# U.S. REITs

## Where they have been, where they are, where they may go next

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Ettore Santucci
Goodwin Procter LLP

GOODWIN

# The REIT Quadrant of the Real Estate Capital Markets

| | Debt | Equity |
|---|---|---|
| **Private** | Conventional Mortgages | Private Owners, Opportunity Funds, Club Deals and Private Syndications |
| **Public** | Bonds, CMBS, Mortgage REITs | **Equity REITs (listed and unlisted)** |

# Evolution of the U.S. REIT Structure

- Until 1990 the REIT market was tiny, despite the existence of REIT legislation since 1960
- Significant catalysts:
  - The Tax Reform Act of 1986 -- liberalized the U.S. REIT regime, permitted REITs to be internally managed and broadened permissible activities
  - debt crisis of the early 1990's -- formation of The Resolution Trust Corporation (1989-1995) meant massive amount of assets needed to be recapitalized urgently
- Wall Street (and REIT legal counsel) came to the rescue with access to the public equity capital markets:
  - creation of the first public UPREIT structure in 1992 (Taubman Centers, Inc. IPO)
  - UPREIT squared the circle by enabling tax efficient (i.e. deferral of built-in gain) migration of assets from private institutional ownership in public listed REITs
  - vast majority of publicity traded U.S. REITs are listed on the NYSE and internally managed (except mortgage REITs which are predominantly externally advised)
- 1992-2003:
  - through many REIT IPOs and follow-on access to the public equity markets REITs rolled up the best portfolios of assets across property sectors
  - the forces of <u>corporatization</u>, <u>securitization</u> and <u>consolidation</u> then took hold and reshaped the real estate industry in the U.S.

# Evolution of the U.S. REIT Structure (cont'd)

- 2003-2007:
  - dramatic increase in volatility of REIT stocks:
    - » cap rate compression
    - » wave of privatization transactions
    - » reduction in number of listed REITs
- Starting in early 2000's an alternative to listed REITs emerged:
  - publicly held, but not listed on an exchange, thus not traded on Wall Street (NTRs)
  - SEC-registered as a "normal" U.S. reporting company, not as a mutual fund
  - externally advised by multi-REIT sponsors
  - sold to retail investors through large networks of commissioned brokers
  - finite life vehicle (7-9 years' life), resulting in obsession with "quick exits" to recycle investors' capital into the next NTR
  - priced at a fixed $10 per share for the duration of the offering (2-3 yrs)
  - high front-end loads, dividend yield often in excess of cash from operations, high ongoing fees to sponsor/advisor

# Evolution of the U.S. REIT Structure (cont'd)

- no NAV transparency, poor governance, opaque disclosure practices
- illiquid (only limited, penalizing redemption not an NAV)

- NTRs raised very significant amounts of capital between the mid-200's and 2014 (which they deployed principally into "core" real estate like single-tenant, NNN lease assets), but were widely criticized for high costs and poor performance

# Evolution of the U.S. REIT Structure (cont'd)

- Starting in mid-2000's a new generation of non-traded REITs was introduced to the market as an alternative to NTRs:
  - externally advised by established capital management platforms
  - open-ended with indefinite life – unlimited and continuous offering of shares
  - NAV-priced (daily NAV) from the outset through rigorous valuation protocols
  - multi-channel distribution:
    - broker-dealer networks (with front-loaded commissions)
    - wealth-management platforms (with low or no front-end load, trailing commissions)
    - Independent financial advisors
  - simpler, lower all-in fees
  - robust liquidity mechanism -- redemption program at NAV funded with:
    - proceeds from sale of new shares
    - "liquid sleeve" of mortgage-backed securities, traded REIT shares, cash-equivalents
    - If necessary, orderly dispositions of real estate assets
  - scale and unlimited duration enable lower volatility of NAV and minimize the need to dispose of assets under pressure or at the wrong point in the cycle

# Evolution of the U.S. REIT Structure (cont'd)

- After the Great Recession the U.S. REIT industry evolved in 3 directions:
  - listed REITs across property sectors consolidated into fewer, larger "index REITs:"
    - advantages of scale
    - greater liquidity
    - tighter pricing spreads for equity and debt capital in market offerings,
    - deep management teams with access to the best portfolios, capacity to undertake large/complex development projects
  - traditional NTRs ran into reputational and structural problems
    - capital raising plummeted
    - many NTRs were able to complete "exits" at valuations from fair to poor…
    - … but many remain "stuck"
  - the open-ended, NAV-priced non-traded model matured:
    - significant amounts of capital raised through multiple channels
    - Blackstone Real Estate Income Trust, though late on the scene, "***the***" REIT phenomenon of 2016 and growing rapidly
    - many other established sponsors looking to launch

# Listed U.S. REITs Today

- As of year-end 2016:
  - well over 300 sizeable publicly-held REITs registered with the SEC
  - vast majority (224) traded on the NYSE
  - 32 REITs in the S&P 500
  - over $1 trillion of combined equity market capitalization
- Listed REITs cover
  - all major property sectors
  - increasingly alternative assets such as cell towers and infrastructure – if permissible for the REIT vehicle under tax rules
  - all major geographic regions in the U.S. and increasingly assets outside the U.S.
  - Increasing organizational complexity below the UPREIT level is increasing
    - downREITs
    - programmatic JVs with sovereign wealth funds
    - discretionary funds with institutional investors

# Equity Market Capitalization of Listed U.S. REITs

| | All REITs | | Equity | | Mortgage | | Hybrid | |
|---|---|---|---|---|---|---|---|---|
| End of Year | # of REITs | Market Capitalization | # of REITs | Market Capitalization | # of REITs | Market Capitalization | # of REITs | Market Capitalization |
| 1992 | 142 | 15,912.0 | 89 | 11,171.1 | 30 | 2,772.8 | 23 | 1,968.1 |
| 1993 | 189 | 32,158.7 | 135 | 26,081.9 | 32 | 3,398.5 | 22 | 2,678.2 |
| 1994 | 226 | 44,306.0 | 175 | 38,812.0 | 29 | 2,502.7 | 22 | 2,991.3 |
| 1995 | 219 | 57,541.3 | 178 | 49,913.0 | 24 | 3,395.4 | 17 | 4,232.9 |
| 1996 | 199 | 88,776.3 | 166 | 78,302.0 | 20 | 4,778.6 | 13 | 5,695.8 |
| 1997 | 211 | 140,533.8 | 176 | 127,825.3 | 26 | 7,370.3 | 9 | 5,338.2 |
| 1998 | 210 | 138,301.4 | 173 | 126,904.5 | 28 | 6,480.7 | 9 | 4,916.2 |
| 1999 | 203 | 124,261.9 | 167 | 118,232.7 | 26 | 4,441.7 | 10 | 1,587.5 |
| 2000 | 189 | 138,715.4 | 158 | 134,431.0 | 22 | 1,632.0 | 9 | 2,652.4 |
| 2001 | 182 | 154,898.6 | 151 | 147,092.1 | 22 | 3,990.5 | 9 | 3,816.0 |
| 2002 | 176 | 161,937.3 | 149 | 151,271.5 | 20 | 7,146.4 | 7 | 3,519.4 |
| 2003 | 171 | 224,211.9 | 144 | 204,800.4 | 20 | 14,186.5 | 7 | 5,225.0 |
| 2004 | 193 | 307,894.7 | 153 | 275,291.0 | 33 | 25,964.3 | 7 | 6,639.4 |
| 2005 | 197 | 330,691.3 | 152 | 301,491.0 | 37 | 23,393.7 | 8 | 5,806.6 |
| 2006 | 183 | 438,071.1 | 138 | 400,741.4 | 38 | 29,195.3 | 7 | 8,134.3 |
| 2007 | 152 | 312,009.0 | 118 | 288,694.6 | 29 | 19,054.1 | 5 | 4,260.3 |
| 2008 | 136 | 191,651.0 | 113 | 176,237.7 | 20 | 14,280.5 | 3 | 1,132.9 |
| 2009 | 142 | 271,199.2 | 115 | 248,355.2 | 23 | 22,103.2 | 4 | 740.8 |
| 2010 | 153 | 389,295.4 | 126 | 358,908.2 | 27 | 30,387.2 | -- | -- |
| 2011 | 160 | 450,500.6 | 130 | 407,528.9 | 30 | 42,971.7 | -- | -- |
| 2012 | 172 | 603,415.3 | 139 | 544,414.9 | 33 | 59,000.3 | -- | -- |
| 2013 | 202 | 670,334.1 | 161 | 608,276.6 | 41 | 62,057.4 | -- | -- |
| 2014 | 216 | 907,425.5 | 177 | 846,410.3 | 39 | 61,017.2 | -- | -- |
| 2015 | 233 | 938,852.0 | 182 | 886,487.5 | 41 | 52,364.6 | -- | -- |
| 2016 | 224 | 1,018,729.9 | 184 | 960,192.8 | 40 | 58,537.1 | -- | -- |

Source: NAREIT®

# Drivers of Structuring Innovation

- All REITs:
  - shares represent tax efficient ownership in diversified portfolio of illiquid assets
  - relatively low leverage
  - attractive dividend yields with range of total return objectives
- Listed REITS:
  - maximum liquidity via market-cleared trading
  - relatively high volatility
  - easiest/cheapest access to equity and debt capital markets
- Open-ended, NAV-priced non-traded REITs;
  - close correlation of NAV to underlying asset values
  - liquidity via redemption subject to “flow-regulator” devices
  - “run on the bank” risk if inflows stop and outflows grow

# Drivers of Structuring Innovation (cont.)

- Traditional NTRs;
  - obsolete
  - doomed by combination of volatility, illiquidity, high costs

# Where may U.S. REITs be Heading?

- Listed REITs:
  - best suited for complex, active asset management strategies
  - can exploit development yield differential
  - increasingly “pure play” focus
  - wholesale-to-retail strategies: capture spreads between private market valuations and public market valuations
  - internal management enables “enterprise model” (as contrasted to “fund model”):
    - full alignment with shareholders
    - cohesion, no potential conflicts
    - operational leverage
    - “best-in-class” corporate governance

# Where may U.S. REITs be Heading? (cont.)

- scale enables access to all quadrants of the capital markets for equity and debt, lowering WACC
- trading means ease of investment/divestment, low transaction costs for investors
- transparency -- reporting and ability to monitor/compare performance among peers
- sell-side and buy-side analysts act as watchdogs
- fanning out of FFO multiples creates “have’s” and “have-not’s” -- fuel for consolidating the best assets in the hands of the best management teams through friendly and unfriendly M&A (including activist pressure)

# Where may U.S. REITs be Heading? (cont.)

- Open-ended, NAV-priced non-traded REITS:
  - best suited for wealth management (target-date/target-return) strategies
  - lower volatility/greater correlation with institutional real estate asset class
  - stable income and attractive total return
  - “fund model” makes both external and internal management possible
  - multi-class share structure allows for bespoke blend of:
    - distribution costs tailored to specific channels
    - management fees
    - liquidity features and limits

# Where may U.S. REITs be Heading? (cont.)

- cost of “on-demand” liquidity could be allocated to investors who need it
- indefinite life:
  - drives scale
  - lowers cycle-dependency
  - enables assembly of optimal portfolios to suit a variety of investment strategies
- a listed share class could be added to offer a market-cleared liquidity option in the alternative to redemption at NAV