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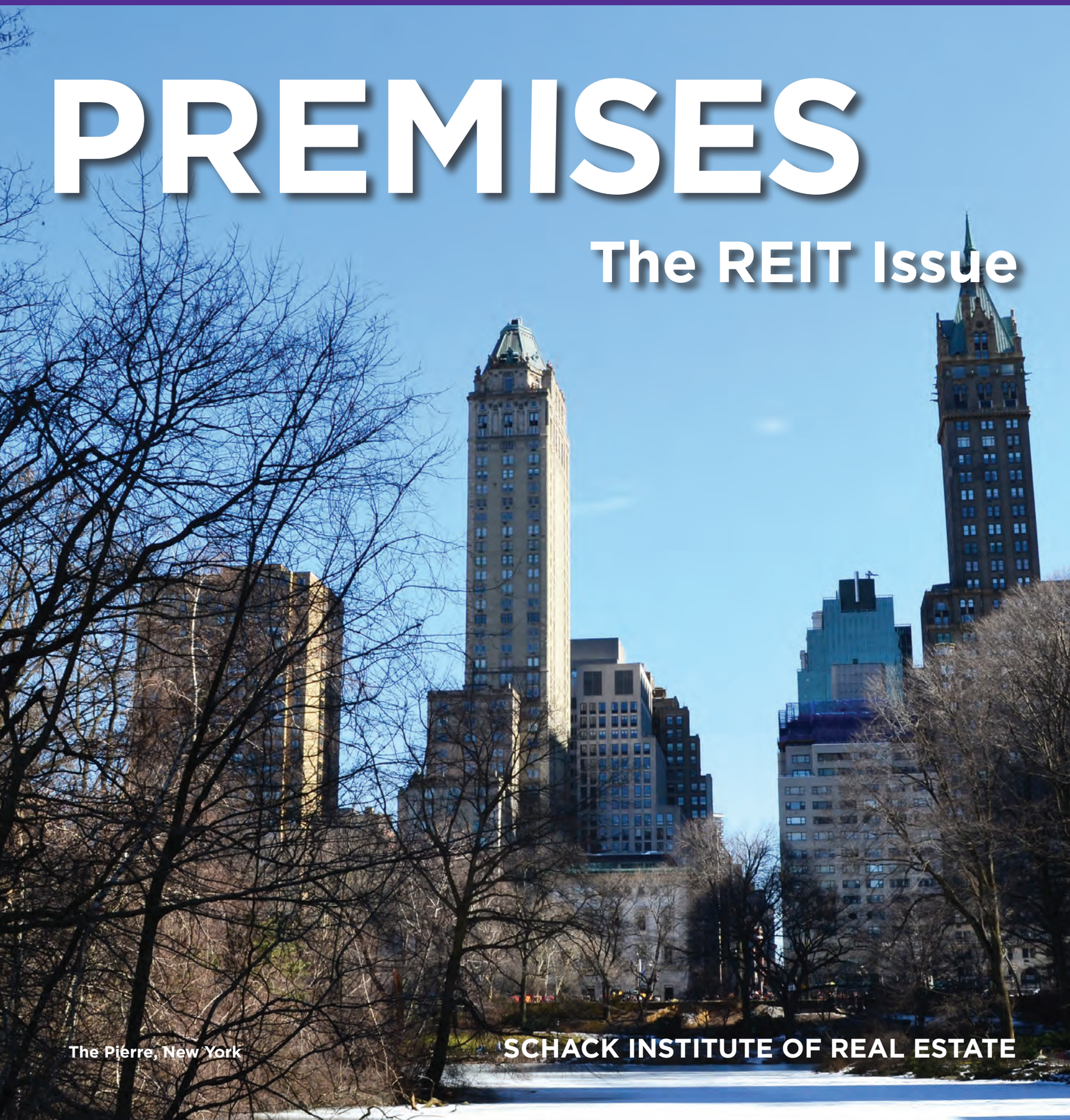
# PREMISES

## The REIT Issue



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SCHACK INSTITUTE OF REAL ESTATE

# ONLY DEATH, TAXES AND REITS ARE INEVITABLE

*By Adam O. Emmerich and Robin Panovka*[1]

One of the themes for NYU's 20th Anniversary REIT Symposium is that *"Only death, taxes, and REITs are inevitable."* We meant this only partly in jest. In light of the many advantages of the REIT structure, the dramatic growth of REITs over the last 20 years *was* inevitable. And looking forward, substantial continuing growth seems equally inevitable, not just in the sectors where REITs have been active so far, but also in new sectors and new markets.

Since the first NYU REIT Conference back in 1995, the "REIT Revolution" has transformed the commercial real estate industry. REITs now own a substantial portion of the institutional-grade real estate in the United States and several other markets, and are a major force in all sectors of the real estate industry. Back in 1995, REITs were more of a curiosity. The total enterprise value of all U.S. REITs was under $50 billion, there were just six REITs with a market capitalization of more than than $1 billion, and none over $2 billion.[2] Only 25 people showed up at the first NYU REIT Symposium, and no one was particularly surprised or discouraged by the turnout.

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## The Last 20 Years

Fast-forward to our 20th annual conference. Attendance has increased from 25 to more than 700 participants, underscoring the dramatic trajectory in the industry. Today, REITs own approximately $1 trillion of commercial real estate assets.[3] There are 147 public-equity REITs with a value over $1 billion, 42 over $5 billion, and more than 20 REITs over $10 billion.[4] Twenty-one REITs are now included in the S&P 500.[5]

Progress has been swift outside the U.S. as well. REIT (or REIT-like) regimes exist in 37 countries,[6] a particularly impressive expansion given that the U.S. stood largely alone

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[2] NAREIT (data as of December 1, 1995).

[3] REIT.com, "Industry Data" (https://www.reit.com/investing/industry-data-research/industry-data) (as of December 31, 2014). Data includes both stock-exchange listed and non-listed REITs.

[4] NAREIT (data as of December 31, 2014).

[5] REIT.com "REITs in S&P Indexes" (https://www.reit.com/investing/investing-tools/reits-sp-indexes).

[6] European Public Real Estate Association (EPRA) (as of September 2014). EPRA also notes that two additional countries not included in this total are developing REIT or REIT-like legislation.

While the REIT universe in 1995 was largely confined to conventional commercial properties, REITs today extend across an array of nontraditional sectors, including telecommunications, timber, data storage, outdoor advertising, and gaming.

in 1995.[7] International REITs haven't grown at quite the pace of U.S. REITS, but have enjoyed their own run of success, with European and Asian REITs now having aggregate market capitalizations well north of $150 billion each.[8]

While the REIT universe in 1995 was largely confined to conventional commercial properties, REITs today extend across an array of nontraditional sectors, including telecommunications, timber, data storage, outdoor advertising, and gaming. Healthcare, self-storage, and technology-driven REITs today represent four of the 10 biggest REITs.[9] REIT governance has also come a long way and is now generally viewed as being on par with other public companies. Executive compensation at REITs is also consistent with the rest of corporate America.[10]

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The benefits of the REIT structure – liquidity, transparency, governance, and superior access to capital chief among them — proved themselves in the 2008 financial crisis and its aftermath. Unlike their private peers, REITs suffered very few fatalities in the crisis, quickly recapitalized and de-levered, and then took advantage of opportunities to acquire cheap assets and grow. While REITs may have been somewhat over-levered in advance of the financial crisis, the governors built into the REIT markets ensured that debt levels remained well below the private markets,[11] and when equity values dropped, the capital markets barely flinched before stepping in to recapitalize. All told, REITs were battle-tested in the financial crisis and, despite some handwringing and share-price volatility, emerged stronger than ever, having learned lessons that will make them better prepared to handle the next downturn.

## The Next 20 Years

So what lies ahead? In a word: growth. Now that REITs have matured through two recessions and the associated real estate cycles and have demonstrated their resiliency, continued migration of assets into public REITs and consolidation among REITs and other real estate companies seems very likely. While REITs have clearly covered substantial ground already, they still own only an estimated 15 percent of the commercial real estate in the U.S. and a much smaller percentage globally.[12] The

[7] Australia instituted a REIT-like regime in 1985 and the Netherlands established one in 1969. By 1995, other countries like Belgium, Turkey, Brazil, and Canada were starting to establish their own REIT-like structures.

[8] Based on overall market capitalization for the FTSE EPRA/NAREIT Europe Index and Asia Pacific Index (as of December 31, 2014).

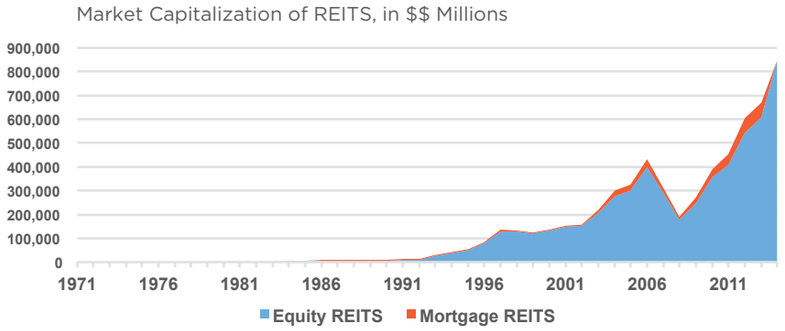
[9] Based on market capitalization at the end of 2014.

[10] Green Street Advisors, "Executive Compensation and Corporate Governance" (June 23, 2014).

[11] Stock-exchange listed REITs at the start of 2007 had a mean leverage ratio of 38.2 percent. Sun, L., Titman, S. D. and Twite, G. J. (2014), "REIT and Commercial Real Estate Returns: A Postmortem of the Financial Crisis," Real Estate Economics.

[12] REIT.com, "REITs and Conversions" (https://www.reit.com/investing/reit-basics/reits-and-conversions).

## Since the Bottom of the Financial Crisis, Publicly Traded REITS Have Tripled Their Market Cap




Source: www.reit.com

commercial real estate market is vast, estimated at roughly $7 trillion in the U.S.,[13] as compared to $25 trillion for all U.S. publicly traded equities.[14]

Since the majority of real estate assets are still held in the highly fragmented private market, there is a continuing opportunity to build value by moving assets into the more liquid, transparent REIT sector. This is not to say that all commercial real estate will be consolidated into a handful of public mega-REITs in short order. The private markets, including private equity firms, will continue to play a significant role, particularly in less stable asset classes, development, or distress situations. And when REIT valuations are lower than private values or abundant cheap debt is available for leveraged buyouts, waves of privatizations will no doubt occur, similar to the nearly $80 billion in privatizations between 2004 and early 2007 that helped build the real estate bubble.[15] Indeed, arbitrage opportunities between public REITs and the private real estate markets are likely to continue to generate substantial transactional activity in both directions. But on the whole, the gravitational pull generated by REITs' incomparable liquidity and lower cost of capital will pull in more and more assets, particularly the stabilized institutional-grade assets that fit so well in the REIT solution.

In addition to the conventional assets that have historically populated most REITs, nontraditional real estate assets are also likely to contribute to the sector's growth. Just in the last few years, the market capitalization of nontraditional REITs has almost quadrupled — from $40 billion in 2011 to $152 billion in 2014.[16] There is, of course, risk of an IRS clampdown on some of the expanding definitions of real estate. We saw rumblings in that direction last year. However, as long as true real estate is involved, we do not foresee major stumbling blocks. The IRS' proposed clarification of the real property definition in the REIT rules may even encourage further REIT conversions now that there is increased certainty around which assets qualify for REIT status.

One of the other sources of potential REIT growth may be corporate real estate: the office buildings, plants, stores, warehouses, data centers, transportation hubs, healthcare facilities, and other properties owned by non-REIT public companies. Since these real estate assets are sometimes trapped within corporations, they may not be fully valued by the markets. As the technology for unlocking this value develops, it may make sense for corporations to consider REIT spin-offs (which can now be accomplished on a tax-free basis) in addition to sale-leasebacks, asset-

SINCE THE MAJORITY OF REAL ESTATE ASSETS ARE STILL HELD IN THE HIGHLY FRAGMENTED PRIVATE MARKET, THERE IS A CONTINUING OPPORTUNITY TO BUILD VALUE BY MOVING ASSETS INTO THE MORE LIQUID, TRANSPARENT REIT SECTOR.

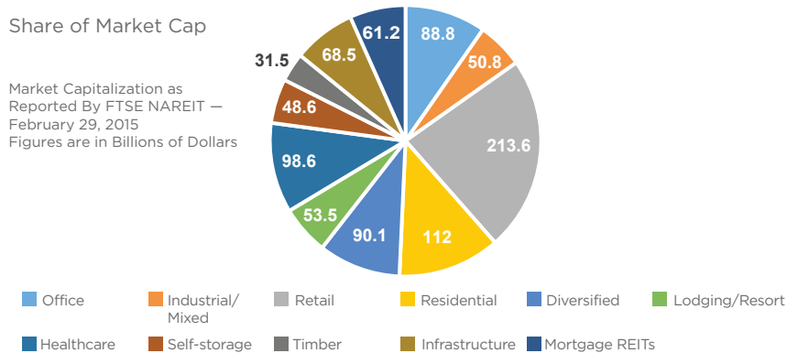
[13] Lazard Asset Management, "Understanding Real Estate's Value Proposition" (June 25, 2014).

[14] Dow Jones estimated market capitalization of U.S stock equities (February 28, 2015).

[15] "Privatization Wave Hits REITs," National Real Estate Investor (Feb. 1 2007), (http://nreionline.com/mag/privatization-wave-hits-reits).

[16] Ernst & Young: "Global Perspectives: 2014 REIT Report."

**Major "Food Groups" Account for About One-Half of REIT Market Cap — Industry Is Spreading Its Influences Widely in 2015**




based financing, and other mechanisms to maximize real estate value. Of course, there are both advantages and disadvantages to these kinds of transactions. They tend to be complex and time consuming and may not make sense in every situation. But as long as REIT valuation multiples remain robust compared to their corporate counterparts, transactions that unlock value by monetizing illiquid assets will continue to be a topic of discussion, especially since activist investors continue to suggest these techniques at an increasing array of targeted companies.

Another potential source of growth is globalization. Admittedly, however, with the exception of a few companies, talk of globalization has thus far generated far more smoke than fire. But this may be about to change. Interest by U.S. REITs in non-U.S. acquisitions is accelerating across several property sectors, fueled by high prices in the U.S. and perceived superior growth prospects abroad. Going the other way, despite the recent appreciation in American commercial real estate values, U.S. property remains attractive to international investors (such as sovereign wealth funds) seeking stable (albeit low) returns. At the same time, the growth of REITs in Europe and Asia raises the prospect of cross-border combinations, and with the increasing globalization of the capital markets truly multinational REITs may not be far away. Of course, frictional costs, cross-border tax leakage, and various

Avalon Ossining, courtesy of AvalonBay Communities, Inc.

complexities must be factored in and may slow the trend, along with market pressures for REITs to maintain focus on their core areas of expertise domestically.

Like private equity funds, non-traded REITs have proven to be useful incubators for public REITs and both may fuel future growth in the REIT space. In 2013 and 2014, the market saw roughly $35 billion and $20 billion of non-traded REIT liquidity events, which generally occurred through public listings or mergers into existing REITs. Longer term, it is unclear whether non-traded REITs will turn out to have been just a post-financial-crisis, low-interest-rate phenomenon or are here to stay. Tellingly, non-traded REIT fundraising was down roughly 20 percent in 2014 compared to the previous year, spurred in part by difficulties at leading non-traded platforms.

While, in general, larger, stronger REITs can be expected to acquire smaller REITs, there is also a trend for larger REITs to spin off or dispose of parts of their businesses. It sometimes makes sense for larger REITs to refocus on their core businesses or regions or on specific asset classes, or quality of assets, and REIT managers may decide to separate disparate business lines or reduce risk or leverage. The gravitational pull of larger REITs on smaller ones, combined with market pressure to spin out non-core or differentiated businesses, will likely continue to generate a dynamic market for corporate control.

As always, there are wildcards that could quickly change things. In the shorter term, an increase in interest rates would have a major impact. Longer term, tax law changes may target REITs or upend the landscape for corporate taxation more generally, complicating the conversion strategies of nontraditional real estate companies. And the impact of the Internet, e-commerce and other disruptive technologies could also have significant implications in retail and other sectors. It is too soon to tell exactly when and where change will come, but the impact on many property types is already clearly evident and we suspect still at an early stage. However, developing technology may also help REITs operate more efficiently as new tools help REITs manage their assets more effectively and improve their cost structures, and, enhance efficiency and business models. Technology may also boost some of the newer REIT sectors, like cell towers and data centers.

On the whole, the drivers of the REIT Revolution of the last 20 years continue to be very powerful and to point to more growth. To employ a nautical metaphor, REITs have the wind at their backs, with mostly fair skies ahead. The growth and maturity demonstrated since the first NYU REIT Symposium position REITs for further dramatic growth over the next 20 years and deepen their capability to weather future emerging economic fluctuations. ■

[17] Robert A. Stanger & Co.

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At Right: Housing development in Orange County, California.