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WHERE WALL STREET MEETS REAL ESTATE

BY MARK G. DOTZOUR

Fortunes of the real estate investment trust (REIT) industry have changed dramatically in the past three years. Access to capital used to be easy. Raising new cash to acquire properties was as simple as issuing an initial public offering or making a secondary stock offering. Stock prices were high, returns were high and optimism for the long-term outlook for REITs was high as well. It appeared to be only a matter of time before Wall Street would become the landlord of commercial real estate.

Three short years later, the outlook is decidedly different. In 1998 and 1999, while the stock market posted dramatic gains, REITs produced negative returns. As a result, investors worldwide moved funds into other industries in which future growth prospects are perceived to be higher. REIT prices have fallen dramatically, and investor interest is low.

What is the future of the REIT industry? Should REITs get bigger through merger and consolidation? Should they invest in foreign real estate markets? Should they buy back their shares at bargain prices? Or should they just turn a cold shoulder to Wall Street and take their companies private? Answers to these and other questions were discussed at a recent symposium sponsored by New York University.

Do REITs have the management talent needed to run a publicly traded company?

Many REITs were formed by real estate "deal makers" whose strengths were purchasing properties. These skills may not be useful in managing public corporations. Professional REIT managers often are not compensated at the levels of public company managers in other industries.

REIT stock prices are not volatile enough to make stock options attractive. With low returns, low compensation, low investor interest and no consolidation occurring, "management fatigue" has become an issue. Some REIT executives are disillusioned because they have seen private developers make a lot of money.

Should REITs get larger through mergers and acquisition of other REITs?

REITs are currently priced at less than their net asset value, an estimate of the underlying value of the equity of the company's real estate. If these companies are priced less than the value of their real estate holdings, would it not make sense for the strongest REITs to acquire the shares of their weaker competitors?

According to symposium panelists, recent history has shown that when REITs acquire other REITs, their stock price underperforms the rest of the industry. In effect, the financial benefits of the mergers have been captured by the company acquired at the expense of the surviving company's existing shareholders

Consequently, there is little incentive for REIT stockholders to grow their companies by buying other REITs.

Another deciding factor is that real estate investment and management requires local expertise in markets where properties are owned. According to John Moody, president of Cornerstone Properties, a company must have sufficient property in a market to justify employing good people on the ground locally.

There appear to be few economies of scale for REITs. Real estate is largely a local market, and there often is an “educational tax” to be paid when REITs acquire a portfolio of properties located in areas where they are not currently invested. One panelist reported that in the last ten transactions involving REITs buying REITs (consolidation of companies), all have underperformed the REIT market as a whole. Without exception, mergers work against the acquiring firms. The total value went to the seller, not the buyer. This will have a chilling effect on future attempts to consolidate within the industry. Hostile takeovers have not occurred because REITs do not allow high ownership concentration and because of “poison pill” provisions in executive compensation packages.

Because REIT stocks are priced less than the value of their real estate, should the company buy its shares back?

Panelists suggested there is no evidence that stock buybacks have influenced share price. In fact, buybacks have caused more problems by reducing liquidity in the REIT market and using valuable capital that may be needed to acquire properties in the future.

Are public-private partnerships attractive to REITs?

REITs will partner with private companies of local developers who have land, expertise or both in a market if the REIT does not have the “critical mass” of management talent in that locale. Joint ventures with private developers are essential for REITs to raise capital in the current market. However, if too much of the REIT balance sheet gets tied up in complex joint venture relationships, the stock market may respond negatively because of the difficulty of analyzing such an entity.

Will REITs sell off their ‘trophy properties’?

In the current market climate, it is difficult for REITs to raise additional capital to purchase or develop new properties for their portfolio, so some may consider selling trophy properties to gain fresh capital for new acquisitions.

Should REITs be taken private and properties they hold be liquidated?

Because the stock market appears to value REITs at a fraction of the value of the properties in their portfolios, another management alternative would be to sell off the properties and liquidate the company. But this could take several years, and transaction costs and tax implications are significant.

Founders of REITs and other stockholders who contribute property to the REIT may have tax problems when they sell their shares, thus dampening their enthusiasm for taking the company private. If principals own companies that provide services to the REIT, they may want the purchase to include the related company as well. REIT leveraged buyouts are usually originated by principals and officers who feel they are not being compensated for their efforts.

Should REITs invest in foreign real estate markets?

The consensus of the experts was that foreign markets are not attractive compared to the current U.S. market. Western Europe and Australia were mentioned as markets that offer sufficient data to permit informed decisions about real estate investment.

“Real estate is a local asset and must be understood locally,” said Charles Lowrey, managing director of J.P. Morgan. Because of this, the skills needed to get tenants for office and retail in the United States may not be transferable to Europe. Most “global” real estate companies are staffed by local experts, not U.S. expatriates.

Liquidity is another issue of concern for foreign real estate investment. Panelists suggested that foreign market liquidity is thin outside of Western Europe and Australia.

Transaction costs of buying and selling property in foreign countries must be considered. Transfer taxes on real estate transactions can significantly reduce the gain realized on successful real estate deals. The U.S. appetite for foreign investment may be tepid because of the low rate of return offered on real estate investments in Europe. The lack of discussion about Asian markets at the symposium spoke volumes about perceptions of current investment opportunities there.

What future investment strategies might REITs adopt?

Steven Roth, CEO of Vornado, the largest landlord in New York City by a factor of two, suggested that REITs could adopt the following investment strategy to achieve higher performance from real estate acquisitions in the current cycle of the real estate market.

- Buy properties for less than replacement cost.
- Buy properties that are presently leased for less than current market rents.
- Go into the “redevelopment business,” and re-use existing underused properties.
- Invest in locations where real estate is a scarce commodity, such as New York City and San Francisco.
- Buy B+ office and shopping centers.
- Never buy trophy properties because they have limited potential for appreciation in price.

Roth also discussed demographic trends that will influence real estate markets. He predicted a rebirth of the “great cities” at the expense of smaller ones. Population will grow faster in these cities, he said, because low unemployment will stimulate immigration, and immigrants flock to large cities, such as New York, San Francisco and Chicago.

Dr. Dotzour is chief economist with the Real Estate Center at Texas A&M University.

LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

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