THE WASHINGTON REIT STRATEGY: FINANCING, INVESTMENT AND MANAGEMENT*

A Case Study

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*We caution the reader that this research is the authors' interpretation of WRIT's strategy and does not necessarily reflect the opinions of WRIT executives or staff.

Of the 245 REITs identified by the National Association of Real Estate Investment Trusts (NAREIT) for the 20-year period 1972 to 1991, only 16 existed for the entire time.[1] The average exchange listed real estate investment trust (REIT) existed for less than ten years and the portfolio of REITs had a 20-year annual compound return of 8.59%; equity REITs had an annual compound return of 9.55%. By contrast, the Washington REIT (WRIT) had an annual compound rate of return of 16.04%. Why the difference? Why has the WRIT consistently outperformed other REITs? Frank Kahn, WRIT's chief executive officer, says it is because of WRIT's unique and steadfast strategy of low debt, concentration on growth, attention to management, diversification across property types, commitment to quality properties and the firm's commitment to its investors[2].

The research described in this article attempts to outline the WRIT strategy: financing, investment and management. It concentrates on the financing and investment aspects of strategy, but management and governance issues are identified. The source data is from annual reports and financial statements from the WRIT and personal conversations with Frank Kahn, other WRIT officials, and industry analysts. The purpose of the research is threefold: to identify the key ingredients in WRIT's strategy, to elaborate these ingredients in terms of principles and to develop testable implications.

WRIT's Corporate Strategy

Financing

WRIT takes a unique approach to financing real estate. It prefers to finance with equity capital and to issue that capital to noninstitutional investors. Thus, its conservative management and growth oriented investment policies afford a low cost of equity capital[3]. That debt reduces its flexibility to undertake, maintain and control the investment mix.[4]

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Low Debt Policy

Kahn says that a key part of WRIT's strategy is the maintenance of a low- to-no-debt policy. This seems contrary to conventional wisdom in real estate investing. First, real estate is considered to be low risk and thus appropriate for leverage potential, and second, leverage offers tax shields. However, WRIT offers answers to these traditional notions. Real estate is not a sure thing and thus always has inherent risk not only from the business cycle fluctuations in realty use, but from potential structural shifts in demand from sources such as office hoteling and space reductions from technological innovations, etc. More importantly, risk comes from the operating company. The REIT can be, and often is, organized in a way that affords significant management fees and adverse incentive problems. Also, there is interest rate and refinancing risk over the business cycle.

Next, the tax benefits of debt to REITs are unclear. In a REIT, 95% of the net income is passed through to the stockholders and not taxed at the corporate level. Thus, the normal tax benefit at the corporate level is not available for the REIT organizational form. Howe and Shilling (1988) make a similar argument in their research on REIT capital structure and security offerings.[5] Capozza and Lee (1994) provide an empirical investigation of the debt benefits to REITs and find no positive association between debt and REIT value.

Lastly, debt offers a firm the opportunity to grow too fast. In an expansive market, debt will allow the firm to concentrate on expansion instead of operations; a pay as you grow policy will constrain management to expand slower and accept the better opportunities. Thus, the lack of debt may reduce the hubris investment problem. For example, Roll (1986) indicates that management may be too optimistic in terms of valuing potential takeover targets. In the same context, Kahn argues that firms may be too optimistic about both their internal and external growth potential and that debt allows them to grow too rapidly—both in terms of selecting projects that have insufficient return and in terms of ability to manage the acquired assets and their debt.

In addition to the arguments made by WRIT's management, the finance literature also offers reasons for low-to-no-debt policy. Smith and Watts (1993) find that industries with high growth potential are characterized by low debt, low dividend payout and low dividend yields.[6] The general thesis is that higher growth firms do not want to give extra value to the bondholders and also do not want restrictions on their ability to achieve the potential higher returns from growth.[7] Thus, to the extent that REITs, such as WRIT, have significant growth opportunities, there is reason to pursue a low-debt policy.

Non-Institutional Equity

WRIT consistently attempts to avoid institutional investors. Road shows are seldom undertaken to educate institutions about WRIT; rather individual investors or institutions rely on the record. Even with this lack of institutional investors, WRIT has succeeded in getting the message out to the public through investment houses and brokers. WRIT consistently receives buy recommendations from industry advisory groups.[8]

While WRIT consistently has achieved a market for its shares and continues to receive good reviews from industry analysts, why does WRIT not favor institutional shareholders? Kahn indicates that institutions have a stronger preference for immediate high yields that would tend to push a REIT into more speculative investments. This is contrary to a more conservative steady long-term growth oriented approach that is favored by WRIT.

This is potentially in contrast to finance theories which suggest that large insider holdings and institutional holdings may help monitor management behavior. For example, Demsetz (1986) argues that large shareholders who are non-management insiders, help to effectively monitor firm activity. The implication is that ownership concentration may lead to increased firm value. This is consistent with Stulz's (1988) work which suggests that high levels of insider holdings tend to make effective management changes difficult.

Investment

WRIT pursues an investment strategy that has two components: long-term growth potential and niche selection. The key to a sustained growth policy in dividend payout and acquisition is to create an increasing cash flow from growth in operating income. WRIT rarely sells a property[9] and never for cash to meet dividends or operating considerations.

Long-term Growth Potential

WRIT attempts to select properties with growth in earnings potential. Typically, a new acquisition will be where WRIT management already has expertise and some expectation on the improved uses of the property. Thus, growth appears to be more from understanding the market niche than from general market growth already priced by analysts in existing property values. A good example is the acquisition of the office complex at 7700 Leesburg Pike. This complex had a poor market profile, a lack of adequate design for movement of office workers and client traffic (for example, one elevator serving two wings of a semi-circular building), and an undefined market niche. WRIT viewed 7700 Leesburg as a destabilized property (having an occupancy rate of just over 60%), and thus expected to buy the property at a price that would allow reasonable

rents even after renovation of key property components. The location's plan was for a primary office complex of small business tenants. It was expected that a reasonable price for the property would allow the WRIT officials to compete with good rents in the small office space market. Additionally, they put money into the property to remedy the existing functional obsolescence. Walls were moved and a second elevator was installed to allow for more convenient client access. The office complex was stabilized as of mid-1993 with 100% occupancy of existing space achieved by late 1993. There are plans to expand the rentable area of the building. Thus, growth has been achieved in three ways: more tenants for current space, higher rents due to better services and functional building improvement and more tenants expected after the expansion.

Niche Concentration

WRIT officials believe in staying with what they know. Deals have been offered from Baltimore to New York, and all have been consistently declined. Their philosophy is to buy what they understand, buy with a purpose in mind, buy with expected growth in revenues from rent increases and square foot expansions and manage within the focus. WRIT's niche involves two aspects. First, to remain primarily in the DC metroplex, a market essentially within a one hour drive from the home office. Second, to own and manage what are known in the industry as B-grade properties. These properties are mid-sized and mid-priced, serving primarily higher scale local and national tenants in non-prime but select locations and generally in need of quality management for success.

Concentration on known areas of expertise is supported by research in the management literature. Prahalad and Hamel (1990) argue that successful corporations concentrate on core competencies. Ehrhardt (1994) also argues that firms should reject apparent net present value projects that are not aligned with their strategic goals. He argues that cash estimates and potential outcomes have higher risk because the firm does not have experience with such projects. Thus, there may be a tendency to overestimate revenues and underestimate costs. Both Prahalad and Hamel's and Ehrhardt's arguments are consistent with WRIT's philosophy and Roll's thesis (called the hubris hypothesis) that firms tend to pay too much for acquisitions.

Diversity Across Property Types

WRIT attempts to diversify across property types, but does not diversify across economic regions. Property type diversification has been shown to have significant risk-return benefits. For example, Miles and McCue (1982) found the correlation coefficient between REITs that held office property versus REITs that held retail property was 0.48. Firstenberg, et al, (1987) also found that property type was crucial in determining the best trade-off in constructing an efficient investment frontier. However, none of these studies demonstrates why investors could not create their own diversified portfolio of REITs which individually concentrated on single property types. There is also evidence that economic geographical diversification is useful (see the works of Hartzell, Heckman and Miles [1986] and Hartzell, Shulman and Wurtzebach [1987], and Pollakowski, Wachter and Lynford [1992] for details).

Thus, in general, we believe there is no reason to expect that such benefits will accrue to firms that pursue strategies where investors can choose portfolios from the market of undiversified REITs. An exception is those instances where the market is too thin to allow efficiency in operating individual real estate firms for each property type.[10] For example, in a small town, sales agents tend to sell all types of property, whereas in larger metropolitan areas, there is specialization in property types sold or managed. A second possibility is that the workers, including management, of the firm believe the diversification protects their human capital since there is less likelihood of a layoff during downturns. In this case, the market is indifferent, but it would be expected to reflect such insurance coverage in the firm's compensation structure.

Operational Management

WRIT seems to concentrate on three principles: low overhead, trim staff and direct executive involvement in day-to-day and long-range operations. Kahn is directly involved in weekly operation decisions and is critically involved in all acquisition, renovation and disposition decisions. Thus, WRIT resembles a closely held family business with a strong key manager structure.

Organization Form And Corporate Governance

WRIT asserts that it has a better equity cost of capital because it reduces agency costs between stockholders and management by having clear ethical standards and a straight-forward compensation program for management. For example, management cannot benefit from sales or property acquisitions or management fees other than salary and bonuses from normal operations. While this is an important issue for strategy and governance, all the important variables in this area are not identified, and this area needs further research.

Testable Implications

While many aspects of WRIT's strategy seem to involve clearly acceptable concepts, most are not testable within a finance frame. Questions as to management concentration on niche markets and key manager structures are difficult to identify and empirically test. Additionally, while finance cannot

verify the concept of niche specialization, there seems to be evidence from the management literature that suggests successful firms concentrate on their areas of core competencies. However, some aspects of the strategy offer clear implications for finance.

Financing: Low-Debt Policies And Institutional Investors

Does debt have any benefits for REITs? In a normal corporation, debt traditionally is thought to provide tax and monitoring benefits. Stewart Myers (1986) provides a good overview of the potential benefits and costs of debt financing for traditional corporations. Tests for the benefit of debt can be structured to analyze REIT returns across firms with different debt structures while holding other differences constant. One problem in studying REIT returns and debt over the past few decades is that, ex post, government policy favored a low debt ratio.[11]

Second, does debt policy depend on investment opportunity? Are REITs like other firms that exhibit lower debt, lower payout ratios, etc. when higher growth opportunities exist? An interesting question is whether debt capacity encourages bad investment decisions for firms with high growth potential? The benefits of debt can be tested by controlling for expected growth using a market value to book value ratio. If firms with high market-to-book ratios have a low or negative coefficient on the debt variable, the implication is that debt potentially dilutes the firm's efforts under growth circumstances.

Investment: Property Type Diversification

The question of diversification and firm value has been well studied in economics and finance, but is real estate different? According to theory, real estate is like other assets and that firms which specialize in real estate likely will respond in a traditional manner. Thus, it is expected that diversification can be achieved by individual investors without assistance from firms or REITs. However, there may be circumstances which allow for a second best solution[12] where REITs and other firms benefit from property type diversity.

In large metropolitan areas, real estate firms have specialized staffs. Sales associates typically specialize in residential or commercial sales and even specialize in particular types of housing or property and geographical areas. However, in small towns, sales agents handle all. The Washington metropolitan area seems to be large enough to afford specialization of investment while allowing specialization and scale of management. Thus WRIT's property type diversity provides no unique advantage from a finance theory perspective. However, WRIT argues that the benefits of property diversification over the business allows for better management of their assets and for more stabilized growth.

Corporate Governance: Reduction In Agency Costs

One of the recent developments in economics and finance research is the notion of agency relationships and their costs in a corporate framework. Jensen and Meckling (1976) demonstrate that organizational form and agency relations influence the value of the firm, and Glascock and Turnbull (1994) demonstrate that the structure of the firm will be influenced by incentive compatibility conditions.[13] REITs and their various management forms, including the UPREITS, offer a rich data set for examining valuation effects of governance forms. Three key questions occur.

First, do REITs with widely held, but individually shallow stockholding and a strong manager with significant shares create, in essence, a closely held firm with potential key executive management problems? What management transition policy does WRIT have? What are the implications for REITs in general?

Second, do UPREITs create additional agency costs that are reflected in stock values? An UPREIT results from the combination of several partnerships into a single limited partnership, called the operating partnership, and the formation of a REIT which is the general and managing entity of the operating partnership. The operating partnership generally owns the property and the REIT owns shares in the operating partnership along with the limited partners. It is usual, but not required, for the REIT to be the majority shareholder of the operating partnership. The limited partners of the operating partnership have the right to sell their shares in the operating partnership to the REIT either for REIT shares or cash at the option of the REIT. However, the REIT does not have a forced conversion right. This arrangement allows the REIT to operate as a tax qualified REIT and also allows the partners, in general, to time their recognition of gain or loss on their partnership shares. As long as the limited partners leave their shares in the operating partnership and do not exchange their operating partnership shares for REIT shares or cash, they recognize no tax loss or gain on their shares, unless they are deemed to have been discharged of any of their share of debt of the previous partnership(s) that were folded into the operating partnership.[14] Thus, the value of the REIT may depend on the timing of the conversion of the limited partnership shares and the form of payment for those shares. Do offerings of the REIT shares in an UPREIT organization behave similarly to traditional REIT shares? If UPREITs are more risky, is the bid-ask spread larger to reflect more risk to the market-maker?

Third, are REITs that allow acquisition and disposition-based compensation different in stock

pricing or return behavior? How do compensation of REITs differ from traditional firms?

Summary

The research in this article provides a description of WRIT's financing, investment and management strategy and indicates areas for analytically testing of the key components of WRIT's strategy. The effort concentrates on the financing and investment questions, but indicates that research also is needed in the areas of management and corporate governance. Kahn indicates that WRIT's success is due to its policies of low debt, growth investment, quality management, diversification across property types, quality property selection and commitment to its investors.

Many of these contentions are not directly testable, but some of WRIT's tenants of operation find support in the management as well as finance literature. Concentration on niche markets is supported by the work of Prahalad and Hamel (1990) who suggest that successful firms pursue areas of core compentencies and Ehrhardt who (1994) suggests that firms should concentrate on projects that support their strategic goals. Research by Howe and Shilling (1988) and Capozza and Lee (1994) supports Kahn's argument that debt may not provide REITs with increased value. Thus, many of Kahn's arguments are supported by academic theories and empirical studies.

REITs, with their various forms of operating companies and compensation schemes, offer a rich data set for studying valuation effects and governance forms. If WRIT is correct, straight-forward compensation schemes for management will be associated with higher equity values for investors. Additionally, is WRIT right in its approach to raising equity capital?

Overall, this research has provided an overview of the strategy and operational philosophy of a successful REIT and indicates there is a strong relationship between successful REIT policies and policies suggested by traditional academic research.

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NOTES

1. For detailed analysis of NAREIT identified REITs, see Glascock and Hughes (1994). Also see Gyourko and Siegal (1994) for a description of REIT returns from 1962 to 1993.
2. While we review the literature for support and contradiction of the various aspects of WRIT's strategy, we do not explicitly consider direct alternatives. This is particularly important in the issue of low-to-no-debt policy. What, for example, is the alternative strategy? Should firms pursue a maximum debt policy? While we believe that these are important questions, this research is limited primarily to a description of WRIT's strategy and general research that exists in the literature as well as future implied research that would help determine the goodness of that strategy.
3. For example, WRIT issued equity at $17 a share in 1992 which was 22 times earnings, and Kahn suggests that he has equity to invest at a cost of 4.55%. Of course this view of the cost of capital ignores the implicit expected growth component of the total cost of capital. However, Kahn tells us that the low cost of equity funds in terms of dividends helps the firm to achieve the needed growth in earning and therefore stock price. He believes that the successful firm observes an interaction between the cost of funds from the equity market demanded in terms of dividends and the ability of the firm to achieve the needed growth. The interaction is important in that lower dividend requirements afford the firm necessary flexibility to achieve growth. A firm that cannot demonstrate growth will be further limited by higher dividend requirements from the market.
4. One of Frank Kahn's favorite examples is that of other REITs that leveraged significantly during the last business real estate cycle only to find themselves forced to refinance during high interest periods. Kahn argues that such inopportune refinancing reduces flexibility in both management and investment actions.

5. There is some controversy in that Jaffe (1991) provides a theoretic argument which suggests that the capital structure of the REIT should be independent of its value. However, his case is based on reasonably strong assumptions about arbitrage opportunities and other aspects of the process.
6. Smith and Watts also argue that such firms will have more reliance on stock based compensation plans and higher levels of executive compensation than low growth potential firms.
7. This is also consistent with Myers' (1977) argument that firms with risky debt outstanding have less incentive to invest in positive net present value projects because these projects provide a redistribution of wealth from stockholders to bondholders.
8. Ferris Baker Watts and Wheat First Securities recommended buying in October 1993; A. G. Edwards & Sons issued a buy recommendation in June 1993; Dean Witter Reynolds recommended buying in September 1993; and Alex. Brown & Sons suggested buying in November 1993.
9. A recent sale of the firms original corporate offices was facilitated by a change in highest and best use. The property had higher market value as a restaurant and WRIT does not operate restaurants. Thus, the firm sold the property and recognized the appreciation. If the gain had been in WRIT's normal operating properties (e.g. a shopping center or office building), WRIT would have recognized the gain in increased rents, not from the sale.
10. We thank Jeff Fisher for providing this insight at a recent Homer Hoyt Seminar presentation of an earlier draft of this research.
11. This occurred primarily because of the volatility in government tax policies that first extended, then reduced, and then further reduced the depreciation benefits of real estate. Additionally, lending policies by banks that were encouraged by government policy led to a volatile market for real estate assets. Low debt individuals, as well as firms, tended to survive this period.
12. Potentially, there are not enough REITs in the Washington, DC area to allow diversification across property types, and thus the Washington REIT can provide some diversification to the investor by owning and operating various types of real estate.
13. Glascock and Turnbull (1994) show that differences in incentive compatibility conditions offer an explanation for the prevalence of owner-operated small real estate rental units.
14. Consult the IRS Code or a tax attorney for complete details of when gains or losses may be required to be recognized by the IRS.