

THE MATURING OF REITs

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[Sidebar] Recent changes in equity REITs are indicative of the continuing evolution of the real estate capital market.

Investment trusts have a long history in the United States. Originally trusts were passive investments that distributed all trust income to shareholders, and thus were not taxed at the corporate level. In the 1930s, the Supreme Court ruled that corporate-like trusts must be taxed as corporations. The securities industry successfully lobbied for legislation that exempted regulated investment companies and mutual funds from federal taxation. In 1960, Congress passed legislation giving real estate investment trusts (REITs) tax treatment similar to mutual funds in order to allow small investors access to real estate ownership. Qualifying REIT earnings and capital gains were taxed only as they were realized by the individual shareholder.

In exchange for this single taxation treatment, numerous regulations control the REIT's organization, income, operations, dividend policy, and assets. In brief, in order to qualify as a REIT today the company must meet the following requirements: it must have fully transferable shares; a minimum of

100 shareholders; it must not be a closely held corporation; it must be managed by one or more trustees or directors; it must derive at least 75 percent of its gross income from real property rentals, loans, gain from sale or other distribution of real estate assets, including abatements and refunds on taxes, as well as income and gain derived from foreclosure property; it may derive not more than 30 percent of its gross income from the sale of real property held less than 4 years or securities held less than 12 months; it must distribute as dividends at least 95 percent of its taxable income (excluding net capital gains); it must invest at least 75 percent of its assets in real estate or real estate mortgages, cash and cash items (including receivables, and government securities); it may invest no more than 5 percent of its assets in the security of any one issuer; and it may own no more than 10 percent of the outstanding voting securities of any one issuer. Compared to regulations governing conventional corporations, these provisions severely limit the ability of a REIT to retain earnings and generate operating income.

Unlike mutual funds, REITs are prohibited from short-term trading of properties. Instead, they are required to be long-term investors. Prior to 1990, REITs were neither growth-oriented real estate operating companies nor property trading mutual funds, but relatively passive long-term real estate asset owners. In contrast, the REITs created in the 1990s are fully integrated real

estate operating companies with operating objectives similar to industrial companies. This raises three questions. Why did the REIT structure change? Does the new structural form matter in terms of performance? Have the pre-1990 REITs adapted in order to compete with the new post-1990 REITs in their respective industries?

Advantages and Disadvantages

Unlike a conventional corporation, the REIT pays no corporate taxes. In exchange for this benefit, REITs must operate under a variety of capital and operating restrictions, including paying high dividend rates to taxable shareholders. During the early 1980s when debt was easily available, development abounded, and tax laws provided rapid depreciation write-offs, owners and developers had little or no taxable Federal income. In that environment the REIT structure offered neither tax nor capital market advantages in exchange for the many operating restrictions. However, more recently, low depreciation rates, harder-to-obtain debt, and limited development opportunities increased taxable income and the need for access to large pools of equity. This altered the balance in favor of the REIT format, causing many leading private operators to go public as REITs.

REITs are restricted in their ability to retain earnings, which limits their ability to fund growth internally. In order to acquire, maintain, and develop properties REITs must continually raise substantial equity while simultaneously paying dividends. This continuous process of capital raising entails excessive fees as well the uncertainty of secondary equity placements. In addition, REITs face significant property trading and investor concentration restrictions. For example, prior to the 1990s the 'five or fewer' rule, which limited the ownership position of large shareholders, severely affected liquidity for institutional investors. In 1993, a 'look-through' provision allowed institutional shareholdings to be allocated among their beneficiaries rather than being counted as a single shareholder, thereby greatly enhancing the depth of REIT capital.

One of the key features of REITs in the 1990s is that they are *self-advised* and *self-managed*. REITs were originally intended to be passive investment vehicles that retained advisors who carried out functions similar to portfolio managers in mutual funds. These advisor-managers selected, managed, and financed properties for the REIT. However, unlike stock or bond portfolios, real estate assets require active management. Fee structures were not tied to performance, creating a conflict of interest between the advisor-managers and REIT shareholders. This conflict was a serious detriment to

growth in the industry. Without the ability to actively manage assets private developers risked losing control when their properties were converted to REITs. In the late 1980s, private letter rulings from the IRS allowed REITs to assume responsibility for selecting investment properties and managing assets, creating the opportunity for self-advised and self-managed REITs.

The importance of this change was not widely recognized until after the Kimco initial public offering (IPO) in 1991. Kimco Realty Corporation, owner of a large shopping center portfolio, was the first mainstream private operator to become a REIT. Like other real estate developer-operators during the 1980s, Kimco financed its rapid portfolio expansion primarily with debt. In November 1991, Kimco raised \$128 million in its IPO. To the surprise of many observers approximately 40 percent of the offering was purchased by institutional investors (compared to the then prevailing 25-30 percent). Kimco used the IPO proceeds to pay down debt, improving its interest coverage ratio (EBITDA/Interest Expense) from 1.4 in 1991 to 3.0 in 1992, and to 4.2 in 1993. Armed with restored borrowing capacity, Kimco rapidly became one of the nation's largest shopping center operators, with an interest in 319 properties, approximately 39 million square feet, in 37 states. In short, Kimco demonstrated that an institutional investor appetite existed for REIT shares of strong operators, that such operators could live with REIT restrictions, and that

access to public capital could be used to successfully execute a rapid growth strategy in depressed property markets.

UPREITs and Paired Shares

The second innovation that fueled the REIT boom of the 1990s was the creation in 1992 of tax-sheltering umbrella partnership REITs or UPREITs. UPREITs defer the seller's tax liabilities by placing properties into a partnership in exchange for UPREIT partnership interests. These interests are convertible to REIT shares (the conversion is a taxable event), while providing dividends as if they were REIT shareholders. This structure solves the undesirable capital gain consequences experienced by private owner-operators who become REITs. Equally important, the UPREIT structure creates a tax efficient currency for acquiring property partnerships. By 1997, on a fully diluted basis, UPREITs accounted for 77 percent of REIT equity market capitalization.

In November 1992, one year after the Kimco IPO, Taubman Centers Inc. went public as the first UPREIT. The UPREIT, Taubman Centers, held a 32.5 percent interest in Taubman Realty Group, the umbrella partnership

created from the mall portfolio developed and controlled by Alfred Taubman and his institutional partners. In its IPO, Taubman Centers Inc. raised \$295 million in equity. By structuring the IPO as an UPREIT, Taubman retained effective operational control of the portfolio and converted debt held by the pension funds into equity without triggering a capital gains tax liability. In August 1998, Taubman Centers Inc. announced a major restructuring in which it exchanged interests in ten shopping centers (together with a pro rata share of debt) for the partnership units held by the General Motors Pension Trust. This represented more than a third of the REIT's equity base. The Taubman UPREIT demonstrated how to defer capital gains, and also signaled that a major operator could operate under REIT restrictions.

As is true of all governance structures, conflicts can arise with UPREITs. Perhaps the most unique is the conflict between new shareholders and the original operators if the new shareholders desire to sell the operator's original properties, triggering capital gain taxes for the original operators. While most REITs generally do not sell their core operating assets, it underscores the need for strong and independent REIT boards.

A true *paired share REIT* is a REIT whose shares mechanically trade with those of an operating company. Both firms have essentially the same management and directors. More recent strategic pairings are spin-off

operating companies with closely aligned management and boards, where shareholders are encouraged by management to trade the shares in unison. To the extent paired trading occurs, pairing structures can overcome the conflicts of interest inherent in engaging a third party operator for services that REITs are prohibited from performing.

In the true paired share format, the REIT owns the real property assets while the operating company provides income-producing activities (for example, operating hotels, hospitals, and nursing homes). The operating company rents the properties from the REIT and generates all income that is not REIT qualified. Since tax law requires that the operating leases between the REIT and the operating company are at “market rates”, the paired share REIT cannot artificially set the lease rate equal to the operating company’s taxable income so as to eliminate all operator taxable income. However, since all such transfer pricing mechanisms have a "margin of error," paired share formats can reduce tax burdens. If this margin of error is only 10 percent, the tax advantage is substantial. Assume a property value of \$1,000 with a true market rent of 10 percent (\$100). If the paired share REIT leases the property at an 11 percent rental rate (\$110), a 10 percent rental margin of error exists in the transfer pricing. This yields an annual tax savings of \$3.6 (at 36 percent tax rate), for a present value of roughly \$36 per \$1000 (at a 10 percent perpetuity rate), or 3.6

percent. Such a tax advantage provides a substantial competitive advantage for paired share REITs.

The paired share structure has the greatest potential advantage for properties such as hotels, nursing homes, and health care facilities, which require significant daily management in order to generate value. It can also be beneficial when there are substantial non-qualifying income opportunities. Since there are only a handful of grandfathered true paired share REITs, a number of REITs are pursuing strategic pairings in which the shares of an affiliated operating company can trade separately from those of the REIT. The so called *paper-clip REIT* was created by Crescent Properties. The paper-clip REIT offers the same operating advantages as the true paired share, however, because the shares of the operating company and the REIT do not necessarily trade together a conflict exists between the two entities. For example, if an investor purchases a significant minority stake in the operating company, but not the REIT, he will not benefit from the high lease rates paid to the REIT. A hostile investor can threaten to sue management for violating their fiduciary responsibility to the operating company by agreeing to excessive leases with the REIT. The potential of such greenmail limits the transfer pricing margin of error for paper-clip REITs relative to paired share REITs.

New REITs

The Kimco and Taubman IPOs inaugurated a new era in the real estate industry. Investors recognized that self-advising and self-management reduced conflicts of interest. Private developer-operators tapped into the public equity market to refinance their heavy debt loads, and to provide capital for growth. Since Kimco, several older REITs (such as Starwood and Security Capital) were purchased by entrepreneurs and transformed into new style REITs. In evaluating the differences between old and new REITs we define new REITs as REITs that have converted to self-advised/self-managed status or gone public as self-advised/self-managed REITs after November, 1991 (the date of the Kimco IPO)

The National Association of Real Estate Investment Trusts (NAREIT) reports that between 1971 and October 1997, the number of equity REITs grew from 12 with a total equity market capitalization of \$332 million, to 174 with an equity market cap of \$134 billion (Table 1). At the end of 1992 there were only 89 equity REITs in operation with a total equity capitalization of \$5.6 billion. Between 1992 and 1993, 46 firms, led by many prominent private real estate companies, became REITs. In 1994, an additional 40 new REITs were created, with an average initial equity capitalization of \$403 million. Rather

than resulting from significant share price appreciation, the phenomenal rate of growth reflected the shift of real estate assets from private to public ownership, both via IPOs and subsequent consolidating acquisitions.

Table 1
Growth in Equity REIT Market Capitalization

Year	Equity REITs	Market Cap (\$ mil)	Operating Units (\$ mil)
1971	12	\$332	-
1972	17	\$337	-
1973	20	\$336	-
1974	19	\$242	-
1975	23	\$276	-
1976	27	\$410	-
1977	32	\$538	-
1978	33	\$576	-
1979	32	\$744	-
1980	35	\$842	-
1981	36	\$976	-
1982	30	\$1071	-
1983	26	\$1783	-
1984	25	\$2286	-
1985	37	\$3314	-
1986	45	\$4390	-
1987	53	\$4759	-
1988	56	\$6142	-
1989	56	\$6770	-
1990	58	\$5552	-
1991	86	\$8786	-
1992	89	\$11009	-

1993	135	\$26082	-
1994	175	\$38812	\$7270
1995	178	\$49913	\$8210
1996	166	\$78302	\$11710
1997	176	\$127825	\$15269

Note: Value of operating units not available prior to 1994. 1997 is as of October.

After the collapse of commercial real estate prices in the early 1990s, commercial banks and life insurance companies were under great pressure to reduce their lending exposure to real estate. This happened just as the massive amounts of loans made to private owner-developers in the 1980s were coming due. To survive--and grow-- these owner-developers required capital to repay their maturing debt. Without debt availability, and absent borrowing capacity, they had little choice but to execute massive debt-for-equity swaps via IPOs. This balance sheet restructuring provided them with renewed access to capital markets, allowing them to opportunistically purchase properties from banks and their less nimble competitors.

Empirical evidence suggests that internally-advised REITs enjoy a substantial market valuation premium relative to externally-advised REITs. For example, in “Debt, Agency and Management Contracts in REITs: The External Advisor Puzzle,” a forthcoming study to be published in the *Journal of Real*

Estate Finance and Economics, Dennis R. Capozza and Paul J. Seguin study REIT performance between 1985 and 1992. They document that externally-advised REITs under-performed internally-advised REITs by over 7 percent per year. Their analysis indicates that this performance differential resulted from inefficient use of debt on the part of externally-advised REITs.

Examining the most recent period, we find a similar, albeit smaller, advantage to internally-advised REITs. Using prices from November 10, 1998, Table 2 shows the weighted average 1-month, 3-month, and 1-year total returns for internally-advised and externally-advised REITs, weighted by equity market capitalization. Consistent with the hypothesis that internally-advised REITs are superior structures, we find that internally-advised REITs continue to outperform externally-advised REITs. Our results show that over the past year, despite a significant market downturn, the total returns of internally-advised REITs were 164 basis points higher than those of externally-advised REITs. In another study (“Organizational Structure and REIT Operating Characteristics”), we examined the relative performance of externally-advised and internally-advised REITs over the period from 1990 to 1996 and found that externally-advised REITs have adapted their operating characteristics to match the performance standards set by the newer, internally advised REITs. In particular, this research shows that externally-advised REIT leverage ratios

have declined significantly in response to their poor performance record relative to internally-advised REITs, just as was documented by Capozza and Segiun for the earlier time period.

Table 2: REIT Total Returns (as of 11/10/98)			
	Internally- Advised	Externally -Advised	Difference
1-Month	10.07	9.45	0.62
3-Month	-1.91	-3.09	1.18
1-Year	-7.82	-9.47	1.64
Source: SNL REIT Datasource			

In an earlier article (“Forces Changing the Real Estate Industry Forever,” *Wharton Real Estate Review*, Spring 1997) Linneman hypothesized that larger REITs enjoy significant advantages over smaller REITs with respect to economies of scale in revenues and expenses, and that these scale economies are translated into lower capital costs. Anthony Downs (“The Pressures on Public REITs to Grow Larger”, *Wharton Real Estate Review*, Fall 1997) observed that as public companies, REITs have built-in incentives to continue to expand and that during periods of rapid stock price appreciation continued consolidation is likely. Linneman also noted that larger REITs may be in a position to capitalize on scale economies with respect to financing, property

management and portfolio management. Samuel Zell (“Liquid Real Estate,” *Wharton Real Estate Review*, Fall 1997) also speculated that consolidation in the property markets resulting from these scale economies and the increased public accountability resulting from the switch to internally-advised management will, in turn, lower capital costs making further consolidation inevitable.

We find that scale economies do exist. Our study finds that every billion dollar increase in market capitalization translates into a 2.2 percent reduction in capital costs. At the same time, REIT rental income as a percent of total revenues and REIT profit margins (NOI / Revenues) increases with firm size. Furthermore, during the dramatic growth period in REIT capital market valuations (1993 to 1996), internally-advised REITs enjoyed higher rental ratios, lower payout ratios, and lower costs of capital. The rapid growth in REIT capital market valuations during the 1990s has created a substantial difference the relative size of internally and externally advised REITs. Differences in market capitalization at the time of writing (December 1998) reveal that internally-advised REITs currently an average market capitalization roughly 2.5 times as large as externally-advised REITs (\$953 million versus \$376 million). Not surprisingly, this same differential is reflected in the average value of total assets (\$1.2 billion versus \$437 million). Thus, the

combined advantages of size and the internally-advised structure suggest that further consolidation among REITs will occur leading to the domination of the new, internally-advised REITs.

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[Author's bios] See Ambrose-Grigsby article

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