Western Real Estate Advisors[1] Case Study: REIT Roll-up

by John McMahan, CRE

This case is based on a series of roll-up proposals offered to institutional investors over the last year. The pressure for "action" inherent in the roll-up situation creates a crucible in which assets, careers, and fortunes may be made or lost in a relatively short period of time.

Camilla Concilatore raced into the management meeting 25 minutes late, her heart pounding, and largely out of breath. Just before the meeting, she had placed a call to Tom Razier to ascertain his receptivity to a "roll-up" of Western's clients' assets into a Real Estate Investment Trust (REIT). Tom was the head of real estate investments for the Bloomfield Urban Retirement Plan (BURP), one of Western's largest clients.

Cami had started at Western in 1991 as a real estate acquisition officer and now served as the firm's director of portfolio management. The management meeting was called to finalize strategy for the proposed roll-up, tentatively scheduled for closing on October 15, 1997, just three months away. Unfortunately, the news she brought would not be well received.

BACKGROUND

Firm's Beginnings: Western was founded in Los Angeles in 1987 as an investment advisor for pension investor clients. The firm was registered under the Advisor's Act of 1940 and was a fiduciary under ERISA. Western specialized in suburban office and industrial properties located primarily in the western United States.

Western's founders, Jim Aires and Serge Leosky, were 1981 classmates from a well-known western business school. They later worked together as mortgage brokers specializing in loans for office and industrial properties. As a result of their mortgage activities, they became acquainted with several major pension funds and believed that they could develop an investment niche that would provide attractive equity returns to pension investors. To raise the initial $200,000 in equity capital for their new firm, they invested their life savings as well as proceeds from second mortgages on their homes.

Clients: Raising pension capital turned out to be harder than they had anticipated. It took over two years to secure their first pension client, who invested $25 million in a separate account.

Exhibit 1

WESTERN REAL ESTATE ADVISORS, INC.
PROFIT & LOSS STATEMENT (Unaudited) - (000's)

	1996 (actual)	1997 (estimated)	1998 (forecasted)
Assets Under Management			
BOP	$688	$725	$835
Acquisition/Development	55	116	165
Dispositions	18	6	0
EOP	725	835	1,000
Revenue[1]			
Asset Management	4.713	5.226	6.675
Acquisition/Development	0.930	1.346	1.980
Dispositions	0.179	0.113	0.000
Total	5.82	6.69	7.80
Expense			
Salaries	1.88	2.01	2.20
Fringe Benefits	0.413	0.442	0.440
Rent	0.120	0.125	0.125
Insurance	0.028	0.030	0.050
Travel	0.541	0.615	0.800
Promotion	0.433	0.492	0.600
Legal	0.057	0.044	0.100
Accounting	0.036	0.042	0.060
Research	0.103	0.305	0.300
Total	3.61	4.10	4.68
EBITDA	2.21	2.59	3.13

[1] Western's standard fee structure was .70% annually for asset management; 1.0% for acquisitions; 2.0% for development; and 1.0% for dispositions. Disposition fees sometimes had a portion of cost recovery reflected in them.

Although from time-to-time they considered sponsoring pooled funds, they continued to focus on separate accounts and by mid-1997, had attracted 14 pension clients allocating $835 million to the firm for investment purposes. Six of the clients were public pension plans; five were corporate; two were Taft-Hartley; and one was a college endowment fund.

Investment Strategy: Western's investment strategy was to concentrate on the rapidly growing suburbs of metropolitan areas in the western United States where they believed they could secure superior investment returns. They focused on new, modern, suburban office buildings leased to local (27.3 percent); regional (39.2 percent); and national business firms (33.5 percent).

Assets: As of December 31, 1996, the firm had approximately $725 million in assets under management comprising 43 properties located in California (48.3 percent); Washington (27.1 percent); Arizona (17.6 percent); Oregon (5.2 percent); and Colorado (1.8 percent). Ninety-three percent (93.0 percent) of the portfolio's value was in office and R&D buildings, with the remainder in industrial warehouse facilities. The average length of leases in the portfolio was 4.2 years. Approximately 20 percent of the investments had been developed by Western's staff.

Investment Performance: Despite the recession of 1991-1993, and the problems besetting the office sector, the properties had performed relatively well over the past seven years, with a 10.3 percent total annual return—of which 8.2 percent represented net operating income (NOI).

And things were getting much better. As a result of asset value write-downs in the early 1990s and rapidly improving property markets in the West, Western's NOI return for 1996 was 10.3 percent, and was expected to be 11.3 percent for 1997. Management believed that NOI returns would reach 12 percent by 1998. Tenant improvements and leasing commissions typically reduced NOI returns by approximately 15 percent annually.

Organization: Western was organized as a corporation, with a functional/matrix organizational structure. Jim was President and CEO with Serge serving as the chief operating officer. Besides Cami, other officers included Mary Ishade, chief financial officer; Bill Closdeale, director of acquisitions; and John Leascom, director of asset management. Property management was performed by independent contractors. Non-founding officers owned 37 percent of the company.

Profitability: During its early years, Western had lost money, but began to enter the black in 1990. Profitability then turned down in 1993, as new

capital dried up and clients demanded higher levels of reporting and other services. With new capital flows in late 1995, however, profitability had returned. EBITDA for 1996 was $2.2 million and was expected to increase to $2.6 million in 1997 and $3.1 million in 1998 *(Exhibit 1)*.

PENSION INVESTORS

Poor Performance: Although Western had faced problems, they paled in comparison with those experienced by older, larger investment advisory firms. And not without reason—pension investors were upset with real estate returns consistently lower than their securities portfolio, largely as a result of losses of up to 40 percent in real estate portfolio value. Also a concern, was the incredible amount of staff time that real estate investing seemed to require.

"Agency" Problem: Many investors believed that a large part of the poor performance record was an inevitable result of the investment advisory delivery system, in which the advisor not only initiated the investment, but managed it as well. Investors perceived a conflict of interest in this arrangement, as no one knew who the investment advisor really worked for. The fact that most advisors did not invest in the properties meant that advisory firms could be making money while their clients, the pension investors, were losing theirs.

Search for Solutions: In order to resolve these concerns, pension investors began exploring alternatives. About 30 percent, mostly smaller plans, decided to get out of real estate altogether. Not wishing to leave real estate, other plans sold their private market assets and invested the proceeds in securitized real estate, primarily REITs. Some of the larger public plans attempted to modify the private market investment process by requiring changes in their investment advisory contracts. They believed that by making certain requirements of their advisors (e.g. dedicated advisor staffs, dedicated reporting, advisor co-investment, etc.), they could capture the major benefits of securitized investing and still enjoy the greater portfolio diversification benefits provided by private market assets.

REAL ESTATE INVESTMENT TRUSTS

Legislation: The REIT Act of 1960 envisioned a conservative investment vehicle with certain tax avoidance features that would encourage long-term investment in real estate by individual, taxable investors.

Although regulations have loosened considerably over the years, REITs still must meet fairly stringent rules if they are to annually maintain their REIT status:

- Have at least 100 shareholders. Five individuals cannot not own more than 50 percent of the stock (5/50 rule);
- Seventy-five percent of assets must be in real estate equity, mortgages, REIT shares, or cash;
- Seventy-five percent of income must come from rents or mortgage interest;
- No more than 30 percent of operating income can come from properties held less than four years;[2]
- Ninety-five percent of taxable income must be paid out annually.

In terms of organization, all REITs must be a corporation or a trust and be managed by a board of directors or trustees. The majority of trustees must be independent of REIT management.

Early History: Less than half of the REITs operating in the 1960s were self-advised (internally managed, no external advisor) and, even in these cases, management did not participate extensively in stock ownership. There was little market activity and not much coverage from the financial community.

In the late 60s, Wall Street began shifting the emphasis of REIT Initial Placement Offerings (IPO) from long-term equity investment to short-term mortgage investment, largely in the form of construction loans. Mortgage REITs were the largest single source of capital funding for the 1971-1975 real estate "boom," largely borrowing short and lending long in order to arbitrage the yield curve. This bubble collapsed in the mid-70s and REITs became tarred with a negative image that they would not overcome for 20 years. Not all of this was investor perception—*REIT market values had declined almost 75 percent from their 1972 highs.*

Largely as a result of the debacle of the 1970s, REITs missed the real estate "bubble" of the 80s. In the subsequent collapse of the real estate markets at the end of the decade, all forms of capital for real estate evaporated. Developers and other owners of real estate found themselves with highly leveraged properties, often built with short-term financing and no source of refinancing. With interest rates falling and real estate yields rising, Wall Street saw an opportunity to arbitrage the private and public markets.

Birth of the "Modern REIT:" The Kimco offering in late 1991 was the first sign that REITs could play a

Exhibit 2

"OLD" vs. "NEW" REITs

Old REITs	New REITs
1960 - 1962	1992 - 1997
Passive investments	Operating company
Externally administered	Self-administered
Institutional sponsors	Entrepreneur sponsors
Small mgt. ownership	Large mgt. ownership
Diversified portfolio	Focused portfolio
Small capital base	Larger capital base
Little analyst coverage	More analyst coverage

major role in financing real estate and, more importantly, real estate operating companies. During 1991, eight IPOs involving REITs raised $808 million. A similar number were completed in 1992, raising $919 million.

While this was meaningful investment activity, particularly in a capital-starved real estate market, 1993 proved to be a real turning point — 75 equity IPOs raised $11.1 billion. Excluding placements of less than $50 million, 39 IPOs were completed raising $8.2 billion—approximately 14 percent of total IPO activity in the entire securities market for the year. This represented more real estate capital than from any other source.

New REITs Were Different: Perhaps more significantly, the character of the 1993 IPOs was dramatically different. Virtually all represented real estate operating companies, specializing by property type. The new REITs were also significantly larger—10 equity REITs had market capitalization of over $500 million (versus two at the end of 1991), and 40 had capitalization exceeding $200 million (versus 10 in 1991). Almost two-thirds of new and proposed REITs were structured as UPREITs, in which the REIT owns an interest in one or more existing partnerships, an approach utilized to reduce the tax impact on selling partners.

Most of the 1993 IPOs were self-administered and, in many cases, management had significant equity positions, minimizing conflicts and enhancing congruency with investors. Most of the management groups had spent their careers specializing in the particular property type and had effectively worked together as a team for many years, (including at least one full real estate cycle). *(Exhibit 2).*

At year-end 1993, the REIT market reflected many of the changes occurring at the individual firm level. Total market capitalization of all REITs increased to $31.6 billion. The 30 largest REITs measured $15.1 billion vs. $8.6 billion at the beginning of the year.

Over the next three years, REITs would grow exponentially. The 1993 IPO calendar had focused on retail; 1994 saw the emergence of investor interest in multi-family and office/industrial; 1995 was the year of hotel IPOs; and 1996 was dominated by office/industrial *(Exhibit 3).* In 1995 and 1996, secondary offerings also became an important source in REIT equity financing, overshadowing IPO activity *(Exhibit 4).*

By the end of 1996, there were 302 REITs with a total market capitalization of $126 billion. Approximately two-thirds of these were equity REITs with a total market capitalization of $95 million *(Exhibit 5).*

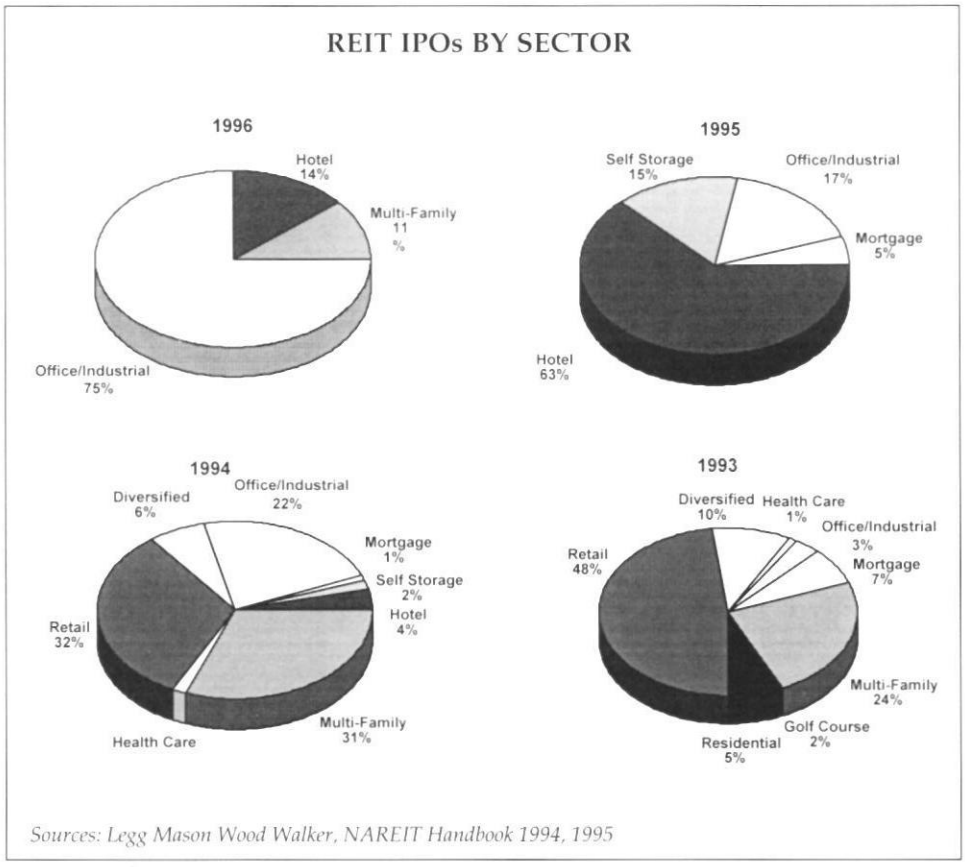
Today, most successful REITs are fully-integrated operating companies rather than the passive conduits envisioned by Congress 37 years earlier. Most are focused by property type and by geographical area, although this is changing as larger, national firms come onto the scene. Retail and apartments are still the dominant property type, although office, industrial, and hotels have grown in importance in recent years. Economic scale is also important as larger REITs reduce their cost of capital and spread operating costs over a larger base.

Market Valuation: REIT earnings are usually measured in terms of funds from operations (FFO), which is net income (GAAP); plus depreciation and amortization; less gain (loss) on sale of investments. Stock prices are generally compared to FFO flows, much the same as price/earnings ratios for non-real estate stocks. More recently, many analysts have begun adjusting FFO for capital expenditures and the impact of floating rate debt. This is termed Adjusted Funds From Operations (AFFO).

REITs are also valued in terms of their premium or discount to Net Asset Value (NAV). Better performing REITs are generally rewarded by premium pricing, reflecting the market's perception of greater enterprise value which should result in enhanced future FFO growth.

Other factors that analysts and investors track are "payout ratios" (percent of distributable income that will be paid out as dividends); "total debt to total capitalization" (the market does not like leverage exceeding 40 percent); the proportion

Exhibit 3



Sources: Legg Mason Wood Walker, NAREIT Handbook 1994, 1995

of floating debt in the capital structure; management compensation; and the alignment of management's interest with shareholders.

Recent Market Performance: 1996 turned out to be a good year for REITs with the average share price increasing 22.5 points, driving average total returns to over 35 percent. Office REITs produced the best investment performance, followed by industrial, hotel, apartments, and retail *(Exhibit 6)*.

A large factor driving REIT investment performance was an increase in the price/FFO ratios, peaking in late 1996. Multiples declined after the first of the year and, as of June 30, 1997, averaged 12.4X 1997 FFO. The average dividend yield was 6.5 percent with an average total return of 15.7 percent over the prior 12 months. The average premium to NAV was 20.5 percent *(Exhibit 7)*.

As indicated in *Exhibit 7*, office REITs traded at a premium of 26.0 percent over NAV in mid 1997, second only to industrial REITs (33.9 percent). The office price-to-earnings multiple of 13.3X was the highest in the industry. Office REITs also traded at a 7.3 percent premium to other equity REITs, reflecting the belief in the market that they would experience higher levels of future growth.[3]

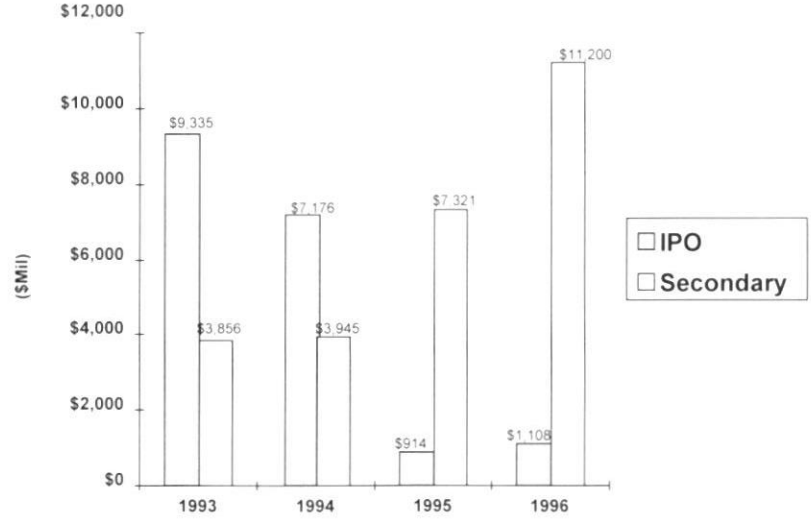
Pension Fund Interest: Despite the promise of the new REIT investment format, pension fund interest was slow to develop. Research on early REITs indicated that they performed in a manner similar to small cap stocks, not real estate. This implied that pension funds could not rely on a low or negative correlation with equities to reduce overall portfolio risk. More recent studies challenged this conclusion, maintaining that modern REITs had a higher level of real estate "effect" and could help to improve portfolio risk-adjusted returns, although not to the extent possible through private real estate investment.[4]

As a result of these studies, as well as continued growth in the REIT market, pension investment in securitized real estate went from virtually nothing in 1989 to approximately 25 percent of their portfolios in 1996 *(Exhibit 8)*. A recent survey of pension investors indicated that they invest in REITs primarily through separate accounts and mutual funds. As with the broader REIT market, residential and retail are the major property types, followed by office, industrial, and hotels *(Exhibit 9)*. Other characteristics of the pension securitized real estate portfolio are—debt ratio: 33.9 percent; dividend yield: 6.4 percent; P/E ratio: 14.2X; and portfolio turnover: 39.0 percent.[5]

Enterprise value: As a tax-avoidance vehicle, REITs should be expected to trade on the yield of underlying real estate assets, less a liquidity discount. Today, however, many successful REITs sell for more than their underlying real estate values, reflecting a premium for the "enterprise value" inherent in a "going concern."[6] Such a premium reflects the market's belief in management's ability to grow future FFO through market and asset selection, development, refinancing, or restructuring investments *(Exhibit 10)*.

Exhibit 4

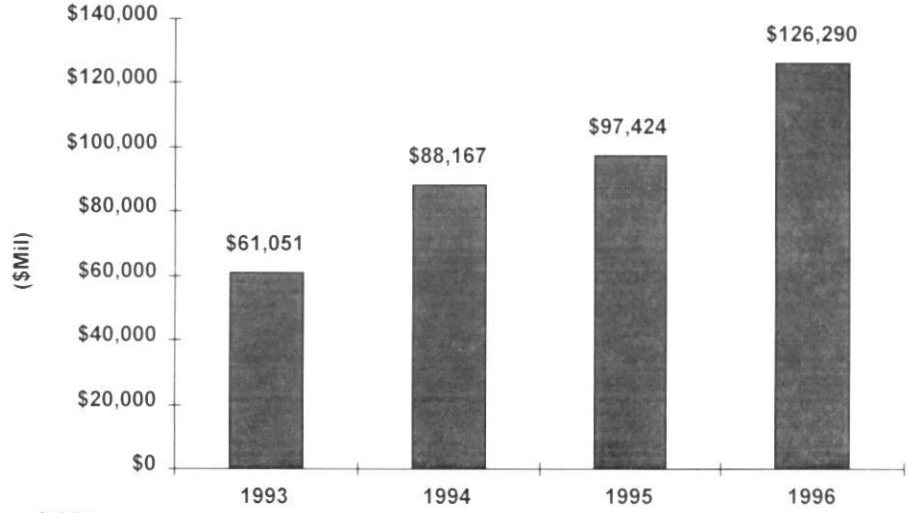
IPO & SECONDARY EQUITY OFFERINGS



Source: NAREIT

Exhibit 5

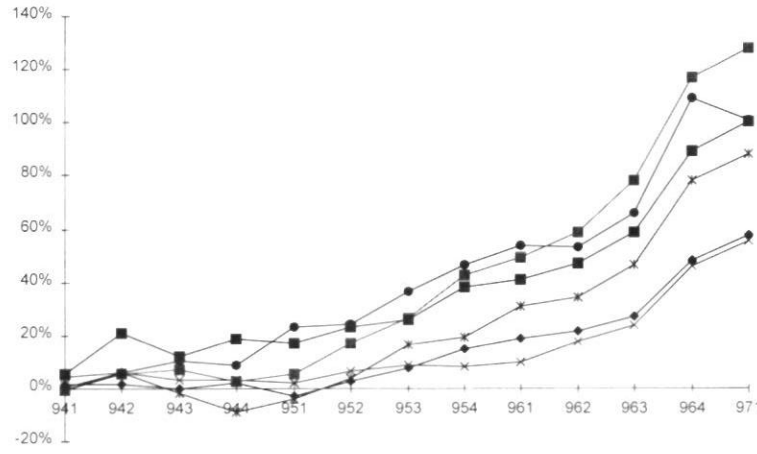
REIT TOTAL MARKET CAP



Source: NAREIT. Annual amounts as of 12/31.

Exhibit 6

REIT RETURNS BY PROPERTY TYPE



Property Type Ranking

	3 Yr Ret	Risk Adj Ret
Office	29.4%	2
Self Str	27.9%	1
Ind	23.7%	3
Hotel	21.1%	4
Apts	13.9%	6
Retail	13.4%	5

Note: Risk Adjusted Return ranking calculated using Sharpe ratio methodology.

Sources: NAREIT, Wall Street Journal. Analysis: The McMahan Group

Problem Areas: Despite the success of many REITs, the industry faced some formidable problems in mid-1997. The combination of analyst and shareholder pressure on short-term FFO growth and the high payout of annual cash flow forced most REITs to return to the capital markets frequently. With highly competitive property markets, the lack of attractive investment opportunities was leading some REITs into marginal investments, both in terms of physical quality and economic return. Many so-called "independent directors" were, in fact, very close to management and it was not always clear how good the vaunted REIT governance policies really were. Finally, many REIT boards and management lacked the vision and courage necessary to reposition their firms for future growth and profitability.

THE BOOM IN OFFICE MARKETS

The office sector had been devastated by the real estate depression of 1987-1994 and as a result, was one of the last areas to experience economic recovery. By early 1997, however, America's office building expansion was in high gear, driven by strong growth in office jobs and the lack of new construction over the prior 10 years. In July 1997, office construction was running at a rate of 23 million square feet annually, vs. 50 million square feet of annual absorption.[7] Reflecting the strong nature of office demand, almost three-fourths of new construction involved build-to-suit facilities where a tenant was already in place.

This surging demand for office space helped to drive down vacancy rates for both downtown and suburban markets. As of March 31, 1997, downtown vacancy rates stood at 13.2 percent, down from 17.6 percent at the end of 1992; and suburban rates were 10.6 percent, down from 19.4 percent in 1992.[8] With less space on the market, effective rental rates were steadily increasing—up 4.9 percent in 1995 and 6.8 percent in 1996.[9]

The nature of office space demand was also changing. As business firms downsized and outsourced their operations, office demand began shifting from larger companies to smaller companies, many of which worked for the larger companies. This trend has been accelerated by the application of new technologies which allowed many employees to operate from venues other than the traditional office (e.g. home, hotel, airplane, etc.). Many firms also have experimented with a variety of new ways to organize the work effort including open space design, "hoteling," and the widely reported "virtual" office format. In all cases, the emphasis is on providing the firm with flexibility in dealing with its office requirements.

These shifts in demand have made many older office buildings functionally obsolete. They may be designed for the large company "footprint" where columns and other obstacles make it difficult to reformat space for smaller tenants. More commonly, many older buildings are not designed to adapt to the requirements of modern technology and retrofitting is expensive, if not impossible. Finally, the building may not be functionally obsolete, but it is an area where people do not wish to work.

The combination of these and other factors has contributed to suburban locations becoming more attractive to many office users. The suburbs offer lower land costs, facilitating new design and construction and are located where most people live. In many cities, (e.g. Dallas, Denver, San Diego, Tampa, etc.) suburban rents exceed downtown locations.[10]

OFFICE REITs SHARE IN THE BOOM

Consistent with their position in the real estate cycle, office REITs did not really get going until mid-1996. In the succeeding 12 months, six office REITs went public and a large number were poised in the pipeline, including Equity Office Properties Trust, a multi-billion national office REIT which went public shortly thereafter. The total equity raised by these REITs was $2.2 billion. As of June 27, 1997, the average price had increased 13.7 percent over the issuing price *(Exhibit 11).*

In terms of operations, these new office REITs had a relatively low debt ratio (27.1 percent), although floating debt was quite high (22.8 percent). FFO is expected to increase 11.3 percent over the next 12 months. FFO multiples, however, were expected to decline in 1998 along with lower expectations for the market overall *(Exhibit 12).*

Interestingly, office REITs own only six percent of institutional grade office square footage in major metropolitan areas.[11] Many observers expect this relatively low penetration to lead to a large amount of consolidation activity as managers attempt to add economic scale to their operations through the acquisition of private market portfolios and companies. The improvement in office property values also makes it more attractive to sell companies than it did a few years ago.

The trend to larger economic units is consistent with and reinforcing of the need of office tenants for

Exhibit 7

REIT PERFORMANCE BY PROPERTY TYPE
30-JUN-97

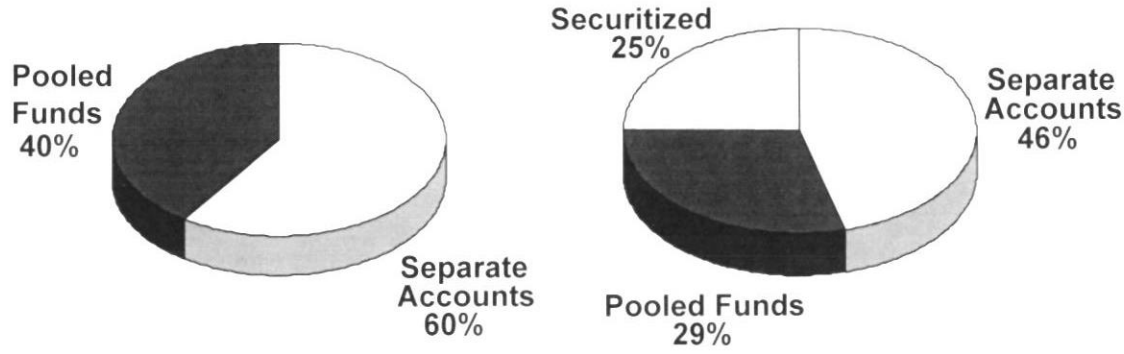
	Apartments	Regional Malls	Office	Industrial	Shopping Centers	Hotels	Totals/ Average**
Equity Market Cap*	$20,493.3	$15,807.1	$12,324.4	$9,590.9	$9,409.0	$7,793.9	**$75,418.6**
Dividend Yield	6.8%	6.7%	5.5%	5.8%	7.5%	6.8%	**6.5%**
Multiple	11.9	13.1	13.3	12.9	11.6	10.9	**12.4**
Premium to NAV	15.5%	16.2%	26.0%	33.9%	17.1%	21.2%	**20.5%**
12-Month Total Return	**15.7%**	**14.0%**	**15.9%**	**18.0%**	**13.6%**	**19.0%**	**15.7%**

* Billions ** Weighted by equity market capitalization

Source: Realty Stock Review; June 30, 1997

Exhibit 8

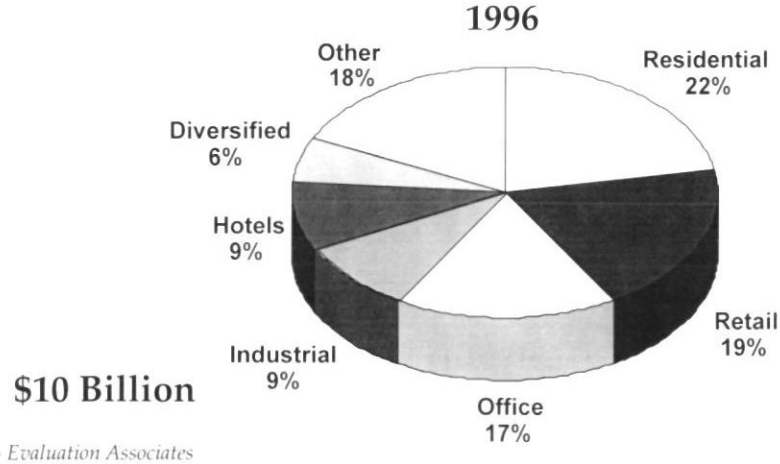
PENSION INVESTMENT IN EQUITY REAL ESTATE



Source: AEW

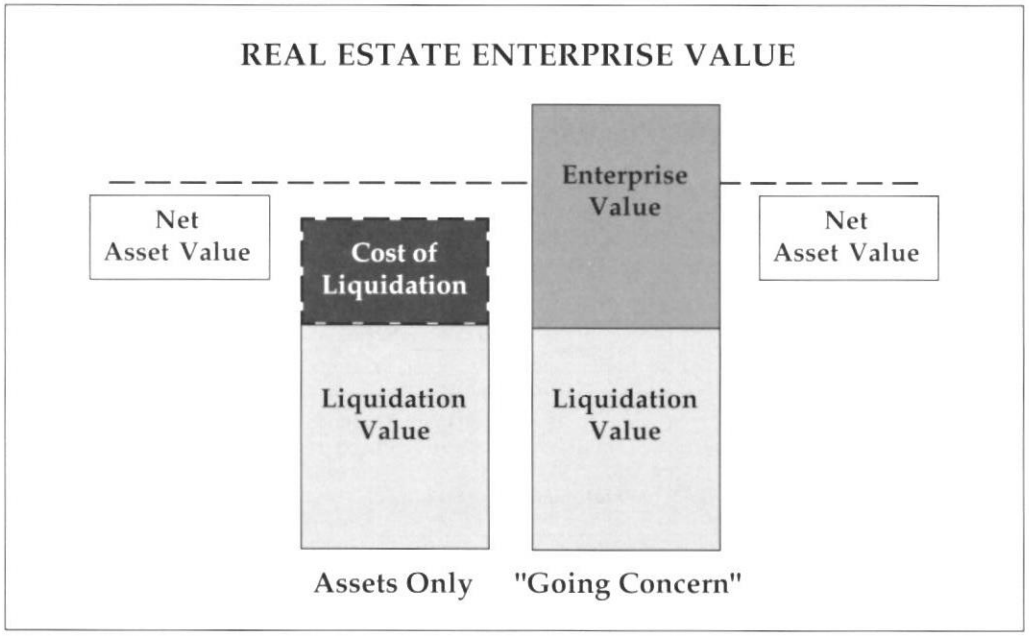
Exhibit 9

PENSION INVESTMENT BY PROPERTY TYPE



Sources: Data - Evaluation Associates
Analysis: The McMahan Group

Exhibit 10



more flexible operating environments and a greater menu of services as a result of downsizing. Many observers believe that ownership and rental of office space will provide a platform to market a wide variety of services to building tenants. Larger companies, the reasoning goes, will have the resources to launch and maintain such platforms and benefit from a broader array of income opportunities.

THE REIT ROLL-UP PHENOMENON

The exceptional market performance of REITs and the continuing strong IPO market has led many investment advisors and other private market managers to propose programs to "roll-up" their clients' assets into new REITs. To some extent, this is a response to client pressure to create new approaches to real estate investing. As of June 1997, as many as 18 roll-ups were under consideration, although one proposal had been withdrawn as a result of investor pressure *(Exhibit 13)*.

The term "roll-up" was coined in the early 1990s to describe the process by which general partners of syndicated real estate limited partnerships forced limited partners to convert their partnership interests to stock ownership, often at a steep discount. Noting that the current REIT roll-ups were usually at a premium and that investors had a lot more influence over the roll-up process, many sponsors prefer to term them "consolidations" or "restructurings."

Sponsors believe that the new entities formed by the roll-up process will be attractive to investors for several reasons. Most institutional real estate holdings reflect higher quality properties than those traditionally held by REITs. The size of the portfolios are often larger than most REITs, in some cases among the largest of their property type. This larger economic scale helps to lower the cost of capital and spread the cost of corporate infrastructure over a larger base, leading to higher investment returns. Some advisors also believe that these they can bring a better quality of management than the public market has experienced to date.

Critics argue that larger economic scale can also create problems as the pressure to acquire large numbers of assets makes it more difficult to develop a "growth story" and have a significant impact on earnings. Furthermore, not everyone agrees that advisors are better managers of assets, as demonstrated by their disastrous performance in the 1980s. There is also concern that managing a public company is "different" and requires special skills most advisors have not utilized in the past. This becomes particularly important if the roll-up process awards a "value premium" to a management team before it has proven itself in the public marketplace.

THE WESTERN ROLL-UP PROPOSAL

In order to retain their clients, preserve Western as a viable firm, and monetize the value of their personal equity positions in the firm, Jim and Serge decided in early 1997 to explore the possibility of a roll-up of their clients' assets into a new public entity. They consulted several investment bankers experienced in REIT public offerings and began to develop a plan which was distributed to clients for comments in early July.

The new entity would be organized as a private REIT, which would continue to acquire and develop properties and go public in six to 12 months when it reached approximately $1 billion in assets. If the REIT did not go public within one year, investors could force a registration through a two-thirds affirmative vote. The new REIT would be

Exhibit 11

RECENT OFFICE REIT IPO'S

Ticker	Company	Market*	IPO Date	Capital Raised**	IPO Price	Price 6/27/97	Percentage Change
ARI	Arden Realty Corporation	CA	10/4/96	$377	$20.00	$26.00	30.0%
PP	Prentiss Properties	TX/WI/CA/GA	10/18/96	323	20.00	25.00	25.0%
KRC	Kilroy Realty Corporation	CA/WA/AZ	1/29/97	331	23.00	25.50	10.9%
CPP	Cornerstone Properties, Inc.	NY/WA/MA/IL	4/15/97	225	14.00	15.00	7.1%
GL	Great Lakes REIT, Inc.	IL/WI/MI	5/7/97	88	15.50	16.00	3.2%
BXP	Boston Properties	MA/DC/CA	6/18/97	903	25.00	26.88	7.5%
Totals/Averages* **				**$2,247**	**$21.67**	**$24.64**	**13.7%**
In Registration							
	Equity Office Properties Trust			**$345**	**$20.00**		
	SL Green Realty			**$186**	**$20.00**		

***States in order of number of properties; ** Millions; *** Weighted by capital raised**

Sources: Montgomery Securities; The McMahan Group

Exhibit 12

OFFICE REIT OPERATING DATA

Ticker	Company	Debt/ Mkt. Cap.	Floating Debt	EBITDA/ Interest	FFO/Share 1997	FFO/Share 1998	FFO Multiple 1997	FFO Multiple 1998
ARI	Arden Realty Corporation	23.0%	100.0%	5.3%	$2.16	$2.39	12.0	10.9
PP	Prentiss Properties	25.0%	3.0%	5.7%	$2.25	$2.45	11.1	10.2
KRC	Kilroy Realty Corporation	18.0%	13.0%	4.2%	$1.97	$2.26	12.9	11.3
CPP	Cornerstone Properties, Inc.	32.0%	4.0%	2.7%	$1.26	$1.37	11.9	10.9
GL	Great Lakes REIT, Inc.	4.0%	0.0%	N/A	$1.49	$1.69	10.7	9.5
BXP	Boston Properties	34.0%	8.0%	N/A	$1.95	N/A	13.8	N/A
Average*		**27.1%**	**22.8%**	**4.6%**	**$1.94**	**$2.16**	**12.7**	**10.7**

*** Weighted by capital raised.**

Sources: Montgomery Securities; The McMahan Group

internally managed, including a new property management group which would be integrated into the overall operation.

In capitalizing the new entity, Western's pension clients would contribute the $725 million in assets currently managed by Western. Western would contribute its management fees (e.g. acquisition; development; asset management; property management, and disposition). Jim and his team would execute three, three-year employment contracts filling similar roles as they had in the advisory firm. Both clients and Western would receive common shares with equal voting rights.

The new REIT would be valued at $750 million, reflecting a value to the management company of approximately $25 million. Both the property values and the value of Western would be confirmed though independent appraisal. When the REIT went public, a fairness opinion would be obtained from the investment banking firm leading the underwriting. Total costs of the public issue were estimated to be approximately $6 million, most of which ultimately would be paid by Western's clients.

The Western portfolio was largely unleveraged. While operating as a private REIT, however, up to 30 percent of the portfolio's value could be borrowed in order to provide funds to acquire and develop sufficient assets to reach the $1 billion IPO threshold. At this point, a five million share IPO would raise an additional $100 million to be utilized for new acquisitions and development projects. The pension investors would agree not to sell their shares for one year after the IPO (termed a "lockout"). Management shares could not be sold for three years.

The new REIT would have a seven-person board: Jim, Serge, Bill, and four independent directors. Western clients could participate in the selection of independent directors, if they chose to do so.

A REIT subsidiary would be formed to own and manage assets which clients did not want to place in the new REIT or properties that Western did not choose to include. Up to 15 percent of Western's portfolio could be owned in the subsidiary, which would also have the right to add private market assets from shareholders in the REIT as well as manage assets for new clients who preferred to own assets directly.

In terms of pricing, most of the investment bankers felt that Western would command a multiple of 12 percent -13 percent since it was active in the suburban office markets in the Western U.S. where growth prospects continued to be very favorable. The offering would also be attractive since Western had quality assets and strong institutional backing. The management team was also seasoned having worked together for many years. Their development capabilities would also be attractive to investors in light of the dearth of new office construction.

Jim believed that the roll-up would be a "win-win" situation for Western's clients. The greater liquidity ultimately created by the daily pricing of a public market would provide greater control over investment programs. The stock value would be "accretive" to investors allowing them to essentially arbitrage the public and private markets and participate in the "enterprise value" of the new firm. Management's interests would be better aligned with investors with a large portion of personal compensation materializing only if investors made money. Finally, the public market process would establish higher levels of scrutiny, disclosure, and governance to help protect the plan sponsor's fiduciary interests.

CONVERSATION WITH TOM RAZIER

Cami had begun her client follow-up calls with some of Western's older, smaller clients who were generally pleased with the firm's performance and with whom they had long-standing relationships. Generally, all of these calls had gone well. She had put off talking with BURP and other large clients until she had a better understanding from the earlier calls as to the questions she might receive and the nature of possible client resistance.

Despite these precautions, she was not prepared for Tom's reaction.

He first reminded Cami that the reason BURP was in real estate was to reduce total portfolio risk by investing in an asset class that had low or negative correlation with its stock portfolio. Tom had seen research indicating that REITs had a high positive correlation to stocks and that he could expect little, if any, reduction in portfolio risk from adding REITs.

He also did not like the idea of the private REIT as an interim step. If he were to give up control over his portfolio, he wanted the right to sell his shares if he did not like the way things progressed. As presently contemplated, the private REIT would be largely illiquid and, when coupled with the one-year lockout, he and other investors would not be able to trade their shares for at least 18 to 24 months. Even then, the size of their holdings would make it difficult to trade large blocks of stock.

Tom contrasted the illiquidity of the roll-up process with the private market where, as a result of intense demand for office properties and little new production, BURP's assets currently could be sold at relatively high prices. He did not know how long this market frenzy would continue and felt that perhaps the clients would be better served if Western began culling portfolios to capture appreciated values and enhance investor returns.

He also was concerned with the REIT subsidiary that Western was proposing to use to continue managing private assets. Although Tom realized that this proposal was to some degree a means of giving investors more choices, he was concerned with the potential conflict of interest between public and private investors and the way the arrangement might be viewed by security analysts and non-pension investors. "Isn't one of the attractions of REITs, their ability to reduce conflicts by better aligning management and investor interests?," asked Tom.

The valuation of Western also bothered him. He felt that $25 million was too much for a company whose only assets were management contracts, the vast majority of which were cancelable on 30 days notice. As he put it, if he were going to trade hard assets (real estate) for "elevator assets" (people), he would at least expect to receive shares with some form of preferential interest. Besides, if he wanted to convert his interest to REIT shares, he could trade his assets for the shares of a seasoned REIT, well-regarded in the public marketplace. He had been approached by several existing office REITs and believed that a workable asset trade could be

arranged. Cami mentioned that such an approach would not provide the IPO "pop" in value inherent in the roll-up.

Tom countered that he was somewhat dubious about the true value of the IPO "pop" to the investors. He felt that much of the anticipated increase in value came from leveraging the portfolio and that the increased risk from leveraging had not been adequately considered by Western in its proposed plan. When asked by Cami if a lower level of portfolio leverage would ease his concerns, Tom did not think it would make much difference.

Finally, Tom was upset with the relatively short amount of time that he and his Board had been given to make a decision. BURP had been systematically considering its strategy for securitized real estate for some time, and the Western roll-up put them under pressure to make a decision much faster than they desired. Tom felt that they needed more time to analyze their overall portfolio strategy and suggested to Cami that the decision on participating in the roll-up be extended until after the first of the year. He also stated that he felt Western should pay for the major portion of the $6 million in underwriting costs.

Cami finally gathered up her courage, and asked Tom if, despite his concerns he would vote for the roll-up. Tom said that if the proposal was the same as the package he received, he would vote "no" and, if asked, would encourage other investors to do the same. He did say, however, that he would consider a revised proposal which addressed his concerns.

In a state of shock, Cami thanked Tom for being candid and said she would get back to him in the next few days.

THE MANAGEMENT MEETING

Before Cami had a chance to catch her breath, Jim interrupted the management meeting to ask what had happened in her phone conversation with BURP. As Cami related her conversation, an enveloping cloud of gloom settled over the meeting. When she finished, the mood of the meeting changed abruptly to heated debate as the whole concept of the roll-up was back on the table and latent wounds reopened.

One group of managers led by Jim, wanted to proceed with the roll-up as it had been proposed. Western had generally good relations with its clients and, with the exception of BURP, all contacted so far had indicated support. Western's investment banker believed that a successful public issue could be completed once Western had $1 billion of assets in its portfolio.

Jim also expressed concern that Western's assets were "in play" and, if they did not proceed with the roll-up, many of the assets would be picked off by office REITs or other advisors undertaking roll-up programs. Jim was particularly concerned with the ability of REITs to trade assets for common shares or for Operating Partner (OP) units which could later be converted to REIT shares. Cami was aware of at least four of Western's clients that had been contacted by REIT representatives since news of their roll-up had leaked to the investment community.

In addition, Jim was concerned with the fall-off in private market commitments from pension investors. Western had been in many fewer RFP situations in the last 12 months and the $110 in uninvested commitments may be all of the new funds they might receive if they did not take a dramatic step such as the roll-up program.

A second group of managers wanted to modify the roll-up proposal to make it more attractive to BURP. They argued that, since BURP was their largest client ($135 million), its rejection of the roll-up most likely would be viewed as a negative by other investors and perhaps by Wall Street. This group wanted to drop the private REIT interim step and move immediately to a public issue to take advantage of the currently strong IPO market. "Who knows what the market will be like in six to 12 months," one of them argued. Several members of this group also were willing to modify management shares to make them subordinate to their clients' position, and extend management contracts and "lockout" provisions from three to five years.

The final and most vocal group wanted to drop the roll-up idea altogether and continue as a private market investment advisor. They believed that the "move" to securitization by pension investors was a more of a temporary "lurch" that would go away with any major drop in the stock market. They were also concerned that their personal compensation would be tied to stock options which could be worthless in the event of such a market downturn. In terms of operation, they also did not believe that property management should be internalized or that a REIT was a good vehicle for development activities.

Exhibit 13

Potential IPOs Involving Advisory Firms and/or Their Assets

Sponsoring Firm	Potential REIT size	Property Type	Current Structure	Status
AMB Institutional Realty Advisors, Inc.	$2.5 B	Industrial with some retail	Commingled funds; sep. accts; private REIT	Studying roll-up as one of several options to present to clients. If approved, AMB would launch an IPO of $200-$300M as early as 4Q '97.
Cabot Partners	$1 B	Industrial; R&D office	Primarily sep accts; 1 commingled fund	Expects to present plan for preliminary first step by June. Pending investor approval, Cabot would proceed with portfolio valuation this summer.
Heitman Capital Management Corporation	$1.6 B (3 REITs)	Industrial; office	18 commingled funds; co-invested w/ sep accts	Withdrew proposal on May 15. Intends to go forward according to original business plan of each fund.
Koll/Bren Realty Advisors	$1.1 B	Industrial; office	4 opportunistic funds; sep accts	In early June, tabled its plan to consolidate industrial and office properties. Intends to pursue original business plans.
MIG Realty Advisors	$1.5 B	Multifamily	Sep accts; 2 priv trusts; priv REIT	Proposing to consolidate into a private REIT this summer that could go public as early as 4Q '97. Investors approved first stage: property appraisals.
The Retail Property Trust (RPT)	$5 B	Retail	Private REIT advised by The O'Conner Group	RPT, Richard E. Jacobs Group, Inc., and New England Development may merge. Pending investor approval, the firm could file a REIT IPO by 4Q '97.
W.P. Carey & Co., Inc.	$800 M (9 REITs)	Triple net lease; R&D office	9 investment partnerships	Hired third parties to evaluate exit strategies for the partnerships.
Zell/Merrill Lynch Real Estate Opportunity Funds	$2.1 B	Office	Comm funds; private REITs	Filed an initial public offering with the SEC in May.

Sources: Institutional Real Estate Securities, June 1997

After two hours, Jim abruptly announced that they were not getting anywhere and that they all should go home and "cool off." The management meeting was rescheduled for 10:30 a.m. the next morning and asked each of the managers to prepare a memo recommending a course of action for Western with full supporting arguments.

As she left the meeting, Cami wondered what she would recommend and how it would be received by Tom and their other clients. She knew it would be another long night.

AUTHOR'S COMMENTS

This case is based on a series of roll-up proposals that have been offered investors over the last year. As such, it is a microcosm of many of the problems and issues confronting the various players in institutional real estate today. The pressure for "action" inherent in the roll-up situation creates a crucible in which assets, careers, and fortunes may be made or lost in a relatively short period of time.

Investment Advisor's Perspective

By most measures, Western would be considered a successful advisory firm. The founders have created a strong management team which has generally delivered good performance to its clients.

The firm specializes in a product type, however, which was severely overbuilt in the 1980s and became subject to the greatest amount of investor scorn in the early 1990s. By 1997, however, this was rapidly changing, largely as a result of improving markets and the success of several office and industrial REITs.

On a longer term basis, the office sector is also facing major long-term problems in terms of functional obsolesce and changing customer needs. Neither Western nor its clients appear to be facing these issues and possible implications that more new capital may be required in the future to mitigate problems and possibly replace buildings.

Western also has been lucky. They did not enter the office market until late in the cycle so they did not have the property wipe-outs experienced by older firms. Because of the personal backgrounds of

the founders, Western also focused on suburban office investment rather than CBD office, where market recovery has been much slower and spottier. The firm operated in the Western United States which, when the real estate recovery gained steam, experienced a fabulous real estate boom, largely as a result of broader economic forces such as technology leadership and proximity to the then-booming Asian market.

As of the time of the case (mid-1997), Western's portfolio is in pretty good shape with broad regional diversification, relatively new buildings, and reasonably good lease tenures. The development capability allows them to access product in tight markets and better fulfill their tenants' growth requirements. They also have a diversified mix of clients with the largest client representing 19 percent of their portfolio.

Their fee structure appears to be competitive and sufficient to produce profitable levels of activity, given a sufficiently large asset base. Currently, the biggest operating question appears to be where new investment capital will come from in light of the reduced RFP calendar and the reluctance of many plan sponsors to add new managers.

Jim and Serge appear to have assembled a pretty good team, with broad management ownership of the firm and a good mix of skills. You also have the sense that the members of management seemed to work well together, at least until the roll-up was considered.

Plan Sponsor's Perspective

BURP is a large public pension plan and Western's largest client. There is little indication that Tom Razier is unhappy with Western's performance to date or that they plan to dump the firm in the near future as they consolidate managers.

What appears to be happening is that the roll-up proposal has caught Tom by surprise and forced him to react to securitization quicker than he had planned. His comments to Cami would also indicate that the industry has caught wind of the proposed transaction and that he is being contacted by advisors, REITs, and other real estate investment firms.

Regardless of the surprise element, the issues Tom raises are very legitimate and representative of the questions other plan sponsors are raising in this type of situation.

Western clearly has opened a Pandora's Box by announcing the roll-up and must now move quickly to prevent the loss of assets to competitors and perhaps the destruction of the organization they have all worked so hard to assemble.

REITs are not a good portfolio diversifier: Here Tom is simply out-of-date with the facts. Most new research indicates that REITs have a high real estate "effect" and, while not as good a diversifier as direct investment, are still better than straight securities. Cami has an education problem here.

Private REIT: A very valid concern. What if they went ahead with the private REIT and the IPO market fell apart?. . . Tom would be stuck without the flexibility to sell his separate account assets directly; a situation he presently enjoys. One could argue, if he wants securitized assets, why not sell his direct portfolio and invest the proceeds in a diversified portfolio of REITs? . . . The problem with this approach is that he misses the IPO "pop."

Lock-Out: Also a legitimate concern, which further reduces liquidity.

Management of Private Assets: This is potentially a high-conflict situation. Western appears to want it all ways and seems to be diffusing rather than focusing their activities, one of the major attractions of an operating company approach. They need to commit one way or the other.

Company Valuation: While the valuation may sound high to Tom, the numbers indicate that, at a 12.5 FFO multiple, Western's value is about 8X 1998 EBITDA, not too out of line with what Western could probably get if they sold the firm to a third party. Western's cash flow actually drops as a result of the transaction ($3.1 million to $2.6 million) and their IPO pop is a little over $3 million. Considering they are tying their future to a public vehicle, the value seems reasonable.

The valuation is, of course, sensitive to changes in the public company multiple. At a 13.0X FFO multiple, the EBITDA multiple increases to 9.5X; at 12.0 it drops to 8.8X.

Assets for Shares: Tom makes a good point that Western does not have public market experience

and maybe BURP would be better-off trading assets for shares in an existing REIT with a seasoned public management team. Although much is discussed about this alternative, it is often a difficult transaction to execute, particularly under the tight time deadlines of a roll-up proposal. Also, Tom would not have the advantage of the IPO pop. Tom's argument that the pop comes largely from leveraging may be true, but it is still money in the bank and probably not too out of line with the leveraging risks.

There is, however, the post IPO stock trading level to consider. If an office REIT's multiples drop below 11.0X FFO, there is no enterprise premium.

Liquidity: Tom is also right on the liquidity issue. With only a few exceptions, REITs do not have extensive breadth or depth of public trading. This is compounded in the case of the proposed roll-up since only 10 percent of the proposed issue would be in "public" hands. The participants will have to wait for a much larger asset base before they will be able to trade any significant amounts of Western stock.

Alternative Courses of Action

Western is faced with at least three courses of action:

Proceed with the Roll-Up: An analysis of the proposed IPO indicates that it is a pretty reasonable offer, particularly when compared to some of the other office IPOs. At a 12.5 multiple, the enterprise premium is 13.9 percent, not too aggressive in today's market. The dividend yield of 6.5 percent is right in line with the market as is the 81.1 percent payout ratio. The 14.8 percent debt ratio is relatively conservative, by office REIT standards.

Tactically, Jim backs the original plan, even if it means proceeding without BURP's involvement. This strategy may work if BURP is the only holdout, but Western has six public plans and these people talk to each other. This is a high risk strategy, particularly since Tom Razier has raised some very good objections that could adversely affect the operation of the public company.

Jim is correct that timing is critical since Western's assets are truly "in play" and the future of the company is on the line. Any major time delays could be fatal. This is compounded by the recent fall-off in new capital raising in the private marketplace.

Cancel the Roll-Up and Continue as an Advisor: This is perhaps an even riskier strategy in light of the rapid movement of the industry to securitization. If Western does not move to an operating company format, the firm not only will have a difficult time attracting new capital but also risks losing its existing assets through attrition to REITs and other advisors. This is compounded by the fact that the company's assets are already in play. To adopt this strategy, you would have really have to believe that securitization is merely a "lurch" on the road to prosperity and happiness.

Revise the Proposal: There is considerable merit in the notion that the roll-up is a joint effort with their pension investors and that legitimate concerns should be heard and revisions considered. The most obvious example is the continuation of private market activity which is not in the interests of either Western or the public company investors. Extension of the term of the management contracts also shows good faith and is a small concession for Western to make.

The concept of Western taking a subordinated ownership interest, while technically possible, seems to defeat the goal of achieving a congruence of interests between investors and managers.

The use of the private REIT, however, is a very difficult issue to resolve. The concept of the two-step process is to give Western an opportunity to "bulk up" to the $1 billion level that the underwriters believe is necessary for a successful IPO. Unfortunately, no one can predict how long the current IPO market will last and Western may lose whatever "window" exists and have to operate as a private REIT for some time. This would put the investors in a much less liquid position than they currently enjoy as separate account direct asset owners.

One alternative would be to convince the investment bankers to go out at a lower threshold level, say the $835 level the firm will have at by the end of 1997. Another would be to sell more than 10 percent to the public, although this has dilution problems. Still another is to ask the participating plans for additional commitments of capital to accelerate the bulking up process. Unfortunately, this takes time and further complicates the process.

The use of the private REIT interim step is clearly one of the toughest questions for everyone, regardless of how it is handled.

As with most good cases, there is no single, preferred solution to Western's quandary. Western clearly has opened a Pandora's Box by announcing the roll-up and must now move quickly to prevent the loss of assets to competitors and perhaps the destruction of the organization they have all worked so hard to assemble.

Whatever the final decision, it must be reached rapidly, unequivocally, and be understood by all. REI

NOTES

1. This case was prepared by John McMahan, Adjunct Professor at the Haas School of Business at the University of California, Berkeley, as the basis for class discussion and does not necessarily illustrate either effective or ineffective handling of a business situation. Copyright: 1997 by The McMahan Group. All rights reserved. Revised October 2, 1997.
2. Current legislation was being considered by Congress which would liberalize or eliminate this provision.
3. Montgomery Securities
4. As an example, see S. Michael Giliberto and Anne Mengden "REITs and Real Estate: Two Markets Reexamined," *Real Estate Research*, December 1995.
5. Evaluation Associates
6. In 1997, the premium ranged from 15% to 35% of the value of the underlying assets.
7. Grubb & Ellis
8. CB Commercial
9. Grubb & Ellis
10. *National Real Estate Index*
11. Montgomery Securities

ABOUT THE AUTHOR

John McMahan, CRE, *is managing principal of The McMahan Group, a real estate management consulting firm in San Francisco. Previously, he was CEO of the 15th largest real estate pension advisory firm and served as chair of the National Association of Real Estate Investment Managers (NAREIM). McMahan managed a public REIT for five years and currently is chair of BREProperties, a major public apartment REIT. He is an adjunct professor at the Haas Graduate School of Business, University of California, Berkeley, and formerly taught at the Stanford Graduate School of Business.*