

FOCUS ON REITs

TAKING REITs PRIVATE

by Robin Panovka



Talk of taking REITs private continues despite the recent rebound in equity REIT stocks. Many smaller REITs have been left out of the multiple expansion being enjoyed by their larger peers and continue to explore strategic alternatives. While the renewed strength of the large cap REITs increases the possibility of selling out to a large competitor (who now can more easily manage a stock-for-stock transaction or perhaps even a cash deal), the option of going private is often an attractive alternative, particularly because of the continued healthy valuations in the private real estate markets. And from the perspective of financing sources, the gap between the Wall Street valuations for REITs and the private market values of the assets held by REITs presents an obvious opportunity. These dynamics have resulted in a number of successful LBO transactions in the REIT sector, and will likely result in additional activity.

While the idea of taking a REIT private is relatively simple, execution is often complex, in that it involves weaving through a number of business and legal constraints. Recent LBO activity in the REIT market and broader experience from other sectors provide a number of useful guidelines which should be kept in mind when evaluating a potential going private transaction involving a REIT:

- **Pricing Considerations.**

It is important to understand at the outset that procedural constraints (outlined below), competition from other bidders, the value demanded by shareholders as an inducement to approve a transaction, and transaction expenses typically will push up the cost of the deal to a number which is not too far off from real value. Bargain basement bids (measured by real value, not just current stock price) usually attract competition, litigation, and other scrutiny, and are unlikely to succeed in their initial form.

- **Inability to Control Outcome.**

Once the LBO process is initiated, the process often takes on a life of its own and the initiators (management and its financing sources) will likely lose control and be unable to assure a particular outcome. Management-led buy-outs typically result in auctions in which third-party bidders have the opportunity to compete with the insider group on a "level playing field." Also, importantly, the ultimate decision of whether to consummate any particular transaction and with whom generally rests in the hands of the shareholders.

- **Managing Conflicts of Interest.**

LBOs and other going private transactions which involve management or members of the board of directors necessarily raise potential conflicts of interest. In the UPREIT context, there is an additional layer of conflicts because of the potentially divergent interests of the OP Unitholders and the shareholders. Procedures must

be implemented to ensure that potential conflicts do not taint the “fairness” of the transaction and result in shareholder litigation which has the potential to derail the transaction or expose the participants to liability. As a practical matter, this usually means that it is advisable to have the transaction evaluated and negotiated by a special committee of directors who do not have a financial interest in the proposed LBO. In order to provide the desired legal protection, the special committee should have independent financial and legal advisors, be well informed, and have the ability and bargaining power to negotiate on behalf of the public shareholders.

▪ **Enhanced Disclosure.**

Extensive disclosure is required by Rule 13e-3 under the Securities Exchange Act – particularly with regard to contacts and negotiations leading up to the transaction – where the acquiror group includes management or any other affiliate of the target REIT.

▪ **REIT Rules.**

In any transaction involving a REIT, consideration should be given early on to the impact of the special tax rules that apply to REITs and to the target REIT’s charter provisions that are designed to preserve its REIT tax status. In that regard, careful thought must be given to the decision to continue the target’s status as a REIT or to operate it as a taxable real estate company. The entity’s ability to service its debt after the going private transaction and still satisfy the REIT income distribution requirement and the tax consequences of the loss of REIT status must be analyzed.

Properly planned and executed going private transactions, of course, often do succeed and yield the expected benefits. It is important, however, to set realistic expectations at the outset and to exercise care in threading through the legal, regulatory, and market challenges.^{REI}

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