

CAPITAL OPTIONS FOR GROWTH
IN TODAY'S MARKET:
CHOICES AVAILABLE TO REAL ESTATE COMPANIES
WITH CAPITALIZATION OF LESS THAN \$100M

by

Brenda M. Radichel
B.S.B.A., Finance
Boston University, 1986

Submitted to the the Department of Architecture
on July 30, 1993 in partial fulfillment
of the requirements for the Degree of
Master of Science in Real Estate Development
at the
Massachusetts Institute of Technology

© Brenda M. Radichel
all rights reserved

The author hereby grants to M.I.T. permission to reproduce and to distribute
publicly copies of this document in whole or in part.

Signature of Author _____

Department of Architecture
July 30, 1993

Certified by _____

Marc Louargand, Ph.d.
Lecturer
Department of Urban Studies & Planning
Thesis Supervisor

Accepted by _____

William Wheaton
Chairman
Interdepartmental Degree Program in Real Estate Development

Rotch

MASSACHUSETTS INSTITUTE
OF TECHNOLOGY

OCT 04 1993

LIBRARIES

CAPITAL OPTIONS FOR GROWTH
IN TODAY'S MARKET:
CHOICES AVAILABLE TO REAL ESTATE COMPANIES
WITH CAPITALIZATION OF LESS THAN \$100M

Submitted to the Department of Architecture
on July 30, 1993 in partial fulfillment
of the requirements for the Degree of
Master of Science in Real Estate Development

Abstract

This thesis examines the vehicles for growth available to small- and medium-size real estate companies in today's capital starved environment. Understanding that the traditional sources of capital for the real estate industry, commercial banks and insurance companies, are not currently attractive resources, the future markets for real estate capital are explored. Capital options which were researched include private, public and master limited partnerships as well as private and public equity REITs. The positive and negative aspects of each of these options are reviewed and the findings applied in a case study of a real estate company owning properties located in Arizona and Hawaii. The company's interests in: 1) reducing its reliance upon existing capital sources, and 2) obtaining funds for expansion, are taken into account.

Thesis Supervisor: Marc Louargand

Title: Lecturer, Department of Urban Studies & Planning

Dedication

This thesis is dedicated to my father, William D. Radichel, without whose help and guidance I would not have had the opportunity to experience this year at M.I.T. By example he has taught me that being a good friend, father, husband and citizen takes a lifetime of dedication. Most importantly, he has provided me with the grounding of a close and loving family that has given me the freedom to venture outward.

Index

Abstract	2
Dedication.....	3
Index.....	4
Table of Exhibits	5
Introduction	6
Chapter 1: Background of the 1990 Credit Crisis.....	7
Banking Legislation	7
Thriffs and Junk Bonds	9
Banks and Insurance Companies	10
Chapter 2: Introduction to Holualoa Realty Advisors, Inc.....	13
Chapter 3: Private, Public & Master Limited Partnerships.....	16
Private Limited Partnerships	16
Public Limited Partnerships.....	19
Chapter 4: Public Equity REITs:	25
History of Public Equity REITs.....	25
Valuation & Risk	27
Positive Leverage	28
Initial Public Offerings and Yield.....	29
Organizational Costs and Access to Capital.....	31
Institutional Influences	32
Pension Funds	32
Mutual Funds	36
Interest Rates & Leverage.....	38
REMICs	39
Small Capitalization REITs	43
Partnership Roll-ups	44
UPREITs.....	47
Chapter 5: Private Equity REITs	50
Chapter 6: Holualoa Revisited	52
Chapter 7: Future of REITs.....	58
Selected Bibliography.....	72

Table of Exhibits

I. Bank Failures From 1980 to 1991.....	62
II. Holualoa Realty Advisors, Inc. Portfolio.....	63
III. Financing Volume for Public Limited Partnerships, Master Limited Partnerships and REITs from 1980-1990.....	64
IV. REIT Legal and Tax Requirements.....	65
V. REIT Equity Offerings from Q1/91 to Q1/93.....	66
VI. Growth of REIT Assets from 1961 to 1991.....	67
VII. The UPREIT Structure.....	68
VIII. NAREIT List of Private REIT Members.....	69
IX. Differences Between a REIT and a Partnership.....	70
X. Breakdown of Publicly Traded Equity REITs.....	71

Introduction

Real estate has traditionally been financed by thrift institutions, banks, insurance companies and private individuals. However, as capital sources have become more scarce, the real estate industry has moved toward having a greater percentage of its inventory securitized on the public capital markets as a means of raising capital. This relatively new form of financing needs to be understood by real estate investors and compared to traditional sources of equity to determine the lowest cost of capital for a particular company.

Although it will not be the only capital option in the future, the impact of real estate securitization on the United States real estate industry will be significant. Securitization will influence who has the capital to purchase and develop real estate and how those real estate assets will be financed in the future. In addition, organizational structures of real estate firms will need to be realigned to suit this new capital source. Real estate professionals, owners, fiduciaries and companies providing services to the real estate industry, such as lawyers and accountants, will all need to understand how the public capital markets operate. This thesis looks at these changes through the eyes of a small firm which is trying to position itself to take advantage of the purchasing opportunities available in today's real estate market and the growth opportunities of tomorrow's.

Chapter I

Background of the 1990 Credit Crisis

The collapse of the Savings and Loan (S&L) and Mutual Savings Bank, or thrift, industries were the precursor to the credit crisis of the 1990's. The thrift's traditional role in the real estate industry was the origination of home mortgages; a relatively safe investment due to the low rate of home mortgage default. However, during the early 1970's, thrifts began losing money because they were utilizing short-term funds, such as passbook and savings account funds, as a means to underwrite long-term, fixed interest rate loans. As interest rates rose to double digits in the mid-1970's, thrifts lost their source of funds as deposits migrated to higher yielding investments. In the early 1980's, Congress tried to aid the failing thrifts by making it easier for them to compete with other financial services providers. Their solution was to deregulate the S&L industry.

Banking Legislation

The credit crunch of the late 1980's and early 1990's was spurred on by two pieces of banking legislation which were approved during the Reagan Administration: 1) the Depository Deregulation and Monetary Control Act of 1980 (DDMCA) and 2) the Garn-St. Germain Act of 1982. In an article for *Real Estate Review*, Donald Nelson and Roger Sindt discussed the impact of these pieces of legislation: "The deregulation of financial institutions in the Garn-St. Germain Act led to the phasing out by 1984 of Regulation Q, the rule that prevented thrifts from competing fully with banks. This led to a bidding war for deposits based on deposit interest rates. The bid-up of deposit interest rates forced

both types of institutions to loan out money at higher and riskier interest rates to retain profitability."¹

The existence of deposit insurance from the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC) exacerbated the results of the new legislation. By raising the insured amount at each institution to \$100,000, depositors were no longer concerned with the financial health of the institution into which their funds were being invested, but only about the rate of interest their deposits would earn. "Consequently, financial institutions, especially those in trouble, ha[d] a perverse incentive to undertake riskier investments than they would [have had to] if the deposits were not insured. This is so because profits associated with risk taking accrue[d] to the bank owners, while losses (that would otherwise [have] be[en] borne by depositors) [were] passed to the FDIC."² Thrifts began investing their deposits in high risk, high yielding investments, as a means of paying for the higher interest rates they had to offer to compete with banks and other S & Ls. "And finally, to add frosting to the cake, the Federal Home Loan Bank Board, which regulated the S & L industry, relaxed the capital requirement regulations for individual thrifts to a minimum."³ This created more problems for the troubled S & Ls because it allowed them to have less of a financial cushion on hand to cover potential losses.

¹Donald A. Nielsen and Roger P. Sindt, "Real Estate, Regional Banking and Bank Failures", *Real Estate Review*, Vol. 22 #3, Fall 1992. p. 95.

²"Real Estate, Regional Banking, and Bank Failures", p. 96.

³ Sonny Bloch and Carolyn Janik, *How You Can Profit From the S & L Bailout*, ©1991 Bantam Books, p. 4.

Thriffs and Junk Bonds

While the deregulation of banks and thrifts was going on in the 1980's, Michael Milken was creating his money making machine at Drexel Burnham through junk bonds. High yield , or 'junk' bonds, as they are more commonly referred to, are corporate bonds which have received a 'non-investment grade' rating from one of the independent rating firms (either Moody's or Standard and Poor's). These bonds are considered less secure than investment grade bonds and therefore involve higher risk regarding the repayment of interest, and in some cases, principal. As compensation to the investor, these bonds pay a higher yield as a means of offsetting the added risk.⁴ These risky investments were being sold to S& Ls across the country which were fighting to raise enough money on their deposits to stay solvent.

Michael Milken did research at the Wharton School which showed that "...the spread between non-investment grade and investment grade bonds had continued to widen since the mid-1950's. Accordingly, he realized that the rewards of a portfolio of high yield bonds far outran the risks."⁵ Unfortunately, too many banks and S& L's were swayed by the high returns being generated by junk bonds. They seemed to be an easy answer to the difficult environment which these institutions were operating in. S&Ls began turning their whole portfolios over to Drexel Burnham for investment. As Drexel Burnham's golden reputation began to tarnish, the losses began to add up for the S&Ls. In a short period of time S&Ls started going out of the lending business and in many cases, out of business altogether. The bankruptcy rate of lending institutions increased from 10 institutions per

⁴Glenn Yago, *Junk Bonds: How High Yield Securities Restructured Corporate America*, © 1991, Oxford University Press, p. 4.

⁵Glenn Yago, *Junk Bonds: How High Yield Securities Restructured Corporate America*, © 1991, Oxford University Press, p. 20.

year in 1980 to 124 per year in 1991. (See Exhibit 1) Consequently, a source of capital to the real estate industry was destroyed during the 1980's.

Banks and Insurance Companies

Banks and insurance companies were also injured by the downward spiral of the S&L failures. As an increasing number of banks failed, the government's inventory of assets from failed institutions increased. The Resolution Trust Corporation (RTC) was eventually established to liquidate the real estate for which the government had assumed control. Meanwhile, regions of the United States were going through economic recessions, which added downward pressure to real estate values. As the RTC became more active, the sale of assets through auction helped to legitimize the discounting of real estate values across the country.

During the 1980's banks searched for growing market sectors and expanded their commercial real estate departments in search of higher returns and greater fee income. As commercial banks fought for customers, the underwriting standards of the warring institutions became more lax. Construction loans, the real estate market segment which commercial banks have traditionally specialized in, are short-term, high risk loans. The default rate of these loans in the late 1980's and early 1990's would underscore this fact.

Traditional sources of debt financing, such as commercial banks and insurance companies, were battered by the real estate devaluation of the 1980's. Commercial banks have been out of the lending market for the past few years due to the extreme pressure put on these institutions by bank regulators and shareholders during the late 1980's. The directive by bank regulators to recognize the devaluation of property in real time and to mark the value of bank's portfolios to current market value caused commercial banks to show huge losses

on their real estate portfolios in the late 1980's. Many of the smaller lending institutions became insolvent due to the losses on their real estate portfolios.

Insurance companies have followed in the wake of the banking industry's revaluation of real estate. Due to their less regulated state, insurance companies were able to avoid recognizing their bad loan portfolios until the early 1990's. However, recently, firms such as Traveler's, Kemper, etc., have had to take significant charges against earnings to account for the current market value of their portfolios. New risk-based capital standards were recently adopted by the National Association of Insurance Commissioners, which may reduce the amount of an insurance company's assets allocated to real estate. In the short-run, these firms will continue to be out of the real estate market while they bring their portfolios back into equilibrium.

A few insurance companies will be less affected by the risk-based capital changes and will be in a position to capitalize on the current disequilibrium between lenders and borrowers. Firms such as Prudential and ITT Hartford are returning to, or re-entering the real estate lending business. These companies will have a competitive advantage over other firms (who will eventually return to the lending business) due to their ability to invest in real estate which is valued at a more realistic value than the real estate which collateralized loans during the 1980's.

The demise of the thrift industry, in conjunction with the battered income statements of the nation's banks and insurance companies, has left the real estate industry with few capital choices. For investors with cash, there have been some silver linings. S&Ls, banks and insurance companies have been unloading their real estate portfolios at unprecedented discounts to book value. This has created an extraordinary ability to purchase a wide array of properties at values which are only a percentage of replacement costs. Real estate

investors are aware that those real estate companies who are able to purchase properties at these unprecedented price levels will have a competitive advantage against other firms in the future.

With such an unusual buying opportunity facing real estate companies today, the most difficult dilemma for most firms is how to accumulate enough capital to take advantage of the disequilibrium in today's market. In the past, the answer was simple, form a private limited partnership and invest in specific properties. This is still an option, however, investors need to be aware of all of the different vehicles of ownership which have been created over the past ten years and what the positive and negative aspects are of each form. Real estate professionals today need to examine how their organizational structure will affect the company's (or partnership's) liquidity, its access to additional capital, cost of debt, tax burden and its ability to grow.

Chapter 2

Introduction to Holualoa Realty Advisors, Inc.

Holualoa Realty Advisors, Inc. is currently a small organization, employing less than 10 people, which is actively engaged in purchasing real estate through the limited partnership form of ownership. Acquisitions have been made in Hawaii, where the head office of the company is located, as well as in Phoenix and Tucson, where regional offices have been established. The focus of acquisitions has been on existing multi-family residential and research and development properties.

The company is run by Michael Kasser, who utilizes his eclectic background to bring in limited partners and to locate acquisitions opportunities. Mr. Kasser was born in Budapest, Hungary, and holds a Bachelors and a Masters degree in Chemical Engineering from M.I.T., as well as a doctoral degree in engineering from the University of Grenoble and an M.B.A. from Harvard Business School. Mr. Kasser speaks five languages fluently and is an avid Marathon and Triathlon participant. His work experience prior to starting Holualoa Realty Advisors includes three years at W.R. Grace, ten years as president of Technopulp, Inc., a private company involved in designing pulp and paper mills, and eight years as Chairman of Booher Lumber Company. Mr. Kasser was first exposed to the real estate industry during his time at Technopulp, Inc., where he was involved in real estate management. Mr. Kasser moved to the island of Hawaii in February of 1985 to train for the Ironman Triathlon (he has since completed seven Ironman Triathlons). He subsequently become a resident of the State of Hawaii and started the Holualoa Companies.

The company has been very successful utilizing the private limited partnerships form of ownership as a means of raising capital for its purchases. Investment objectives for the company include a cash-on-cash return to investors of at least 10% and an Internal Rate of Return in excess of 20%, which is figured based upon a 4 year holding period. To date, the company has achieved cash-on-cash returns of greater than 14% (annualized) to investors. The partnerships contain a small number of high net worth individuals as limited partners which allows the general partner to keep overhead expenses low. The general partner charges overhead costs to the partnership at a rate of 4% of the purchase price, plus 4% of the annual gross income. This structure has not yet caused a constraint on the company's growth; however, in preparation for the future, the company's president, Michael Kasser, is interested in determining how the company should be structured in the future.

Holualoa has the fortune of having acquisitions expertise in one of the areas of the country which was hardest hit by the S&L debacle, and therefore has the most under priced (foreclosed) real estate which was, or is, being held by the RTC, banks and insurance companies. The opportunities to purchase properties at a percentage of replacement value have been abundant, over the past several months. In addition, the economy of the Southwest is the fastest growing area in the United States. The company has been trying to quickly purchase properties which have a high cash-on-cash return before the market becomes overpriced. Holualoa is currently seeking acquisitions in Arizona and is exploring potential acquisitions in the Southern California and New Mexico markets.

With a current portfolio valued at approximately \$22 million and an average debt-to-equity ratio in the 50% range (see Exhibit II), the company is interested in reviewing the organizational vehicles available to real estate companies today. Holualoa would like to obtain the lowest cost of capital while providing the highest return to investors. In the

following chapters the positive and negative aspects of structuring the company as: 1) a private limited partnership, 2) a public limited partnership, 3) a master limited partnership 4) a public equity REIT and 5) a private equity REIT are each examined.

Chapter 3

Private, Public & Master Limited Partnerships

Private Limited Partnerships

Private limited partnerships have been the most traditional, and the most entrepreneurial, means of capitalizing real estate. Because the partnership interests are not widely held, relative to public partnerships, operational expenses are minimized. In addition, under the private placement exemption, "...if the offering is made exclusively or nearly exclusively to accredited investors..."⁶ it is exempt from registration with the Securities and Exchange Commission (SEC). Accredited investor status is satisfied if the investor has either: 1) a net worth in excess of \$1,000,000, or 2) has had an income in excess of \$200,000 for the last two years and expects to retain at least that amount in the current year.⁷

Private limited partnerships also have the advantage of requiring minimal overhead expenses relative to finding investors, distributing offering memorandums, keeping investors informed, and valuing the assets of the partnership. In a private limited partnership a larger percentage of the funds which are raised go directly into the investment than in most other organizational structures. However, many times, the private limited partnership is only as good as the general partner. This can be a positive or a negative aspect depending on the general partner's level of expertise, management ability and ethics.

⁶Robert L. Nessen, Esq., *Real Estate Finance and Taxation: Structuring Complex Transactions* ©1990 John Wiley & Sons, Inc., p. 172.

⁷Robert L. Nessen, Esq., *Real Estate Finance and Taxation: Structuring Complex Transactions*, p. 172-173.

A private limited partnership is comprised of one or more general partners who have unlimited liability and one or more limited partners who have financial liability for no more than the amount of their investment(s). The general partner is responsible for managing and controlling the properties held by the partnership. Limited partners inherently do not have control over the management of the partnership. If limited partners try to assert too much control they could jeopardize their limited liability status and be classified as general partners.

Legally, there are several criteria which separate a partnership from a corporation. If a partnership meets two or fewer of the following criteria, it will generally be taxed as a partnership and avoid the double taxation which is required of the corporate structure:

1. Centralized Management-control of operations resides with one person or body [in the case of a limited partnership it is the general partner, in the case of a company, the Board of Directors].
2. Continuity of Life-a corporation typically has a perpetual life, whereas a partnership dissolves upon the death or retirement of the general partner.
3. Limited Liability-a corporation generally has limited liability versus a partnership where the general partner has unlimited liability.
4. Free transferability of interests-a corporation allows the sale of shares, while a partnership usually requires the consent of the general partner to any transfer of interests.⁸

⁸Robert L. Nessen, Esq., *Real Estate Finance and Taxation: Structuring Complex Transactions*, p. 175.

The advantages of a limited partnership before the Tax Reform Act of 1986 were: 1) limited liability for the limited partners, 2) ability to avoid double taxation of income (as required in a corporate structure), and 3) the ability to pass losses through to the limited partners, which could be utilized to shelter income from other sources. Since the Tax Reform Act of 1986, income from real estate has been classified as passive income and is only allowed to be off-set against passive losses. This change in regulation redirected the focus of partnerships from vehicles for generating tax losses to vehicles for generating cash flow.

The private limited partnership's major drawback is a lack of liquidity. This form of ownership has no secondary market; therefore, a partner's interest is considered illiquid. A second drawback is the bookkeeping requirements of a portfolio of private limited partnerships. At some point the general partner needs to balance the cost of maintaining the individual partnerships against holding the assets in a organizational structure that may be more suited to the growing value of the assets, such as a corporation or a real estate investment trust.

Legally, there is no limit on the amount of funds which can be raised through a private limited partnership; however, the partnership's interest can not be advertised for sale without being registered with the SEC. Due to this fact, the size of private limited partnerships, on average, tends to be smaller than public limited partnerships.⁹ In addition, private limited partnerships tend to be structured for the purchase of one, or a group of, specific building(s). This means of specific investment also tends to limit the size of private limited partnerships. This vehicle is best suited to the small- to medium-

⁹Robert L. Nessen, Esq., *Real Estate Finance and Taxation: Structuring Complex Transactions*, p. 173.

size investor who has access to private sources of equity. As a portfolio becomes larger and the capital requirements become greater, this structure becomes increasingly more inefficient.

The private limited partnership has been an effective vehicle for Holualoa Realty Advisor's acquisitions program. With capital being provided from a small number of limited partners, the general partner has been able to keep overhead costs low, provide a high level of information and analysis to the investors and seek out specific properties in the Phoenix and Tucson markets which provide cash-on-cash returns. These benefits should not be underestimated.

Public Limited Partnerships

Public Limited partnerships (PLPs) are similar to private limited partnerships with the following exception: they are publicly traded securities and must be registered with the Securities and Exchange Commission (SEC). Public Limited Partnerships were very popular during the 1970's and early 1980's. Many PLPs which were formed prior to the Tax Reform Act of 1986 were structured to generate tax losses, not income. At that time public limited partnerships, like private limited partnerships, were allowed to pass-along tax losses to investors to offset taxable income from other sources. However, when the tax laws changed, it was difficult for partnerships already in existence to change their investment strategies and many public partnerships' returns suffered.

During the 1970's and early 1980's, public limited partnerships were very lucrative for general partners and brokers. Sales commissions ran in the 10%-15% range and many times these partnerships were formed by investment companies which acted as the general partner, sales agent and property manager for the partnership. The overhead costs of

PLPs were significantly higher than those for private limited partnerships. Formal sales brochures and prospectuses were required, which increased legal and accounting fees for the offerings.

During the 1980's public limited partnerships invested on a much larger scale than the majority of private limited partnerships. "These partnerships are often funded with as much as \$100 million or \$200 million through a single offering, and there may be as many as 20,000 or 30,000 investors, with each contributing as little as \$2,000 or \$3,000."¹⁰ By giving smaller investors access to real estate, public limited partnerships attempted to be the mutual funds of the real estate industry.

Publicly traded limited partnerships created a rather tainted history for themselves. As shown in Exhibit III, the data compiled by Robert Stanger & Co. shows that the sales volume of public limited partnerships peaked in the year 1984 and has dropped off steadily since. Many of the public limited partnerships formed in the past were "blind pools", meaning that the properties to be purchased were unknown at the time the money was raised. This led to a capital driven form of investment, rather than a property or return driven form, which resulted in poor investments by many public limited partnerships.¹¹

In addition to the high fees and poor returns generated by these partnerships the problems of public limited partnerships have been compounded by the inefficiency of the secondary market for these securities. Firms which tried to create a secondary market have found it difficult to make a profit in the past few years due to the size of the market and the

¹⁰Robert L. Nessen, Esq., *Real Estate Finance and Taxation: Structuring Complex Transactions*, p. 173.

¹¹Hal Katersky and Klara Katersky, *Real Estate Limited Partnerships: A Guide for Profits* © 1989 Prentice Hall, Inc., p. 48.

marginal number of trades. Some firms involved in making secondary markets have been censured by the National Association of Securities Dealers (NASD) for charging excessive fees in order to maintain some form of profitability. Other firms, such as Liquidity Fund Investment Corp. and MacKenzie Patterson Group, have chosen to get out of the business completely.¹²

Although they are still being utilized, public limited partnerships are no longer a very satisfactory means of raising capital. After 1986 this capital structure was no longer able to provide a tax advantage to investors. In addition it could not provide the liquidity which investors desired and it generated returns believed to be inferior to private limited partnerships. It is doubtful that public limited partnerships will be a significant organizational option in the future. Due to these issues and the poor public reputation which PLPs have received, it is not a recommended form of capitalization for Holualoa Realty Advisors.

¹²Karen Slater Damato, "Liquidity Fund Ends Role as an L.P. Matchmaker" *Wall Street Journal* June 17, 1993 p. 23.

Master Limited Partnerships

A Master Limited Partnership (MLP) is a form of a public partnership. "The Master Limited Partnership had its genesis in the oil industry. An MLP was created in 1981 as a vehicle that made it possible for certain companies, led by Apache Petroleum Company, to realize the value of undervalued assets and to pass income and tax-deductible losses directly through to their shareholders."¹³ Master limited partnerships are a form of ownership which allows the individual partnership interests to be freely traded on the major public stock markets. Interests in an MLP may be called depository unit receipts, beneficial assignment certificates, or certificates of limited partnership interest.¹⁴ During the early 1980's, Master Limited Partnerships were quickly adopted for real estate (See Exhibit III, 1985-1989). The abilities to pass income and tax losses through to the limited partners, while having the liquidity of being able to buy and sell shares of the MLP on the public markets were the great advantages of MLPs.

An MLP must meet the legal criteria required to be classified as a limited partnership, rather than as a corporation (see private limited partnership section). One of the problems of the MLP structure was the legal requirement that the partnership be dissolved if more than 50% of the shares are sold in a year. Because MLPs were traded publicly and often purchased in "street name", meaning that the stock broker's name, not the investors, is listed as the owner for public record, it was generally difficult to control the trading of these partnerships.¹⁵

¹³Stan Ross, "Real Estate Master Limited Partnerships: Why Investors Like Them", Real Estate Review, Spring 1987, Vol. 17, #1 p. 28.

¹⁴Stan Ross, "Real Estate Master Limited Partnerships: Why Investors Like Them", p. 28.

¹⁵Stan Ross, "Real Estate Master Limited Partnerships: Why Investors Like Them", p. 31.

There were also other problems associated with MLPs: 1) Administratively, the MLP distributed income on a monthly basis and records needed to be kept regarding limited partner information, as well as buy and sell dates, 2) because these interests were publicly traded, they were subject to the Securities Act of 1933 and required registration with the SEC, 3) holders of depository unit receipts in MLPs did not have inherent voting rights, as investors in limited partnerships did, and 4) the MLP structure was cumbersome for investors from a tax reporting perspective (Form K-1 was required of partners).

A final blow to the Master Limited Partnership form of ownership was the passage of "...the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). TAMRA effectively pulled the rug out from under MLPs by requiring them to be treated as corporations under certain circumstances."¹⁶ The Revenue Act of 1987 required most MLPs to be taxed as a corporation which effectively took away the competitive advantage the MLP structure had over a limited partnership.

Roll-ups of Limited Partnerships to MLPs

For a period of time, limited partnerships were being rolled-up into MLPs as a means of gaining liquidity for investors. The swap of partnership interests for depository receipts in the MLP was considered a tax free exchange. The first firm to accomplish a roll-up to a MLP was Southwest Realty, Ltd. in 1982. According to Robert Sherman, President of the Southwestern Property Trust, Inc. (formerly Southwestern Realty, Ltd.), "The company's partnerships were maturing and some of the limited partners wanted an exit vehicle. The properties in the portfolio were throwing off taxable income and [the investors] wanted to raise capital to purchase properties which could shelter that income.

¹⁶Ray A. Knight and Lee G. Knight, "REITs Reemerge as Attractive Investment Vehicles", *Real Estate Review*, Summer 1992, p. 47.

The MLP structure allowed the partnership to change its organizational structure without incurring a tax liability to the partners, it gave the partners the ability to time when they wanted to recognize the capital gain on their investment, and it allowed the firm to avoid being taxed as a corporation.¹⁷

Income from MLPs is treated as passive income and therefore can be offset against passive losses from other sources. For a period of time in the late 1980's, syndicators were structuring cash flowing MLPs as a means for investors to utilize the passive losses they had acquired on other investments, but were no longer able to use after the Tax Reform Act of 1986.

Due to the legislative changes which require taxation of MLPs as corporations, the basic reason for their popularity has been eliminated and their usefulness as an investment vehicle has been hampered. The structure still allows the interests to be transferred freely, but the implementation of double taxation on this structure gives it no advantage over the corporate form of ownership and makes it inferior to a private limited partnership. For an organization such as Holualoa Realty Advisors, which is seeking future liquidity, this option would be appealing if the company did not need to sacrifice its ability to be taxed only once at the individual level. Chapter 4 will show that one of the many attractive attributes of Real Estate Investment Trust (REITs) for sponsors and investors is the ability to provide liquidity along with the retention of the taxation structure of a partnership.

¹⁷7/1/93 telephone interview with Robert Sherman, President of Southwestern Property Trust, Inc.

Chapter 4

Public Equity REITs:

History of Public Equity REITs

Equity based Real Estate Investment Trusts (REITs)¹⁸ have been in existence since the passage of the Real Estate Investment Trust Act of 1960. This legislation was established to create a vehicle for small investors to invest in real estate as a means of diversifying their portfolios. By allowing the purchase of shares of real estate at a valuation of less than \$100 per share, small investors could purchase property without the significant financial exposure required to purchase whole buildings.

A REIT is actually an election by the operating entity on how the organization will be taxed. The requirements of a REIT can be found in Section 856-860 of the Internal Revenue Code. A summary of the requirements of a REIT are listed in Exhibit IV. This organizational structure creates a portfolio of real estate which is packaged to look like a security. Just like any other security, shares of the portfolio are sold on the public market, researchers follow the value of the assets versus the stock price and valuation adjustments are made on a daily and hourly basis. By being readily tradable via a secondary market, investors are given liquidity in an asset class which has traditionally been an illiquid investment. In addition, the REIT structure allows income from the REIT to be taxed only once at the individual level versus a corporation which is taxed once at the corporate

¹⁸Although REITs can be structured as mortgage REITs, equity REITs or hybrid REITs, this paper will use the term REIT to mean only equity REITs (which invest in real property). These REITs have shown the highest returns and created the largest market over the last several years.

level and again at the individual level. REITs are listed daily on any one of the national exchanges- New York Stock Exchange, American Stock Exchange or the NASDAQ, (the National Association of Securities Dealers Automated Quotation system).

During the late 1960's and early 1970's, REITs were structured as mortgage-lending REITs, equity REITs or a combination of the two known as hybrid REITs. When interest rates climbed and the 1973-1975 recession hit, real estate markets became over-built and the values of REITs plummeted. Mortgage REITs suffered the most due to the dramatic change in interest rates, while equity REITs were affected by the simultaneous impact of the mid-1970's economic recession and the end of the real estate cycle. Due to their difficulties during the 1970's, both mortgage REITs and equity REITs were saddled with a notorious reputation in the public capital markets.

The Tax Reform Act of 1986, however, set the stage for the resurgence of the REIT industry. Those REITs which were able to survive the difficult environment of the 1970's turned out to be equity REITs with low amounts of leverage which engaged in relatively safer real estate investments than private developers were involved in during the 1980's. The majority of the surviving REITs were involved in the acquisition of strip malls, apartments or industrial space, compared to the speculative office and condominium investments being supported by private firms.

The REITs of the 1990's have been restructured to be safer, more passive investment vehicles and are valued on a more conservative basis (cash flow, not capital appreciation). When the Tax Reform Act of 1986 created income categories for real estate (i.e. passive, active and portfolio) and reduced the ability of limited partnerships to pass tax losses on to their investors, limited partnerships no longer had an organizational advantage over REITs. In contrast to the public limited partnerships of the day, REITs of the late 1980's

and early 1990's were established as cash flowing entities, not as tax-shelters. This difference has allowed the survival of REITs while the use of public limited partnerships has declined precipitously.

REITs have come back into vogue because as a security which is part stock and part real estate, they are considered leading indicators for the real estate industry. Researchers at Kemper Securities have found that "...the [REIT] stock cycle usually lead[s] the real estate cycle by two years or so. The apparent reason for this huge lead time (especially relative to the six to 12 months that the S&P leads the economy) is the private nature of real estate investment and the slowness of the appraisal process."¹⁹

A quality REIT today combines several factors: 1) it has a track record of steadily increasing dividends, 2) it has a solid in-house management team, 3) the REIT sponsor holds a substantial equity stake in the REIT, 4) the REIT's portfolio is product and geographically specific, 5) the portfolio has a low debt-to-equity ratio, and 6) the REIT has little or no exposure to short-term debt (which carries interest rate risk).

Valuation & Risk

REITs are valued based upon Funds From Operation (FFO), which is net income plus depreciation. The determination of a formal definition has been critical to the industry due to the need for conformity across reporting lines and a need for comparison with other asset classes. "...(T)he accounting committee of the trade industry group, the National Association of Real Estate Investment Trusts, spent more than a year fashioning a

¹⁹"Cycles, Valuation and Returns: A Statistical Analysis, *Kemper Securities Newsletter*, June 4, 1993, p.4.

definition of funds from operations."²⁰ This value allows the REIT's earnings to be compared to other investments, which is important for all potential investors, and is the basis for the determination of the company's dividend level.

Positive Leverage

For sponsors of REITs, the dynamics of today's public capital market provides an arbitrage opportunity. With the cost of public capital at rates lower than property returns, an opportunity for positive financial leverage has been created. "Financial leverage is defined as benefits that may result to an investor by borrowing money at a rate of interest that is lower than the expected rate of return on total funds invested in a property. If the return on the total investment invested in a property is greater than the rate of interest on the debt, the return on equity is magnified."²¹ Some REITs, such as Southwestern Property Trust, have been able to raise funds through the public capital markets and pay off debt which was at a higher rate than the cost of capital, or invest in properties which are returning yields higher than the company's cost of capital.²²

Tim Fluetsch, Assistant Vice President of Aldrich, Eastman & Waltch, relayed the story of Holly REIT which invests in apartment buildings in the Pacific Northwest. The REIT was able to go back to the market with a secondary offering which paid a dividend yield of 8%, has a management cost of .75%, and issuance costs of 1% for a total cost of 9.75%. Through a debt and equity offering they were able to gain funds at a weighted average cost of capital of 7.45%. As long as the REIT is able to invest the borrowed funds in

²⁰Barry Vinocur, "These REITs are Sound, but no Bargain", *Barron's*, December 14, 1992, p. 58.

²¹William Brueggeman, Jeffrey Fisher and Leo Stone, *Real Estate Finance*, © 1989, Richard D. Irwin, p. 363.

²²7/1/93 telephone interview with Robert Sherman, President of Southwestern Property Trust, Inc.

properties which generate Internal Rate of Return (IRR) greater than the interest rate the REIT is required to pay on the borrowed funds, it is able to increase the REIT's return on equity.²³ [The IRR is the discount rate which equates the present value of a property's future cash flows with the initial cash outflow (equity) required to purchase the property.]

With other sources of capital nonexistent, general partners are attracted to Wall Street's willingness to underwrite new REIT offerings and the ability of sponsors to achieve positive financial leverage (something that the real estate industry has not seen in many years). Due to the combination of these factors the lure of the public capital markets seems irresistible. Potential REIT sponsors should insure that they are calculating all of the REIT's operating costs into the cost of capital, not just the investment bank's underwriting fees. A REIT can erroneously appear to be an inexpensive form of raising capital if all of the cost are not factored in.

Initial Public Offerings and Yield

The amount of funds raised in REIT Initial Public Offerings (IPO's) during 1992 and the first half of 1993 has been significant (See Exhibit V). "From \$9.5 billion in 1985, [equity, mortgage and hybrid] REITs have grown into a \$50 billion industry today."²⁴ (See Exhibit VI) S. Michael Giliberto, a REIT industry analyst, formerly of Salomon Brothers, stated in a July 7th telephone interview that the REIT IPO market had grown by \$4 Billion for 1993 year-to-date. Mr. Giliberto expects the market to grow by another \$1-2 Billion by

²³6/29/93 telephone interview with Tim Fluetsch, Assistant Vice President of Aldrich, Eastman & Waltch.

²⁴David C. Walters, "Investors Buy Real Estate Firms to Beat Poor Returns on CDs" *The Christian Science Monitor*, January 21, 1993.

the end of 1993, which will result in a 50% increase in size for the market over year end 1992.²⁵

The growth in securitized real estate puts the U.S. in an unusual situation relative to the property markets of the rest of the world. Mark Decker, president of the National Association of Real Estate Investment Trusts (NAREIT), claims that "In most industrialized countries, from 5 percent to 50 percent of commercial real estate is held by public companies. In the U.S. we have only half of 1 percent."²⁶ This benchmark creates optimistic expectations for the growth of the U.S. REIT market by its supporters.

The convergence of several different forces in today's financial markets has led to a growing interest in public equity REITs. With a stock market which many on Wall Street believe has been overvalued for months, and a desire for higher returns, the dividend yields on REITs (currently ranging from 6 to 8%)²⁷ are attractive to investors compared to the yields on other asset classes. Yields on stocks, bonds, money markets and c.d.'s currently can not compete. The total yield on common stock can be stated as the sum of the dividends paid, plus growth in the market price of shares divided by the price paid per share. Taking into consideration a REIT's need to pay out 90% or more of its earnings in dividend payments, the growth of future dividends is important to the value of REIT shares.

²⁵7/7/93 telephone interview with Michael Giliberto, REIT Industry Analyst formerly of Salomon Brothers.

²⁶David Walters, "Investors Buy Real Estate Firms to Beat Poor Returns on CD's", *Christian Science Monitor*, January 21, 1993.

²⁷Lawrence Raiman, "The REIT Revolution is Here", *Paine Webber Newsletter*, April 19, 1993

The short-term track record for the total return on REITs is quite impressive. "After posting a 29.4% total return in 1991, equity REITs (excluding health-care REITs) chalked up a 20.7% total return last year. Through the end of [March, 1993], NAREIT reports the same group posted a 21.4% total return."²⁸ REITs, on a total cumulative return basis, have out performed the S&P 500 for eight consecutive quarters since fourth-quarter 1990.²⁹

Organizational Costs and Access to Capital

REIT underwriting, organizational and offering costs are generally estimated to be between 9% and 12% of the amount of funds raised.³⁰ As noted in the section on positive leverage, these cost should not be confused with a REIT's total cost of capital. The investment banks have been earning larger fees on REIT IPOs and secondary offerings as the size and amount of the offerings continue to grow. According to Dean Witter's *Equity REIT Monthly Statistical Review*, "Investment bankers last year raised more money in underwritten equity offerings (initial public offerings and secondary offerings) for real estate investment trusts than in any one of the previous five years, and nearly as much as they did in the prior three years combined."³¹

Continued access to capital is a significant issue for REIT sponsors and one of their main reasons for moving to the REIT vehicle. Industry experts seem to agree that there are significant private capital resources for the acquisition of distressed properties, but for

²⁸Barry Vinocur, "How Property Shares Fared in the Quarter", *Barron's*, April 12, 1993, p. 69.

²⁹"REIT's Shine in '92; Industry Looks to Washington for Help", *Commercial Property News*, January 16, 1993.

³⁰Stan Ross and Richard Klein, "REITs as a Source of Capital: Considerations for Sponsors", *Real Estate Finance*, Vol. 9 #2, Summer 1992, p. 17.

³¹Barry Vinocur, "How Property Shares Fared in the Quarter", *Barron's*, April 12, 1993, p. 69.

larger portfolios, or portfolios with healthy debt-to-equity levels, capital sources are minimal. Large real estate organizations can no longer rely on traditional lending sources. For some of the large REIT sponsors, a REIT is the difference between having access to capital for growth and being stagnant. With such large up-front costs being charged by Wall Street, a REIT sees the rewards for choosing a more complicated and regulated structure in the savings that it achieves on secondary and tertiary offerings.

Institutional Influences

Pension Funds

To institutional investors, the current interest in REITs is significantly different from the REIT interest being generated by smaller investors. Institutions, such as pension funds, have a completely different set of goals and problems in relation to real estate. However, because of the impact institutional players have, and could have, on the REIT industry (by the sheer dollar volume they invest) it is important that their needs be understood.

Foreign and domestic pension funds constitute a very large potential buyer's market for REIT shares. Although pension funds invested approximately \$120 billion in real estate over the past two decades, to date, pension funds have not invested a significant amount of their capital in real estate investment trusts.³² Industry-wide, the average real estate investment is from 3-4 % of a pension fund's portfolio. However, if the needs of pension fund managers can be addressed by the REIT vehicle, pension funds could have the potential to invest between \$150 and \$ 300 billion, based upon estimates of total pension fund assets at \$3 trillion with an allocation to real estate of between 5% and 10%.

³²Barry Vinocur, "Now: Index Funds for Property Stocks", *Barron's*, May 10, 1993, p. 56.

Pension Fund managers continue to be frustrated by: 1) the illiquidity of real estate, and 2) the appraisal method of valuing real estate. Fund managers had hoped that the entry of larger REIT portfolios to the market would allow institutional investors to move in and out of the REIT market without affecting value. Unfortunately, due to the small size of today's REIT market compared to the amount of funds institutions have to invest, this flexibility has not been realized.

In fact, when ABP, the Dutch pension fund, invested in 30% of New Plan Realty Trust (the largest REIT at the time of its initial public offering) it was required by the sponsor to leave its funds in the REIT for 5 years because the sponsor feared that liquidation of the pension fund's holdings could adversely affect the REIT's value³³. Some pension funds, like ABP, have started to venture into the REIT waters. General Motors, IBM and AT&T all have positions in REITs, but REIT sponsors hope that their involvement is just the tip of the iceberg.

"Salomon Brothers estimates that the [equity REIT] market will have to grow to between \$25 and \$50 billion in order for market liquidity to be of a size whereby institutional investors can trade without significant market impact."³⁴ With a current market capitalization of less than \$20 billion, the relatively small size of the REIT market is put into perspective when compared to the size of just one company, such as Microsoft, which has a market capitalization of \$25 billion.³⁵ The positive aspect to this problem is that a three year time horizon is considered a short-term investment period for a pension fund,

³³5/25/93 interview with Cordell Lietz, Senior Vice President of U.S. Alpha Inc., the North American real estate subsidiary of ABP.

³⁴Nori Gerardo, "REITs: No Substitute for Private Real Estate", *Pension Real Estate Association Quarterly*, April 1993, p. 36.

³⁵Barry Vinocur, "How Property Shares Fared in the Quarter", *Barron's*, April 12, 1993, p. 70.

and if the REIT market continue to grow at or slightly below the existing rate, the liquidity issue many be resolved quickly.

Many fund managers, who are judged by the returns they are able to generate on their portfolios, have been disappointed by the yields their real estate investments have generated in the past. As fund managers have become more savvy about their investments, they have become interested in being able to compare the returns on their real estate investments to their investments in other asset classes. The ability to price the value of their real estate investments on a daily basis via a secondary market, instead of through the traditional appraisal-based valuation method used for real estate, is an important benefit to fund managers. Pension funds are also interested in the dividend-based valuation of today's REITs, which values only today's cash flow from the properties. After several years of being battered by the real estate recession, fund managers are more comfortable with this conservative approach to value.

Current legislation, which should be enacted by January 1, 1994, will change the existing disparity between the way domestic and foreign pension funds are treated regarding their ability to invest in REITs. Current REIT requirements allow that no more than 50 percent of a REIT's shares be held by five or fewer individuals during the last half of the taxable year.³⁶ (Known in the industry as the "5 or 50 rule") Some say that this requirement has limited the ability of domestic pension funds to invest in REITs because they have been counted as one shareholder, whereas foreign pension funds have been counted according to the number of beneficiaries the fund has.

³⁶National Association of Real Estate Investment Trusts, Inc., *REIT Fact Book*, ©1989 N.A.R.E.I.T., Appendix I, p ii.

Fred Carr, Jr., Principal of the Penobscot Group, a firm involved in researching the REIT industry, claims that changing the 5 or 50 rule is not the answer to the liquidity issue. He feels that pension funds are not interested in owning more than 5% or 10% of an individual REIT offering. Instead, he feels that the answer is not to revise the 5 or 50 rule, but to bring the REIT market capitalization up to a size where institutional trading does not affect share prices.³⁷

Another topic of interest which fund managers are currently debating is the appropriate use of REIT stocks in a diversified portfolio. In 1990, S. Michael Giliberto found that equity REITs were highly correlated to stocks instead of to real estate. His research found that from 1978 to 1989, 59% of the variability (R^2) of an equity REIT's total variability was explained by stock and bond returns.³⁸ Further statistical analysis, done by Nori Gerardo of Pension Consulting Alliance (a pension advisory firm) in April of this year, shows that REIT stocks behave not only like stocks, but more specifically like small capitalization stocks, rather than like real estate.³⁹ Since real estate has traditionally been viewed as having a negative correlation to the stock market, many fund managers have held real estate for diversification purposes. This research brings into question the need by pension fund managers to invest in real estate investment trusts. The research would justify direct investment in real estate by pension funds, but not investment in REIT stocks.

If pension fund managers agree with this research, and REIT stocks are viewed as just a segment of the small cap. market, the anticipated involvement of pension funds into the

³⁷7/13/93 interview with Fred Carr, Jr., Principal of The Penobscot Group.

³⁸S. Michael Giliberto, "Equity Real Estate Investment Trusts and Real Estate Returns", *The Journal of Real Estate Research*, Vol. 5#2, Summer 1990, p.261.

³⁹Nori Gerardo, "REITs: No Substitute for Private Real Estate", *Pension Real Estate Association Quarterly*, April 1993.

REIT market may never materialize. For smaller pension funds where direct investment is not feasible, REITs may still have a place. The debate over whether REITs should be classified as small cap. stock or real estate continues.

One product that is being created, which could additionally keep pension funds out of REITs is a real estate swap. Dick Gunthal of Banker's Trust believes that: "The Russell-NCREIF index, which tracks the value, income and appreciation of 1,855 properties valued at approximately \$25 billion, could be the index off of which swaps are made."⁴⁰ A swap product would allow fund managers to hedge their position or simply to bet on the direction the real estate market will head as a whole. This would allow fund managers "...the opportunity to take bets on real estate without actually investing in the product itself."⁴¹

Mutual Funds

Wall Street and REIT sponsors are becoming more aware of the interests of institutional investors. The larger REITs, in the \$200 million to \$500 million capitalization range, which have recently come to market are being structured specifically for the institutional investor. The Taubman, Oliver Carr, and General Growth REITs are all examples of offerings which have been tailored to attract institutional investors. Although these REITs attracted some pension funds, the majority of the stock has been purchased by mutual funds. According to Mr. Carr, mutual funds are the largest buyers of new issues and could account for 60%-70% of the new capital coming into the REIT market.⁴²

⁴⁰Barron's Pension Report, *Barron's*, June 28, 1993.

⁴¹Barron's Pension Report, *Barron's*, June 28, 1993.

⁴²7/13/93 interview with Fred Carr, Jr., Principal of The Penobscot Group.

Mutual fund managers have been investing in REIT IPOs due their recent trading history. Over the last year, REITs have been trading at higher values than the IPO was floated at and mutual fund managers have been following this trend. In addition, REIT stocks have given some of the highest returns on Wall Street. Recently, over the last three months, IPO offerings have stayed flat after the initial sale. This value trend could affect the interest of mutual fund managers in REIT stocks and reduce the current investor appetite for both IPO and secondary offerings.

In a 6/10/93 telephone interview with Barry Greenfield, fund manager for Fidelity's REIT mutual fund, as well as The Fidelity Fund, Mr. Greenfield stated that he has been surprised by the media's attention to REITs. The increased attention caused the money flowing to Fidelity's REIT fund to increase from \$95 M to \$500 M over a period of 5 months.⁴³ When the 15% correction to REIT prices occurred in the Spring of 1993 (which Mr. Greenfield predicted), the assets in the REIT fund dropped from \$550M to \$350M, showing the volatility inherent in the REIT market due to yield driven investors.

Mr. Greenfield has been following the U.S. REIT market since its inception in 1960, and has been investing in the French equivalent of REITs since the late 1980's. Even with the current highs and lows, Mr. Greenfield feels that the long-term outlook (7 to 10 years) for REITs is positive: "We're in the second inning of a nine-inning game and this is a second-inning stretch."⁴⁴

However, having the mutual fund industry as such heavy buyers could give a false impression of the depth and efficiency of the REIT secondary market. One portfolio

⁴³Barry Vinocur, "REIT Shares Take Some Lumps", *Barron's*, May 3, 1993, p. 48.

⁴⁴Barry Vinocur, "REIT Shares Take Some Lumps", *Barron's*, May 3, 1993, p. 48.

manager who was quoted in Barron's states: "If the market was as deep as the investment bankers would like us to believe, you wouldn't see a high-quality REIT like Federal Realty trading more than 4% below where its April 13th secondary offering price was. What's happening is that you have a lot of 'non-traditional' REIT buyers jumping on the bandwagon because of the stocks' yields and the performance of the IPOs. At this point, those buyers aren't long-term REIT investors. So when they see an opportunity to take profits, they do."⁴⁵

And taking profits at some point will mean mutual funds getting out of the market. When that occurs, and the market has not grown to a size where pension funds are able to be significant players, trading volume is likely to fall off. This may increase the volatility of REIT stocks and tend to reinforcing the view of pension funds that REITs are really small cap. stocks.

Interest Rates & Leverage

REITs appear to be very interest rate sensitive. Stanley Perla, a partner of the accounting firm of Earnst & Young, claims that the demand for REITs may slow down if interest rate yields go to 7%.⁴⁶ If interest rates rise, will REITs go through the same drop in prices that were observed in the 1970's? This time around it is more difficult to determine because the individual REITs are structured so differently. REITs with a high amount of variable rate debt will be more prone to changes in interest rates than REITs with fixed rate debt, or those who have purchased interest rate caps. And for some REITs, the impact of an increase in interest rates will be determined by the type of properties in their portfolio. Some advisors, such as Mike Kirby of Green Street Advisors, believe that in a high

⁴⁵Barry Vinocur, "Big Fast-food REIT in the Works", *Barron's*, July 5, 1993, p. 60.

⁴⁶David Walters, "Investors Buy Real Estate Firms to Beat Poor Returns on CD's".

interest rate, high inflation environment, apartment and regional shopping mall REITs would perform better than most REITs due to their inherent inflationary hedges.⁴⁷

One of the negatives of REIT formation is the write-down of property values from an appraisal-based valuation. Wall Street appears to be only interested in the current return of the REIT, and therefore does not value the future appreciation potential for the property as an appraiser might. For the sponsor, the need to acknowledge a decrease in the value of his/her real estate portfolio could be a psychological problem. For the investor, this could potentially be viewed as an undervalued asset. If the purchaser of REIT shares is interested in a long-term investment, the future capital appreciation on real estate would be a bonus.

Additionally, the market is requiring a low amount of leverage on the higher yielding REITs. A debt-to-equity ratio of less than 50% is a must, and many REITs operate with between 20% and 40% debt-to-equity ratios. This is an issue which Holualoa Realty Advisors should focus on. If a decision is made to move toward being organized as a REIT in the future, loans should be structured without high prepayment penalties whenever possible. Due to traditional forms of real estate financing, many existing portfolios have high amounts of leverage and in many cases the REIT's Initial Public Offering (IPO) goes to pay-off the debt on the properties.

REMICs

REMIC is the acronym for Real Estate Mortgage Investment Conduit, and is an entity created by the Internal Revenue Code, just as a REIT is. The Government National

⁴⁷Eric J. Savitz, "The REIT Maze: Picking a Safe Path Through a Hot Group", *Barron's*, May 24, 1993, p. 22.

Mortgage Association (GNMA or Ginnie Mae) has been pooling residential loans and selling them to buyers for decades. These instruments are known as mortgage backed securities. The REMIC was structured off of this model as a way for the private sector to utilize the growing mortgage backed security market.

A mortgage conduit can be structured using either a Grantor Trust or a REMIC. Under a Grantor Trust, the sponsor sets up a trust, funds the trust with existing mortgages and sells beneficial interests in the trust to third parties. Under this structure only one class of interest can be sold, resulting in each buyer owning a proportional share of the total loan portfolio. Under a REMIC structure, unlimited classes of interests may be issued, allowing the specific interest to be separated, as desired and priced according to the risk that entity assumes. In the past, trying to divide the interest payments from the principal payments of a loan has created problems for the packagers of these securities. Because most mortgages are underwritten with a prepayment clause, the purchaser of these cash flows does not have any knowledge of when his investment will be paid back, which can affect the expected return on his investment. Due to the fact that the probability of prepayment increases as interest rates decrease, the purchaser could get all of his payments at a time when he can not reinvest the funds at an equivalent return. By assigning most of the prepayment risk to the more junior part of the REMIC and no prepayment or little risk to the more senior part, each piece can be graded and priced according to its specific risk. This structure allows the sponsor of a REMIC to sell an interest in the mortgages held by the REMIC to a large number of people without the double taxation of a corporate form of ownership.⁴⁸

⁴⁸7/26/93 telephone interview with Trudy Ernst, Esq. of Goodwin, Procter & Hoar.

Because the sources for refinancing existing loans are few today, and because of the "due on sale clause" of many loans (the change in ownership to a REIT triggers this clause) a REIT/ REMIC combination is becoming more frequent. By utilizing a REMIC the sponsor is able to: 1) refinance the mortgages as a package, 2) reduce the overall loan-to-value ratio of the REIT, and 3) increase the yield on the REIT because funds from the REIT are not used to refinance mortgages on the REIT properties. It should be noted that due to the legal and accounting time required to structure a REMIC this form of financing is more costly than traditional sources.

Short-term debt

Investors are also becoming wary of REIT offerings which rely on short-term and/or floating rate debt. Investors, such as Mike Oliver of PRA Real Estate Securities Advisors, a firm which specializing in advising institutional investors on publicly traded real estate securities, are continually reminding sponsors that long-term assets should be financed with long-term debt. "I remind them that we bought their shares because of their real estate expertise, not because we thought they could predict the direction interest rates were headed."⁴⁹ Steven Brown, of Cohen & Steers Capital, notes that several of the REITs which have come public in the last six months have "...taken advantage of a low interest rate environment by using floating rate debt. While they were able to obtain high credit ratings on the security, sizable over-collateralization was required, in the 2x coverage range. Additionally, numerous covenants were required which could impede a growing REIT's ability to make the optimal asset management decision. Typical covenants on these securities relate to restrictions on property sales and restrictions on additional debt."⁵⁰ On new issues especially, the temptation to use floating rate debt is

⁴⁹Barry Vanocur, "A Big Calendar of REIT Offerings", *Barron's*, May 31, 1993, p. 44.

⁵⁰Steven R. Brown, "The Growth of Commercial Mortgage Securitization-and Impact on the REIT Industry", *The REIT Report*, Vol. XIII, #3, Summer 1993, p. 10.

strong: "By using floating-rate debt, a REIT inflates its cash flow and boosts its yield, which gets the issuer a higher price and generates more fees for the bankers. The investor is left holding a ticking time bomb."⁵¹

⁵¹Barry Vanocur, "A Big Calendar of REIT Offerings", *Barron's*, May 31, 1993, p. 44.

Small Capitalization REITs

A small capitalization REIT is one which has a total capitalization of under \$100 million. This cut-off point has been established by Wall Street due to the lack of time industry analysts have to follow small offerings and the need for a large enough secondary market in the REITs shares to provide liquidity to investors. One of the more successful examples of a small cap REIT is Southwestern Property Trust. This REIT was originally organized as a limited partnership in the 1980's. In 1982 the structure was changed to a Master Limited Partnership (MLP) and the company went public as a REIT in October of 1992. Underwritten by Kemper Securities and NatWest, the partnership's shareholders received one share of the REIT for every five shares of the MLP. The REIT owns apartment buildings in the Southwest, one of the more fashionable areas to specialize in today.

With an original market cap of \$55M at year end 1992, the REIT has since gone back to the market several times to raise funds for the acquisition of specific portfolios of properties which have rapidly pushed them above the \$100 million dollar capitalization mark. With a price of \$14-3/8 on 4/2/93, and a dividend yield of 5.6%, the offering has been relatively successful as a REIT and has increased in value from when it was held in a limited partnership or master limited partnership form of ownership. As a self administered REIT, with the officers and directors owning 46%, the company has been able to invest in undervalued real estate and purchase properties at a rate above their cost of debt. During a telephone interview with Robert Sherman, President of Southwestern Property Trust, Inc., Mr. Sherman explained that the REIT format made sense to the MLP shareholders due to several factors: 1) the liquidity it provided, and 2) the ability to shelter dividend income, and 3) the structure was the darling of Wall Street and provided a low cost of capital.

Many Wall Street experts feel that a REIT offering under \$100 million will not get enough attention to be attractive to investors or analysts, however, regional and second tier investment banks are underwriting secondary offerings for existing small REITs such as Dial REIT Inc., Sizeler Property Investment Inc., and Bradley REIT. Doing an IPO for a small cap. REIT is definitely one option for Holualoa Realty Advisors. The cost of capital on the public market needs to be balanced against the ability to grow quickly if an attractive portfolio of acquisitions can be assembled for investment. In addition, the need to do several offerings in order to get over the \$100 million hurdle should be weighed in relation to the cost of private capital and the time which the President of the company, Michael Kasser, and his staff would need to set aside to deal with the requirements for financing a public offerings.

The advantages of having a source of capital which is not constrained by a small number of investors, is readily accessible and is not subject to the currently stringent lending requirements which many financial institutions have imposed, are obvious with REITs. The liquidity which is provided to sponsors and investors alike has made them an attractive vehicle for raising capital. The best way for Holualoa Realty Advisors to structure its existing portfolio into a REIT will likely be through a "partnership roll-up".

Partnership Roll-ups

The ability to combine individual properties held in partnership into a REIT is of great interest to small- and medium- size real estate companies like Holualoa Realty Advisors, Inc. Limited partnerships have been a preferred choice of ownership in the past due to their favorable tax treatment prior to 1986; therefore, a large percentage of the real estate owned today is held in limited partnerships. After the Tax Reform Act of 1986 eliminated

the ability to shelter income through the limited partnership structure, investors searched for other vehicles which were more beneficial forms of ownership.

Many real estate limited partnerships were "rolled-up" into Master Limited Partnerships or more recently into REITs. Changing the ownership structure from a private to a public entity allowed investors to liquidate their positions, if desired. Unfortunately, the liquidity roll-ups provided was offset by sharp declines in value. "Once shares of the freely tradable entity actually begin to trade, prices plummet as the new shareholders (the former partners) rush to sell and few buyers materialize. Indeed, one study showed that, on average, the share prices of roll-ups that had been completed through 1991 fell 37.4% on the first day of trading alone." However, this price adjustment may also be partially explained by the inaccurate price placed on the new security by the sponsor and the unwillingness of the former partners to address the decline in value of their real estate investments due to the Tax Reform Act of 1986.

A major concern to partners is the ability to avoid a taxable event when a roll-up is being contemplated. The Limited Partnership Roll-up Reform Act of 1993 is expected to be signed into law by the end of the summer. Its focus is not to keep roll-ups from happening, but to ensure that dissenting partners are treated fairly. Roll-ups have historically been formed by general partners and complaints have been registered that information regarding a proposed roll-up, which is distributed to the limited partners for approval, has been incomplete or slanted to encourage the adoption of the change which has sometimes generated additional fees for the general partner. In addition, "Security and Exchange Commission (SEC) regulations that allow secrecy to prevent hostile takeovers

in corporate restructuring also enable partnership roll-ups to be planned in secret."⁵²

Limited partners who were not interested in joining in the roll-up were swept along by the majority and given no choice.

The Thompson Killea Limited Partner Protection Act of 1992 is a piece of California legislation which has recently been passed and addresses these roll-up abuses. The Act allows dissenters the right to exchange their partnership shares for cash, or a liquid security, upon determination of the current value of the partnership by an independent appraiser. In addition, the general partner must pay all organizational expenses related to the proposed roll-up if the roll-up is defeated.⁵³ The testing of this legislation by Shurgard, Inc., a warehouse owner and operator who is proposing a partnership roll-up which involves California investors, has potential roll-up sponsors holding their breath.⁵⁴ However, if the existing partnership(s) do not have any investors who are domiciled in California, the Shurgard case is a non-issue. But, because the California legislation is more stringent than that proposed by National lawmakers, and due to the size and population of California, and the number of real estate investors in the state, the Shurgard issue is being used as a test case. Shurgard declined to comment on their case, as it is still in the SEC review process which began in February of this year.⁵⁵

Roll-ups are not for everyone. General partners who view a roll-up as a means of salvaging the remaining value in troubled partnerships will find the public capital markets unsympathetic. However, many sectors of the industry are championing the use of roll-ups. "Peter Fass, a partner at Kaye Scholer, commented that because Wall Street is

⁵²Margaret Opsata, "New Law Seeks to End Abusive Roll-ups", *The Real Estate Finance Journal*, Summer 1993, p. 101.

⁵³"New Law Seeks to End Abusive Roll-Ups", p. 102.

⁵⁴Barry Vinocur, "REIT Shares Take Some Lumps", *Barron's*, May 3, 1993, p. 48.

⁵⁵7/21/93 telephone interview with Investor Service department of Shurgard, Inc.

currently valuing real estate securities at a premium to their underlying asset value, a case could be made that a general partner has a fiduciary obligation to at least consider doing a roll-up."⁵⁶ Although the current market dynamics may not remain, the ease with which a portfolio, which contains a small number of limited partners, can be rolled up into a REIT makes it an attractive vehicle to keep in mind once the costs of managing and financing Holualoa Realty Advisor's expanding portfolio become burdensome. One word of warning: partners looking into a roll-up should be prepared for the delays which an SEC review can entail. Due to the abuses chronicled in the past, the SEC is scrutinizing all proposed partnership roll-ups.⁵⁷

UPREITs

UPREITs were created to deal with IRS Tax Code Section 351(e), which stipulates that conversion to a corporate structure triggers a taxable event.⁵⁸ As a REIT must be structured as either a trust or a corporation this section of the Code applies to the formation of a REIT. "A partnership that wants to convert to a REIT must convince all existing partners to sell the properties to the REIT and to incur a tax upon the termination of the partnership."⁵⁹ The UPREIT (Umbrella Partnership REIT) structure was developed and utilized for the Taubman REIT offering in order to avoid the capital gains tax which would normally be associated with the roll-up of partnerships into a REIT. In the Taubman structure, the REIT stockholders own an interest in a partnership, which owns

⁵⁶Barry Vinocur, "David Murdock's Mega-REIT", *Barron's*, March 15, 1993, p. 63.

⁵⁷"Accessing Capital Markets: Is the Crunch Over?", *The REIT Report*, Vol. 8, #1, Winter 1993, p.6.

⁵⁸Barry Vinocur, "They're Downright Ga-Ga Over UPREITs", *Barron's*, December 28, 1992, p.35.

⁵⁹Robert A. Frank, "The Umbrella Partnership REIT: Keys to the Real Estate Kingdom?" *The REIT Report*, Vol. XIII, Winter 1993.

the properties and the property management company (See Exhibit VII for typical organizational structure of an UPREIT).

Due to the low basis on most of the properties slated to be included in the Taubman REIT, recognition of the capital gain (due to the change in structure) for the Taubman portfolio would have been prohibitive. Without a means of postponing the capital gains tax, the REIT offering would never have gone through. According to David Samber of Kimco Realty Corporation, Kimco was also apprehensive of the low basis on their properties, but found that Section 1374 of the Internal Revenue Code gave the company some breathing room. "Provided that properties are held for 10 years from the IPO, a sale thereafter is given the benefit of the value of the property at the IPO date, in computing tax due on the sale."⁶⁰A positive aspect for the original limited partnership investors.

As this form of ownership is very new, it has been necessary for investors and sponsors to go through a learning curve relative to the pros and cons of UPREITs. Six months ago investors were concerned about conflict of interest issues due to the fact that the assets are controlled by the umbrella partnership, not the REIT itself. Under the UPREIT structure, the original partners are allowed to retain their partnership interests rather than converting them to REIT shares, while investors own shares in the umbrella partnership instead of in the properties, as a traditional REIT shareholder would. Conflicts may arise when the UPREIT can sell a property for a sum that may be beneficial to the UPREIT shareholders, but may not be sufficient to cover the capital gain taxes and expected returns of the initial partners. Critics claim that the UPREIT structure is only beneficial to the original partners and that it puts an unnecessary layer between shareholders and the properties. Some

⁶⁰David M. Samber, "Accessing Capital Markets: Is the Crunch Over?", *The REIT Report*, Vol. XIII, #1, Winter 1993.

analysts feel that UPREITs may require a 5%-10% pricing discount due to these issues⁶¹ Today lawyers and accountants are learning how to offset these issues in order to allow UPREITs to be used. It does not appear that Holualoa's potential REIT portfolio is structured as to require this complicated ownership vehicle. Of course, a real estate attorney should be consulted in order to determine the best vehicle for any potential REIT sponsor.

REITs and UPREITs are expensive forms of ownership and are not very well suited for small portfolios. Potential sponsors should beware of the positive view being taken of REITs by investment banks, which are interested parties. With a REIT, the overall cost of debt can not be determined until the offering is priced by the public markets. Organizational fees paid to investment bankers, accountants and lawyers are substantial. In addition, an opportunity cost for the time a general partner must spend away from his/her main line of business should also be factored into the cost/benefit analysis.

⁶¹Barry Vinocur, "They're Downright Ga-Ga Over UPREITs", *Barron's*, December 28, 1992. p.35.

Chapter 5

Private Equity REITs

Private REITs are exempt from registration with the Securities and Exchange Commission as outlined in the U.S. Securities Act of 1933. Due to this fact, private REITs are kept out of the purview of regulators, securities analysts and the financial press.⁶² For this reason it is difficult to determine the size and capitalization of the private REIT market. According to the National Association of Real Estate Investment Trusts, Inc. (NAREIT), there are at least 14 private REITs which are listed with this trade organization (See Exhibit VIII). It is thought that the overall capitalization of private REITs is close to that of public REITs, but definitive information is unavailable.

Private REITs have typically been formed by investment advisors and individuals who are interested in utilizing this tax-effective form of ownership. The major difference between private and public REITs revolves around the marketing of the shares of interest. Private marketing of shares reduces overhead costs of the REIT, and thus the cost to investors. Many of the private REITs registered with N.A.R.E.I.T. sell only to institutional buyers. Because the shares are not traded on a secondary market, there is no increase in liquidity which is usually associated with a public REIT.

Valuation of shares relies upon the traditional appraisal-based valuation. Due to this fact, the shares of a private REIT tend to perform more like real estate than stocks (which public REITs are more highly correlated with). Private REITs are also not exposed to the volatility of the public capital markets. A public REIT can be constrained by the state of

⁶²Paul S. Saint Pierre, "The Private World of Private REITs", *The REIT Report*, Vol. XIII, No.1, pp. 1,8,9,15.

the capital market, while a private REIT is only constrained by its ability to find additional investors. However, private REIT investors may demand a greater return on their investment due to the relative illiquidity compared to public REITs.

Private REITs for non-institutional investors do not appear to be an efficient organizational structure. Because of the legal requirements of a REIT, specifically the minimum of 100 shareholders and the "5 or 50" rule, this form of ownership is difficult for private sponsors to find investors, keep track of ownership interest, etc., while providing no liquidity to the investor. For non-institutional investors, such as Holualoa Realty Advisors, Inc., a limited partnership or a public REIT would be a more efficient form of capitalization.

Chapter 6

Holualoa Revisited

So what avenues are left to the real estate industry for locating capital? The answer today is much shorter than it was ten years ago. The thrift industry is gone. Some bank and insurance companies are active on a small scale, but many experts feel that these institutions will be more risk-averse throughout the 1990's and will not be significant players in the real estate lending industry.

A bright spot on the horizon is the active creation of private limited partnerships. Although no public records are kept, it is commonly understood that private limited partnerships are currently involved in the acquisition of real estate throughout the country. Most of these partnerships could be categorized as "Vulture Funds", a term which carries negative implications, but simply means that private investors have found inefficient pricing in the real estate market and are taking advantage of the current opportunities.

Public limited partnerships were so battered during the 1980's, that few people expect this phoenix to rise from the ashes. In fact, several of the larger sponsors of public limited partnerships are looking at rolling-up the public limited partnerships in their care into their own REITs. The success of these offerings will be determined by the quality of the real estate which is chosen to be packaged under the REIT form of ownership.

Master Limited Partnerships suited a need for a period of time, but were essentially a creation of the tax code. They allowed partnerships the flexibility of being traded on the public markets and provided a daily pricing mechanism, but after Wall Street understood the REIT vehicle, quickly fell out of favor.

That leaves Real Estate Investment Trusts (See Exhibit IX for comparison of REITs to partnerships). This form of ownership is expected to be the real estate issue of the 1990's, and should not get any significant competition as a form of ownership until the banks and insurance companies become competitive by loosening their underwriting standard, or until a change in the tax code creates a vehicle which is more efficient or better suited to the needs of real estate buyers and sellers.

After reviewing the options available, it becomes apparent that the choices for Holualoa are at opposite ends of a continuum. Private limited partnerships work well for property specific investments, the structure is efficient and relatively cost-effective, but this form of ownership begins to become cumbersome and capital constrained as the partnership's portfolio grows.

REITs on the other hand are much more of a corporate form of ownership, but are able to retain the tax advantages of a partnership. They are better suited for large portfolios; however, an advantage of a REIT is the fact that its ability to raise capital is only constrained by the price and dividend yield demanded by investors. Being open to the variability of the stock market and the vagaries of a new, still somewhat misunderstood form of ownership, does also have its costs.

Wall Street would not yet consider the Holualoa portfolio large enough to efficiently be launched as a REIT, especially in today's superheated IPO environment. Jim Snyder of Paine Webber Properties stated in a telephone interview that the \$100 million dollar mark

is the cut-off level for REITs to be followed by analysts at major investment banks.⁶³ In addition, due to the demand for yield from mutual fund investors, along with the track record of new REIT IPOs and the lack of alternative capital sources for real estate companies, investment banks are focusing on larger deals which are more lucrative. The existing backlog is staggering. In June of this year, a Kemper Securities publication estimated that there were \$10 billion dollars worth of new deals (IPOs and secondary offerings) in the pipeline for the end of 1993.⁶⁴

This does not mean that REITs under \$100 million have not been formed. Many REITs such as Bradley REIT, Southwestern Property Trust, DIAL, etc. have utilized the unique aspects of today's capital markets as a springboard for achieving exponential growth. Smaller REITs will have a hard time attracting the attention of first tier investment banks, but second tier or regional investment banks are willing to underwrite a REIT IPO for a solid company. Many of the people spoken to as research for this thesis; however, stated that for a small REIT to survive, it would have to continue to grow, and that those REITs which chose to stay under a \$100 million in capitalization will be lost in the shadow of the larger and more heavily traded offerings. Many REITs over the past several months have been placing properties in escrow in anticipation of a primary or secondary REIT offering. By having a portfolio of acquisitions lined up, and specified in the REIT's prospectus, REITs are trying to use the acquisition of a portfolio of properties to increase the capitalization of the REIT's portfolio quickly. In this way REIT sponsors hope to use the current availability of public capital to move above the \$100 million cut-off mark.

⁶³7/19/93 telephone interview with Jim Snyder, Senior Vice President of Paine Webber Properties.

⁶⁴"Cycles, Valuation and Returns: A Statistical Analysis", *Kemper Securities Newsletter*, June 4, 1993, p. 4.

For potential REIT sponsors who hold a long-term view of the industry, there may still be an opportunity on the horizon to take portfolios public. Barry Greenfield stated in a telephone interview that now was a bad time to launch a REIT. Mr. Greenfield felt that it would be better for a company to wait until the existing round of IPOs fell out of favor, and to launch an offering in a more controlled market, say in 1995 or 1996.⁶⁵

For Holualoa to grow to a size which makes launching a REIT possible, the company needs to embark on an acquisition campaign in the \$50 to \$75 million range. Assuming an acquisition in the \$5 million price range is made every month, this process could take 1 to 2 years, which would leave the company at the point Mr. Greenfield suggested for launching a new REIT. Of course, the quality of the acquisitions must remain high, and the underlying economics of each deal should allow the individual properties to stand on their own. In addition, a concentration on residential and industrial real estate, two of the more popular product types for REITs today (See Exhibit X) should be maintained. Holualoa Realty Advisors needs to determine if the market will accept their existing combination of multi-family and R&D properties under one REIT structure. If the market requires that these product types be offered under separate vehicles it will take the company a longer time to reach a portfolio size which is attractive to Wall Street.

Holualoa, like other possible REIT sponsors, faces the possibility that they may miss the window of opportunity open to REIT IPOs today. If interest rates should rise suddenly, or the IPO market should become saturated, the environment for launching a REIT will deteriorate. The only thing that can be done by the general partner is to maintain the current acquisition strategy, while preparing the company for a possible REIT offering in

⁶⁵6/10/93 telephone interview with Barry Greenfield, Fund Manager for Fidelity Investment's REIT mutual fund.

the future. Preparation includes having three years of audited financial statements, locating an investment bank that may be interested in doing the underwriting, keeping informed on REIT industry issues [N.A.R.E.I.T. and Barron's are good sources] and making acquisitions only in the apartment and R&D product types, with a geographic focus on the Southwest.

When the portfolio becomes large enough to offset the additional costs of public capital with the REIT form of ownership, a roll-up into a REIT structure will probably prove to be the best vehicle for the limited partnerships held by Holualoa Realty Advisors. Due to the small number of limited partners currently involved in the partnerships, a roll-up appears to be the least complicated and most efficient means of attracting public capital. Because none of the limited partners are from California, the difficult legislation instituted in that state should not pose a problem, however, the progress of Shurgard's case should be watched closely, and the amount of lead time which the SEC imposes upon Surgard's offering should be noted. Through telephone interviews it was found that the existing limited partners consider themselves long-term investors and would probably want to be included in a proposed roll-up, thereby reducing the need to buy-out dissenting limited partners.

The sponsors of a potential REIT should be aware of how the new ownership structure will affect their day-to-day operations. In the Summer 1993 issue of *The REIT Report*, several REIT managers were interviewed on their reactions as to how the REIT form of ownership had changed their business operations. The most common responses were that the reporting requirements of the SEC were a new layer of paperwork which the organization had to adjust to, and that more of upper management's time was taken up speaking to industry analysts. Public companies require more reporting to the SEC and the IRS, which can increase the managerial and accounting costs of the operation. In

addition, a more professional marketing staff is required to keep investors informed and to convey the REIT's management as organized, professional, fiduciaries of the public's funds. Taking a private organization public means educating the entire staff of the company on the operational and organizational changes that will occur.

The opinions of Holualoa's limited partners regarding the possibility of doing a partnership roll-up were as one might have expected.⁶⁶ The partners understood the potential cost savings which could be provided by having the partnerships in one management vehicle at some point in time. They were also aware of the added liquidity and access to capital which taking the partnership public could provide. They noted that they would be concerned if acquisitions were increased solely for the purpose of forming a REIT, and were not subject to the usual scrutiny of past acquisitions. On the whole, the investors were not concerned with the change in the type of income being generated from their investments (passive income as a limited partnership versus portfolio income as a REIT) and viewed the move to a REIT as a positive change if the market provided added value and the investors were not required to recognize a capital gain on their partnership interests.

⁶⁶Telephone conversations with limited partners on various dates.

Chapter 7

Future of REITs

Throughout the research process for this thesis, there were several issues relative to the future of REITs, which kept being brought up by experts in different sectors of the REIT industry. Those issues were: 1) quality of future offerings, 2) real estate development within the REIT structure, and 3) hostile takeovers of REITs. As the future unfolds, these issues will be watched closely by prospective REIT sponsors, Wall Street investment banks, analysts and pension funds. A short discussion of each issue follows:

Quality of Offerings

Many of the players in the REIT industry (analysts, investment bankers, etc.) are concerned about the reputation being created for the REIT industry during the current boom. REITs were labeled as poor investments when investors suffered extensive losses during the 1970's and the last thing the industry wants is to stifle its growth potential by issuing poor quality offerings. Unfortunately, there appears to be no formal braking mechanism. Investment bankers are trying to underwrite new offerings as fast as possible, while sponsors are trying to get their REIT launched before the current window of opportunity closes on them. As more regional investment banks and smaller real estate owners become more active in the industry, investor will have to take greater care to be more informed, and potential REIT sponsor will have to find a way to stand-out from the crowd.

Dealer Status

A REIT can be disqualified from its preferential tax status if it operates as a dealer in real estate. Disqualification occurs if a REIT receives more than 30% of its annual gross

income from the sale of properties held for less than 4 years. In addition, if the following qualifications are not met, a tax of 100% of the net income from sales will be imposed: 1) properties must be held for at least 4 years, 2) capital expenditures on the property over the four year holding period must not exceed 30% of the sales price, 3) no more than 7 property sales are allowed in a year, and 4) sales of more than 10% of the REIT's assets in a taxable year are prohibited.⁶⁷ This requirement keeps REITs from speculating on real estate and being merchant builders, but it hasn't kept them out of the development business.

Many REITs are trying to determine how they can structure development subsidiaries under the REIT vehicle. One issue that could potentially work against them is that under the REIT form of ownership the development subsidiary of the REIT is not taxed at the corporate level as it would be if it were formed as a corporation. Mr. Carr feels that Congress may be upset by the loss of potential tax income and change the current rules, either by not allowing development subsidiaries within the REIT structure, or by imposing a tax on the income or capital gain derived from development. REIT managers who are looking ahead are trying to work on these issues. As Mr. Greenfield stated, REITs will have an opportunity to be the first organizations back in the development game due to their access to capital and their ability to fund development from internal sources.⁶⁸

Takeover Issues

During the formation stage of a REIT, sponsors should consider the vulnerability of ownership of a publicly traded company, such as a REIT. Many sponsors who have done business in the private sector are unfamiliar with anti-takeover provisions, but their

⁶⁷NAREIT, *REIT Fact Book*, © 1989, Appendix I, pp. v-vi.

⁶⁸6/10/93 telephone interview with Barry Greenfield, Fund Manager of Fidelity Investment's REIT mutual fund.

inclusion, while not necessarily being in the best interest of the shareholders, (it has been shown that the adoption of anti-takeover provisions reduce the price of a REIT stock due to the inability of the company to be taken over by new management, which may enhance shareholder wealth) provides a sense of security that the long-term goals and objectives of the sponsor will be reached.

There are several anti-takeover strategies which have been created in the public environment, one of which is the poison pill. "A poison pill, also known as a rights plan, is a dividend distribution of rights of securities with redemption or conversion provisions. It is activated by an unsolicited takeover bid, and it allows shareholders to increase their ownership in the firm by purchasing shares at a substantial discount."⁶⁹ In essence, this requires the bidder for the REIT to negotiate with the existing Board of Directors rather than just buying a controlling interest without management's input.

If the 5 and 50 rule is modified significantly, it is possible that the takeover clauses, which have been painstakingly included in many of the 1990's REITs, could become invalid in the future. Takeover clauses have been included in the new REIT offerings for several reasons: 1) because the current law does not allow a large percentage of the stock to be held by a few individuals, 2) because most REIT sponsors were entrepreneurs who converted the structure of their portfolios to a REIT format, but wanted to retain control of the operations of the REIT, and 3) because many REITs are estate planning vehicles for allowing the ownership of the existing portfolio to pass to the next generation. If the 5 or 50 rule is changed, hostile takeovers of REITs could be a real possibility. Mr. Carr claims that if this should happen, Real Estate Trust of America (RETA) may be a good example

⁶⁹Willard McIntosh, "The Effects of Poison Pill Securities on REIT Stock Prices", *Real Estate Issues*, Vol. 16 #1 Spring/Summer 1991, pp. 34-35.

of the outcome of such a scenario. In the 1970s, RETA was the hostile takeover target for a foreign pension fund. The courts found the 5 or 50 rule unenforceable and allowed the takeover to proceed, which removed existing management from control of the REIT.⁷⁰

⁷⁰7/13/93 interview with Fred Carr, Jr., Principal of The Penobscot Group.

Exhibit 1

Bank Failures from 1980-1991

Year	All Banks	-----Commercial Banks-----				
		Midwest	Northeast	Southeast	Southwest	West
1991	124	1	53	16	41	9
1990	168	6	16	9	119	16
1989	206	10	5	7	166	18
1988	200	24	2	3	147	20
1987	184	38	4	6	95	34
1986	138	45	1	6	52	29
1985	120	52	2	8	29	21
1984	79					
1983	48					
1982	42					
1981	10					
1980	10					

Source: Donald A. Nielsen and Roger P. Sindt,
 "Real Estate, Regional Banking, and Bank Failures",
Real Estate Review,
 Vol. 22, #3, Fall 1992.

Exhibit II
Holualoa Realty Advisors, Inc.
Portfolio
as of June 22, 1993

Property Name	Property Location	Type	Purchase Date	Value at Purchase (\$Million)	%Debt
Butterfield Business Center	Tucson	R&D	3/92	\$5.35	63
Palo Verde Business Center	Tucson	R&D	1/92	\$1.46	51
Fox Point	Tucson	Apartments	5/92	\$4.00	77
Bay Colony	Tucson	R&D	12/92	\$1.74	0
North Tucson Business Center	Tucson	R&D	12/92	\$1.80	0
Rancho Las Palmas	Phoenix	Apartments	3/93	\$2.60	75
16th Street & Campbell	Phoenix	Office/Retail	3/93	\$0.31	0
Raymond Building	Phoenix	R&D	4/93	\$0.96	79
Alapa III Business Center	Hawaii	R&D	11/85	\$0.65	89
Keauhou Heights	Hawaii	Resid. Land	12/88	\$1.05	75
Kailua Trade Center	Hawaii	Office	12/89	\$2.75	73
Toyota	Hawaii	R&D	9/89	\$0.38	57

Average debt-to-equity ratio = 53%

Exhibit III
Annual Financing Volume
Totals for 1980-1990

(\$ Millions)

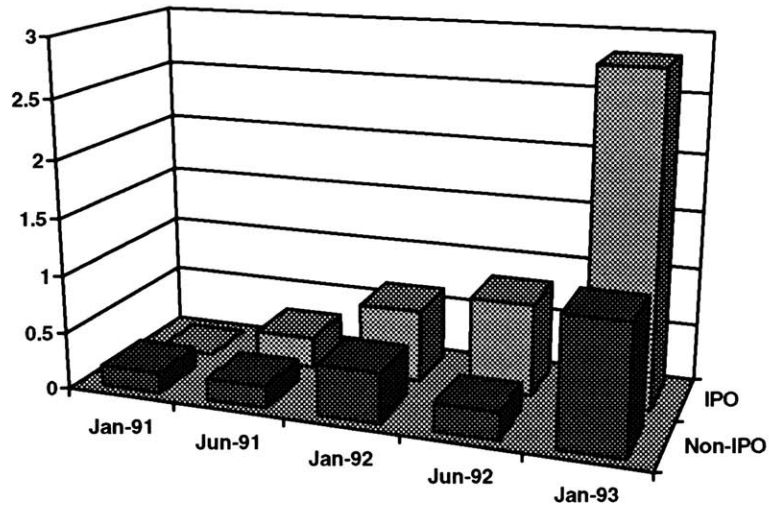
Year	Public Limited Partnerships	Master Limited Partnerships	REITs
1990	400	0	525.0
1989	600	58	705.3
1988	800	70	1,192.1
1987	1,000	463	1,363.8
1986	2,119	972	1,370.7
1985	4,682	200	2,721.3
1984	5,308	0	362.8
1983	3,983	0	425.5
1982	1,647	0	153.6
1981	1,066	0	102.6
1980	788	0	171.0

Source: Ray A. Knight and Lee G. Knight,
"REITs Reemerge as Attractive Investment
Vehicles", *Real Estate Review*,
Vol. 22 #2, Summer 1992

Exhibit IV
Excerpts from REIT
Requirements as Stipulated in the
Real Estate Investment Tax Act of 1960

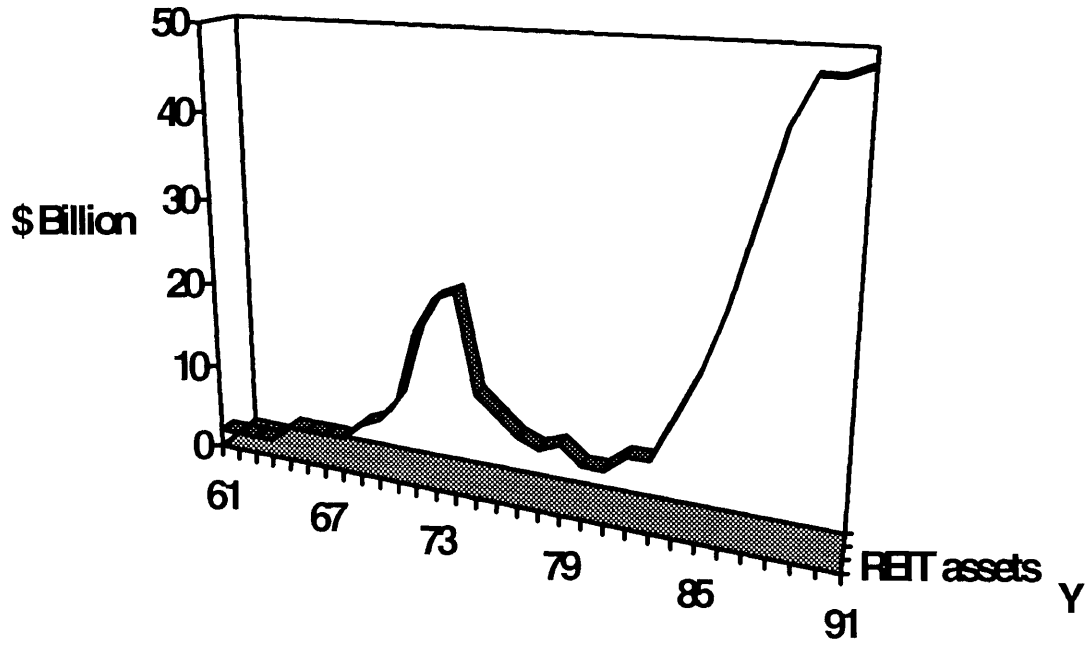
Organization:	A REIT must be organized as a: 1) corporation, 2) trust, or 3) association.
Taxation:	If structure meets qualifications of a REIT, income is only taxed once at the individual level.
Ownership:	Ownership must be held by at least 100 shareholders (not enforced for the first year of operation), with no more than 50% of shares being held by five or fewer individuals.
Income Source:	At least 75% of a REIT's gross income must come from real estate sources (See Act for more detailed description). Hotels can not be held in the REIT format, they are considered a business, not real estate.
Income Distribution:	At least 95% of a REIT's taxable income must be distributed to shareholders at year end, or income is subject to taxation .
Penalties:	A 100% tax is applied to net income from "prohibited transactions"
Investor Tax Forms:	From 1099
Dealer Status:	REITs are not allowed to be dealers in real estate, and are required to hold properties for an average of 4 years. Income from the sale of real estate should not be greater than 30% of net/gross income.
Income Category:	Portfolio, can not pass through losses. Can use depreciation to shelter distributed income only

Exhibit V
REIT Equity Offerings
1991-1993 YTD
(\$Billions)



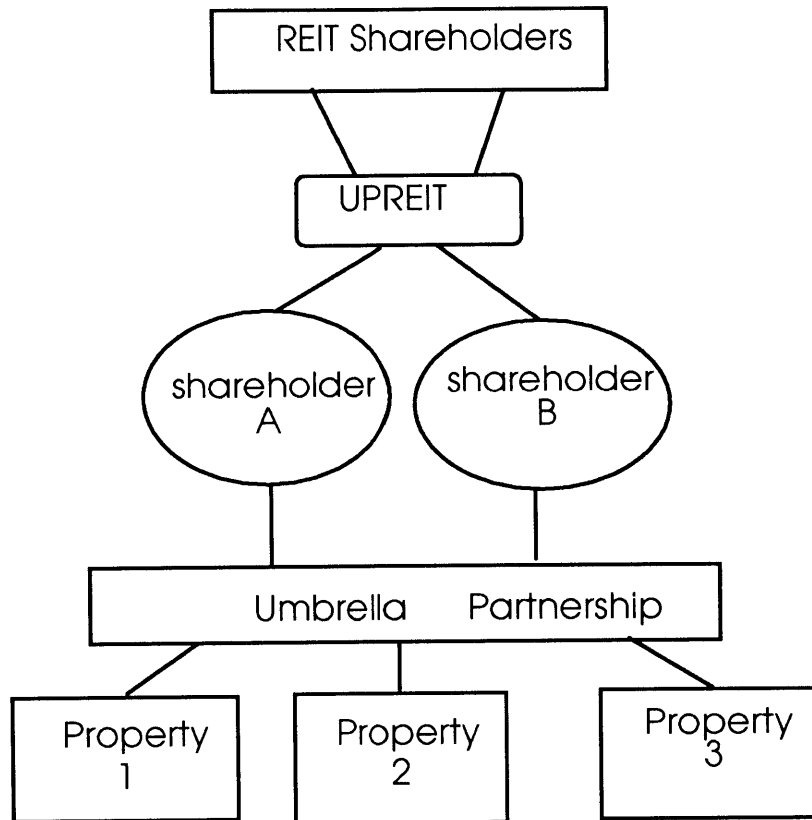
Source: Lehman Brothers

Exhibit VI
Growth of REIT Assets
1961-1991



Source: Lehman Brothers

Exhibit VII
Umbrella REIT Structure



**Source: Robert A. Frank, "The Umbrella Partnership
REIT: Keys to the Real Estate
Kingdom?"
*The REIT Report***

Exhibit VIII

N.A.R.E.I.T. List of Private REIT Members

Private REIT	Initial Equity Capitalization
Corporate Property Investors	\$3.2 billion
Retail Property Trust	\$1.0 billion
LaSalle Street Fund	\$700 million
US Prime Property Inc.	\$340 million
Endowment Realty Investors	\$363 million
Endowment and Foundation Realty-JMB II	\$121 million
Endowment and Foundation Realty-JMB III	\$161 million
PCA Sammis Industrial Fund	\$125 million
PCA Tishman Speyer, Inc.	\$111 million
USAA Real Estate Equities, Inc.	\$171 million
Met. Life Int'l. R. E. Equity Shares, Inc.	\$142 million
General Electric R. E. Investment Co.	\$102 million

Source: Paul S. Saint-Pierre
"The Private World of Private REITs"
The REIT Report
Vol. 13, #1, Winter 1993, p.9.

Exhibit IX
Important Differences:
REITs vs. Partnerships

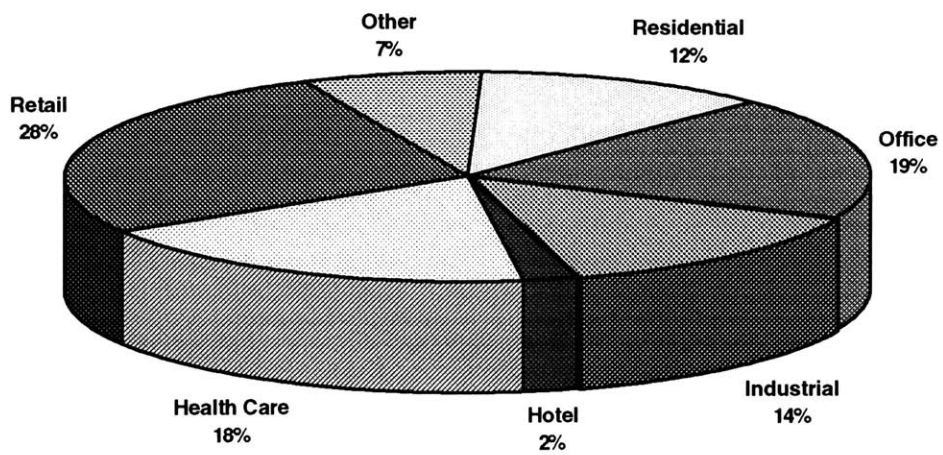
	REITs	Partnerships
Liquidity	Yes, more REITs are listed on stock exchanges	No, when liquidity exists, generally much less than REITs
Minimum Investment Amount	None	Typically \$2,000-\$5,000
Reinvestment Plans	Yes, including some at discounts	No
Ability to Leverage Investments without Incurring UBIT for Tax-Exempt Accounts	Yes, this makes REITs suitable for individual IRAs, KEOGH and other pension plans	No
Investor Control	Yes, investors re-elect directors and, in some cases, approve advisors annually	No, controlled by general partner who cannot be easily removed by limited partners
Independent Directors	Yes, state law typically requires majority to be independent of management	No
Beneficial Ownership	At least 100 shareholders required ...most REITs have thousands	Shared between any number of limited and general partners
Ability to Grow by Additional Public Offerings of Stock	Yes	No

Source: "Real Estate Investment Trusts: Frequently Asked Questions About REITs", N.A.R.E.I.T.

Exhibit X

**Breakdown of
Publicly Traded Equity REITs
1992**

Source: N.A.R.E.I.T.



Selected Bibliography

1. Donald a. Nielsen & Roger P. Sindt, "Real Estate, Regional Banking and Bank Failures", *Real Estate Review*, Vol. 22 #3, Fall 1992, p.95.
2. Sonny Bloch and Carolyn Janik, *How You Can Profit From the S & L Bailout*, © 1991, Bantam Books.
3. Glenn Yago, *Junk Bonds: How High Yield Securities Restructured America*, © 1991, Oxford University Press.
4. Robert L. Nessen, Esq., *Real Estate Finance and Taxation: Structuring Complex Transactions*, © 1990 John Wiley & Sons, Inc.
5. Hal Katersky and Klara Katersky, *Real Estate Limited Partnerships: A Guide for Profits*, © 1989 Prentice Hall, Inc.
6. Karen Slater Damato, "Liquidity Fund Ends Role as an L.P. Matchmaker", *Wall Street Journal*, June 17, 1993
7. Ray Knight & Lee Knight, "REITs Reemerge as Attractive Investment Vehicles", *Real Estate Review*, Summer 1992, Volume 22 #2, pp.42-48.
8. Barry Vinocur, "These REITs are Sound, but no Bargain", *Barron's*, December 14, 1992, p.58.
9. David C. Walters, "Investors Buy Real Estate Firms to Beat Poor Returns on CDs", *The Christian Science Monitor*, January 21, 1993.
10. Lawrence Raiman, "The REIT Revolution is Here", *Paine Webber Newsletter*, April 19, 1993.
11. Barry Vinocur, "How Property Shares Fared in the Quarter", *Barron's*, April 12, 1993, p. 69
12. "REITs Shine in '92: Industry Looks to Washington for Help", *Commercial Property News*, January 16, 1993.
13. Stan Ross & Richard Klein, "REITs as a Source of Capital: Considerations for Sponsors", *Real Estate Finance*, Summer 1992, Volume 9 #2 pp.13-18.

14. Barry Vinocur, "Now: Index Funds for Property Stocks", *Barron's*, May 10, 1993, p.56.
15. James L. Kuhle, "The Long-Term Performance of Real Estate Investment Trusts", *Real Estate Finance*, Summer 1992, Volume 9 #2 pp.25-30.
16. *Real Estate Investment Trusts*, New York Institute of Finance, © 1988, NIF Corp.,
17. Nori Gerardo, "REITs No Substitute for Private Real Estate", *PREA Quarterly*, Vol. 6 #2, April 1993.
18. Eric J. Savitz, "The REIT Maze: Picking a Safe Path Through a Hot Group", *Barron's*, May 24, 1993 pp.8-29.
19. Mitchell Pacelle, "For Wall Street, REITs Are Hot Properties", *Wall Street Journal*, January 6, 1993, p.
20. Barry Vinocur, "Big Fast-Food REIT in teh Works", *Barron's* July 5, 1993, p.60.
21. *REIT Fact Book*, © 1989, National Association of Real Estate Investment Trusts, Inc.
22. S. Michael Giliberto, "Equity Real Estate Investment Trusts and Real Estate Returns", *The Journal of Real Estate Research*, Vol. 5 #2, Summer 1990, pp.259-263.
23. Barry Vinocur, "REIT Shares Take Some Lumps", *Barron's*, May 3, 1993, p.48.
24. Steven R. Brown, "The Growth of Commercial Mortgage Securitization and Impact on the REIT Industry", *The REIT Report*, Vol. XIII #3, Summer 1993, p.10.
25. Barry Vinocur, "A Big Calendar of REIT Offerings", *Barron's*, May 31, 1993.p. 44.
26. Margaret Opsata, "New Law Seeks to End Abusive Roll-ups", *The Real Estate Finance Journal*, Summer 1993, pp.100-102.
27. David M. Samber, "Accessing Capital Markets: Is the Crunch Over?" *The REIT Report*, Vol. XIII, #3, Winter 1993.
28. Robert A. Frank, "The Umbrella Partnership REIT: Keys to the Real Estate Kingdom?", *The REIT Report*, Vol. XIII, Winter 1993.
29. "Inching Down the Path to Recovery", *Business Week*, December 28, 1992, pp.108-109.

30. Paul S. Saint-Pierre, "The Private World of Private REITs", *The REIT Report*, Vol.XIII #1.
31. Willard McIntosh, "The Effects of Poison Pill Securities on REIT Stock Prices", *Issues, Real Estate Issues*, Vol. 16 #1, Spring/Summer 1991, pp.34-38.
32. Lynn Asinof, "Investors in Search of High Yields are Flocking to Some REITs", *The Wall Street Journal*, November 12, 1992.
33. John R. French, "Stocks-For-Assets: A Viable Conduit Between REITs and Institutional Investors", *The REIT Report*, Vol. XII #4, Fall 1992.
34. "How Long Will The Bull Run?", *Time*, May 17, 1993, pp.44-47.
35. Robert Gorlow, David Parr & Louis Taylor, "The Securitization of Institutional Real Estate Investments" *Real Estate Review*, Vol. 23 #1 Spring 1993.
36. Allan Sloan, "Beware These Trusts", *Newsweek*, May 24, 1993, p.46.
37. Ron Galperin, "Pension Investment: Caution, Cash Flow, Control", *Real Estate Forum*, March 1993, Vol. 48 #3 pp.38-47.
38. Mark Decker, "REITs Industry Celebrates 33rd year; Seeks Active Role in Securitization", *National Real Estate Investor*, February 1993, pp.52,54,87.
39. Anthony Downs, "What Will Happen to Commercial Real Estate Values in the Rest of the 1990s?", *National Real Estate Investor*, April 1993, pp.17,18,20,22,33,109.
40. June 10, 1993 telephone interview with Barry Greenfield, manager of Fidelity Investment's REIT Mutual Fund.
41. Mitchell Pacelle, "Distressed Real Estate Lures Wall Street Powerhouses", *The Wall Street Journal*, May 24, 1993.
42. Lynn B. Sagalyn, "Real Estate Securities: Risk and Return Over the Business Cycle", M.I.T. Center for Real Estate Development, Working Paper FP#2, June 1989.
43. Jack H. Halperin, *Private Placement of Securities*, ©1984, John Wiley & Sons, Inc.
44. Stephen P. Jarchow, *Real Estate Investment Trusts: Tax Securities and Business Aspects*, ©1988 John Wiley & Sons, Inc.
45. William W. Bartlett, *Mortgage Backed Securities: Products, Analysis, Trading*, ©1989 New York Institute of Finance.

46. G. Tomothy Haight and Deborah Ann Ford, *REITs: New Opportunities in Real Estate Investment Trust Securities*, © 1989 Probus Publishing Company.
47. Stan Ross, "Real Estate Master Limited Partnerships: Why Investors Like Them", *Real Estate Review*, Vol. 17 #1, Spring 1987, pp.28-37.
48. Stephen E. Roulac, "Capital Access: That was Then, This is Now", *The Real Estate Finance Journal*, Winter, 1993, pp.5-7.

Interviews:

7/1/93 telephone interview with Robert Sherman, President of Southwestern Property Trust, Inc.

5/25/93 interview with Cordell Lietz, Senior Vice President of U.S. Alpha Inc., the north american real estate subsidiary of ABP.

6/29/93 telephone interview with Tim Fluetsch, Assistant Vice President of Aldrich, Eastman & Waltch.

7/7/93 telephone interview with Michael Giliberto, REIT Industry Analyst, formerly of Salomon Brothers.

7/13/93 interview with Fred Carr, Jr., Principal of The Penobscot Group.

7/26/93 telephone interview with Trudy Ernst, Esq. of Goodwin, Procter & Hoar.

7/19/93 telephone interview with Jim Snyder, Senior Vice President of Paine Webber Properties.

6/10/93 telephone interview with Barry Greenfield, Fund Manager for Fidelity Investment's REIT mutual fund.