarily due to the lack of other capital sources in the marketplace. Commercial real estate today has virtually no access to the traditional sources of financing which include commercial banks, insurance companies, and to a lesser extent, direct pension fund investment. Equity REITs do provide access to capital needed to fill the financing void, however, few private owners of real estate have the resources to overcome the impediments to equity REIT formation in the current market. This is evidenced by the fact that the Kimco Corporation offering in 1991 was the first new equity REIT offering since 1978.

As the market improves and more demand is generated for real estate investments, one can expect to see an increase in equity REIT formations by private owners. However, this trend will be influenced by the role of the traditional financing sources and the availability of private capital at lower costs.

For private developers currently considering converting partnership assets into a REIT vehicle, the barriers to successfully bringing an offering to market include a minimum offering size in the range of $60 million and hard dollar costs in the range of 8-10% of the market value of the assets. In addition, the typical valuation of

the properties offered by the stock market involves a writedown of 10-15% from current appraised values. On top of the hard dollar costs, there are a myriad of intangible issues as well. The effort required to convert existing partnership interests and the structure of REIT management required by the public market, are just two of the major issues involved. Valuation issues, however, should be less of a burden in the future as the market's perception of commercial real estate improves and less restrictive pricing is available for new offerings.

With the impediments facing developers and smaller private owners of commercial real estate considering equity REIT conversion, many are looking to the institutional managers of real estate as a source of offerings. In addition, the pension funds demand for liquid real estate investments is often considered to be the catalyst needed to rapidly expand the REIT industry. In deed, REITs appear to offer the type of real estate investment most suitable for small to mid-sized tax exempt investors. Most public REITs provide the liquidity and accurate valuation which has been missing from institutional portfolios. However, in the short term, the majority of tax-exempt investors are wary of real estate investments in general. On the supply side, the advisory firms are struggling with valuation and cultural issues which are impeding the conversion of their assets under management to the REIT vehicle. It appears that in the long

term, many advisory firms will convert their managed holdings to equity REITs as a way to maintain their market share and retain existing clients.

So where does that leave the equity REIT industry? In my opinion, the equity REIT industry will grow substantially by the end of the decade, perhaps doubling in size. The need for capital should overcome the short term impediments to new offerings, especially for the institutional players. In addition, as the health of the commercial real estate industry improves, more interest will be generated from the demand side to grow the industry. In the long term, the growth of the equity REIT industry will be dependent on the ability of private owners to obtain non-recourse financing and the tax driven benefits historically associated with real estate ownership. If the changes in credit availability and the tax laws remain in place, the U.S. equity REIT industry will expand to a market capitalization in line with securitized real estate in other parts of the world.

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