Detecting Intangible Asset Value (or Capitalized Economic Profit) in Sales to REITs:

A Practical Framework for Analysis

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> *"To begin with there is no such thing as 'value,' except in the eyes of the beholder. And one must understand where the beholder is coming from."*[1]—Bertram Lewis, "Do Syndicators Overpay," *The Appraisal Journal,* April 1985.

MANY CONTEND THAT REAL ESTATE INVESTMENT TRUSTS (REITs) overpay on an individual asset basis. Whether this is true can be significant for tax assessment purposes. Previous commentary posited that intangible value existed (or did not) in such sales as a general rule. The industry is variegated. Some purchases are non-market due to factors common to REITs, while others represent market value. A fuller understanding of the factors that might lead to overpayment, and an analysis of the sale at hand on a case-by-case basis is needed. This article should assist in determining whether a REIT purchase price may have been influenced by non-market factors.

INTRODUCTION: THE NEED FOR AN ANALYTICAL TOOL

The real estate investment trust (REIT) is a dominant player in today's real estate marketplace. Following exponential growth over the course of the last decade, REIT-owned properties and sometimes entire REIT portfolios can now be found in every major central business district (CBD). Most suburban markets and even many rural areas are home to REIT-owned shopping centers, apartments, industrial/warehouse properties, offices, and golf courses, among many other property types.

REIT investing increased from a market capitalization in 1991 of $8.78 billion held by 86 Equity REITs to $151.2 billion held by 149 Equity REITs in 2002.[2] Sales of properties and entire private real estate portfolios to real estate investment trusts soared through the mid- to late-1990s. Today, despite a slowing of sales activity among REITs and a general change in the motivations related to raising capital through public offerings, REITs remain a powerful force in today's national real estate market.

The flurry of REIT activity over the last 10 years leaves a trail of purchase prices that may or may not be significant in the appraisal process for property tax valuation. These purchase prices, like any others, are of primary interest to assessors, many of whom presume them to be a fair reflection of ordinary market value. There has been extensive research on REITs generally over the last 15 years.[3] Much of this research focused on issues of concern primarily to the investing public and REIT performance from a shareholder's point of view. Yet there remains only limited treatment of REITs at the asset level, which is the predominant concern of *ad valorem* professionals.

In most cases, a recent arm's length sale of real property provides high-quality evidence of value. Yet, many appraisers, investment analysts, and REIT property tax managers (and even some assessors) contend that REIT purchase prices are not indicators of market value because the prices REITs pay for property include value for items that are not "realty." In our experience, this contention is sometimes true, but not in every case.

Because of their ability to extract more value from a given parcel of real estate than conventional bidders while still obtaining the same or a better return on investment, the REIT will often be able to pay more and will pay more to get the property—or the portfolio—it wants. As Hardin and Wolverton observed in the context of apartment REITs,[4] just as data supported the notion that properties obtained via foreclosure sold at a discount to market value, so too can it be hypothesized that REITs have in many cases either chosen, or been "forced into acquisition strategies that made over payment for individual properties more probable." It is also often true that a REIT may be buying much more than just the real estate, although this is often not reflected in portfolio purchases in which a total purchase price is allocated among many individual properties.

In the end, just as most individual properties have their own unique characteristics, so do the transactions involving them. As a result, some generalizations may be made but each sale requires careful analysis to determine whether, in fact, the price paid is above market value for *ad valorem* taxation. The purpose of this article is to provide a practical guide to several of the areas that would require examination in order to determine whether the price paid includes so-called intangible value.

DISTINGUISHING BETWEEN MARKET VALUE AND INVESTMENT VALUE

Because a REIT's corporate objectives are not usually the same as those of ordinary real estate investors, we begin by considering the difference between investment and market value. Investment value has been defined as "the value of an investment to a particular investor, based on his or her investment requirements, as distinguished from market value, which is impersonal and detached."[5] The investment value of an asset is the amount a specific investor might pay for the asset, as opposed to the amount the unidentified, hypothetical market purchaser might pay. In determining investment value one must consider the unique motivations, opportunities, investment criteria, conditions of sale, risk tolerance, cost of capital, and other investment variables of an identifiable purchaser.

In determining market value, on the other hand, each such variable would be detached from specific investor identification, and would instead be determined by the general characteristics of the market as a whole, the characteristics of the reasonable, prudent investor.

In every purchase there is investment value, because it is equal to the amount the successful purchaser believed the asset was worth. In many cases, this amount is also reasonably within the range of, or coincides with, the market value of the asset. One may find, for example, that two-thirds of all office buildings within a given market are sold within a price range of just 20 percent of each other. With the accumulation of many purchases by "typical" investors of fairly similar assets, purchasing patterns begin to take shape (particularly in an active market) and values will fall within a normally distributed bell curve. Multiplied over many transactions, the investment value of a particular asset to one ordinary investor begins to also influence the investment value of a similar asset to another ordinary investor by shaping investment expectations. Then there are the outliers. The foreclosure sales, the bankruptcies, the sales between relatives, the business enterprise sales, the portfolio purchases. These all have an associated investment value, but each is, almost by definition, not necessarily market value.

Because of their ability to extract more value from a given parcel of real estate than conventional bidders while still obtaining the same or a better return on investment, the REIT will often be able to pay more and will pay more to get the property

For assessment purposes in most jurisdictions, property is to be assessed at market value and not investment value where investment value is different from market value. In most jurisdictions, a recent arm's length sale is legally considered strong evidence, and the sale is therefore considered indicative of market value. The key, then, is determining when a particular sale is not equal to market value.

In dealing with a sale of property to a REIT, the first order of business is to compare the purchase price with current local sales data. If the local market price range for office properties is predominantly between $160 and $200 per square foot and the subject sale is at $180 per square foot

the investment value for the subject is fairly equivalent to the market value and a more probing analysis of the sale is not likely to reveal otherwise. In contrast, if the purchase is at $300 per square foot, the analyst would be irresponsible in summarily concluding this to be the market value of the subject property. Though it may well turn out to be market value (for a variety of reasons one might imagine), closer analysis is still required.

Frequently, such pricing anomalies occur in sales to REITs. This article is intended to provide a (non-exhaustive) overview of the specific factors one might consider in determining whether a seemingly above-market price was produced by investment variables unique to the REIT investor and unavailable to the ordinary market participant. Significant in this analysis is the identification of the characteristics of the investors in the local market. To an extent, a large CBD may not only have a great number of REIT participants who enjoy similar investing advantages, it will likely have other institutional market participants such as pension funds and insurance companies that mimic many of the REIT advantages such as a lower cost of capital and reduced risk through diversification of assets and tenancies. A suburban or rural market may see greater contrast among the players and their respective abilities to pay a premium. Here too, one must be cautious in making distinctions, for with larger CBD properties, a seemingly minor difference between the profiles of two institutional purchasers may be greatly magnified, such as through cost-savings based on one company's ability to self-manage its buildings.

REITs prioritize cash flow and its growth ahead of asset appreciation in their acquisition strategy. A building with a strong cash flow projection will ultimately be more desirable to shareholders in the company than a building that may operate on a razor-thin margin but hold out the possibility of significant appreciation in 15 years

THE REIT ACQUISITION MINDSET

The *ad valorem* standard that governs taxation of real property requires the assessment professional to stand in the shoes of the hypothetical purchaser, make the assumptions of that purchaser, seek the return on investment of that purchaser, and assume the concerns of that purchaser relative to risk. Presumably, then, one arrives at a value that should roughly equate to the amount a typical market participant would pay for the asset. To the extent that a REIT purchaser may make different assumptions, anticipate a different return from a given set of rents, and anticipate risk differently from other purchasers, a value may be produced that is correspondingly different from what an appraiser might consider the fair market value of the asset.

Therefore, in addition to acknowledging the definitional distinction between market value and investment value, one must begin the analysis with an understanding of the factors a REIT acquisition team would be concerned with and contrast those factors with the approach taken by an ordinary investor.

Like any investor, each REIT is somewhat different in its approach to buying and operating real estate, so generalizations about how REITs do business are limited. Nevertheless, common threads run through a great many REIT acquisition and holding strategies, particularly as a result of their obligations to shareholders. This can be said to characterize a common REIT approach, or mindset, and that will often differentiate the amount a REIT will offer for a given asset from those of other investors.

Non-REIT real estate investors tend to buy property primarily in the hope of substantial asset appreciation over the holding period, anticipating much of the return on investment will accrue through the residual value of the property at the time of disposition or refinancing. Cash flow is primarily a concern to the extent that rents must cover operating expenses, reserves, and debt service so that there is no negative outlay of cash beyond the initial equity. A common example is the so-called "taxpayer" property, in which the property owner accepts the prospect of doing little better than breaking even (paying the taxes) during the holding period, which is offset by the build-up of wealth in the asset's appreciation over time.

In contrast, REITs prioritize cash flow and its growth ahead of asset appreciation in their acquisition strategy. A

building with a strong cash flow projection will ultimately be more desirable to shareholders in the company than a building that may operate on a razor-thin margin but hold out the possibility of significant appreciation in 15 years. Like virtually all public companies, a REIT's shareholders have little interest in the disposition value of the corporation's assets and are mainly focused on an assurance of positive and growing cash flow over a long period of time. In a REIT, the corporation's assets are its real estate holdings, which are a vehicle for the generation of income as opposed to the accumulation of personal wealth through net asset value. The same is true, for example, of the value of a railroad corporation, in which it is the ability of the railroad's assets—trains, rail lines, shipping contracts, and workforce—to generate income, and not in the physical assets themselves. As in any corporation, REIT shareholders would surely be outraged if the corporation in which they held stock decided one day that the company could generate more immediate and substantial cash by simply disposing of its assets.

So long as the REIT can predict that a property—or more often a portfolio as a whole—will produce the desired cash flow then it becomes irrelevant to the REIT what the market value of a particular property might be from the perspective of the ordinary investor.

In his examination of the reduction of unsystematic risk in lease portfolios through a so-called Monte Carlo Simulation, Colacino[6] suggested the concept of "baskets" of commercial office leases being pooled and traded in a secondary market. To a great extent, it can be said that the REIT model does exactly this: the corporation is merely the securitizing entity that gathers together a vast volume of cash flows from its leases and sells securitized ownership rights in those cash flows to those purchasing stock in the company.

As a result of this cash flow-oriented approach to real estate investing, REITs tend to have longer holding periods for their assets than non-REIT real estate investors. To dispose of assets that generate a reliable source of cash flow, even at an opportune time for sale, is often contrary to the corporate strategy of a REIT. As in most industries, the liquidation of a major revenue-generating asset is considered an "extraordinary" event under generally accepted accounting principles (GAAP) that could materially distort the depiction of a company's performance for forecasting purposes.

This approach is also aided by the REIT's lack of "below-the-line" expenses such as debt service (or at least less than typical) and income taxes. This means a REIT may produce a profit from the same cash flow that would have allowed the traditional investor to merely break even, and for which the traditional investor would probably have paid less for the asset.

So long as the REIT can predict that a property—or more often a portfolio as a whole—will produce the desired cash flow then it becomes irrelevant to the REIT what the market value of a particular property might be from the perspective of the ordinary investor. The following disclaimer from a REIT prospectus is typical of the industry approach to investing:

> *The company did not obtain appraisals of the fair market value of any of the original properties or related assets that the company will own immediately after consummation of the Offering. The public offering price of the shares and the related underlying valuation of the company have been determined primarily by capitalizing estimated cash flow of the company available for distribution, the enterprise value of the company as a going concern and other factors, rather than through a property by property valuation based upon historical cost or current market value. This methodology has been used because management believes it is appropriate to value the company as an ongoing business, rather than with a view to values that could be obtained from a liquidation of the company or of individual properties owned by the company.*[7]

As discussed in detail below, it is also true that a REIT acquisition team may employ different assumptions in modeling potential returns than ordinary investors will. It is this very belief on the part of REIT managers as buyers of property that they can obtain efficiencies in operation—regardless of whether they are correct in their belief—that may make it more likely that the REIT will acquire its properties at a premium.[8] Another major concern to the

Figure 1

	NON-REIT OWNERSHIP		REIT OWNERSHIP	
INCOME		PSF		PSF
Total Base Collected Rents				
320,000 SF Avg. Occupancy	$7,840,000	$24.50	$7,840,000	$24.50
Escalations & Recoveries (Actual)	$396,800	$1.24	$396,800	$1.24
Parking & Other Income (Actual)	$35,200	$0.11	$35,200	$0.11
Total Recoveries	$432,000	$1.35	$432,000	$1.35
POTENTIAL GROSS INCOME	**$8,272,000**	$25.85	**$8,272,000**	$25.85
Market Vacancy (Market - 97%)	$8,023,840	$25.07	$8,023,840.00	$25.07
EFFECTIVE GROSS INCOME	**$8,023,840**	$25.07	**$8,023,840**	$25.07
OPERATING EXPENSES				
Utilities (not recovered in base rent)	$1,020,800	$3.19	$1,020,800	$3.19
Operating Services	1,113,600	$3.48	1,113,600	$3.48
General & Administrative	12,800	$0.04	12,800	$0.04
Management	321,782	$1.01	22,000	$0.07
Reserves for Replacement (EGI)	0	$0.00	0	$0.00
Real Estate Taxes	1,024,000	$3.20	1,024,000	$3.20
Amortized Leasing Commissions	156,800	$0.49	156,800	$0.49
Amortized Tenant Improvements	326,400	$1.02	326,400	$1.02
Total Expenses	**$3,976,182**	$12.43	**$3,676,400**	$11.49
NET OPERATING INCOME	**$4,047,658**	$12.65	**$4,347,440**	$13.59
VALUATION ANALYSIS:				
Net Operating Income	**$4,047,658**		**$4,347,440**	
Capitalization Rate	**0.09750**		**0.09750**	
Fair Market Value	$41,514,441	$129.73	$44,589,128	$139.34

Difference: $9.61 PSF

Capitalization of Management Savings:

Savings PSF: $9.61
x 320,000 SF:
$3,075,200

Total Value of REIT Self-Management:

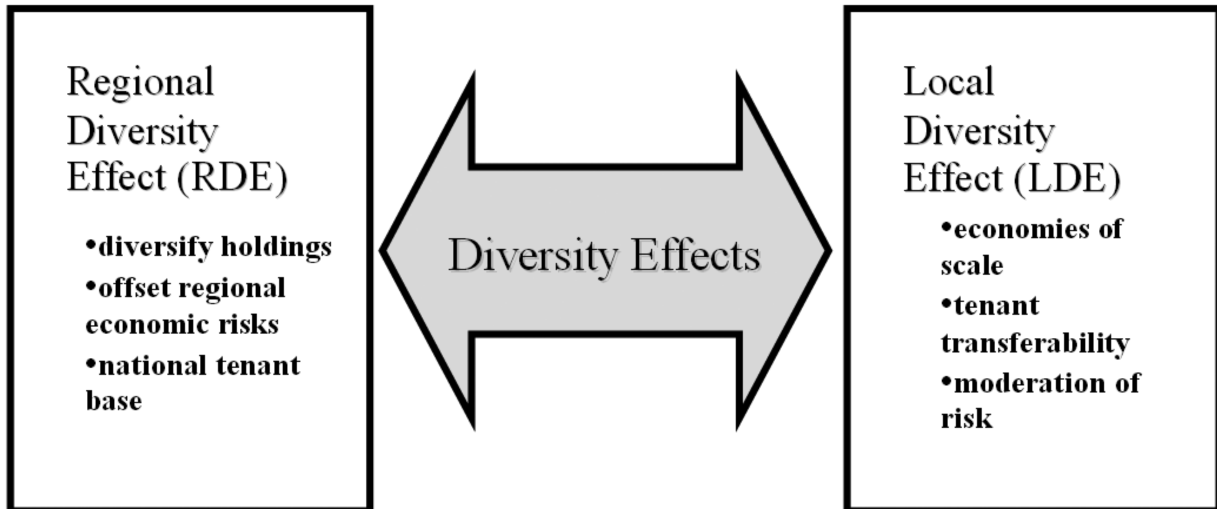
$3,075,200

acquisition team, particularly when assembling a multibillion dollar portfolio purchase, is the passage of time. The acquisition team may often operate within a much larger corporation in which the concerns of other departments—such as the property tax director who must wrangle with the after-effects of a transaction—are of only moderate concern at the time of purchase. More significant is the goal of simply closing the deal—a mark of success or potential failure for the acquisition team, which is often characterized by a highly short-term outlook. The net asset value of the portfolio as a whole may be important, but haggling over individual property values rarely occurs. If the deal can be closed while paying what some might say was more than market value for an individual asset, the overpayment is of little significance compared to the costs of a failure to close the whole portfolio because another player jumped in at the last minute while the first was haggling.

The cost of an overpayment relative to net asset value may also pale in contrast to the increased transaction costs, such as accruing interest on a billion-dollar loan, that would be incurred if the parties were to dicker over individual asset values. In perspective, so long as the overall price relative to the overall cash flow obtained makes sense, the deal should go forward as quickly as possible.

With these concepts in mind, it quickly becomes apparent that our goal of determining market value for *ad valorem* taxation purposes may be a very different objective from

Figure 2



what the typical REIT is aiming for when it purchases property.

OPERATING EFFICIENCIES, SELF-MANAGEMENT, AND TENANT SERVICES MAY INCREASE REIT INVESTMENT VALUE

As noted, REITs may well purchase their properties in part on the belief that greater returns will be generated simply because of the REIT operation and the efficiencies the company brings as an owner and operator of a large portfolio of real estate.[9] When analyzing a particular transaction price to determine whether it contains some component of intangible value paid by the REIT, one must consider the operations of the particular REIT involved. Often, itemized income and expense statements generated for the property a year or more after purchase, particularly as compared to operating statements from the previous owner, can reveal operational changes due solely to REIT ownership.

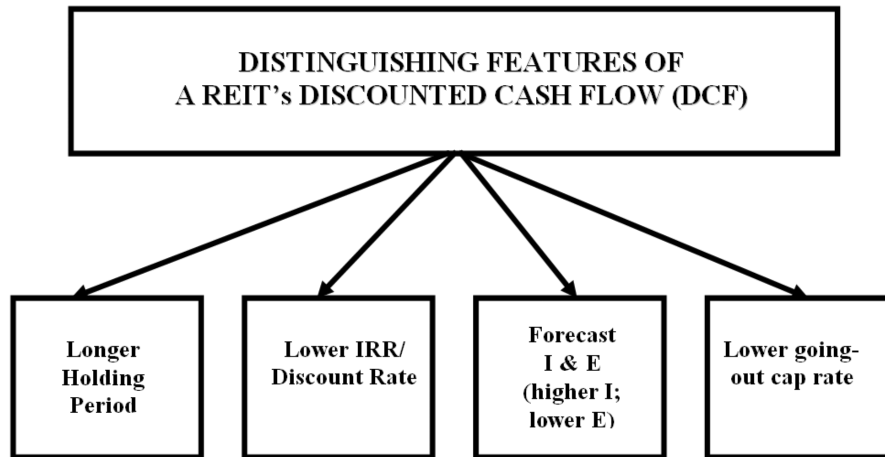
Other items of information will be available to the appraiser through researching the particular REIT's business operations, such as the particular types of ancillary services the company may provide which may include management, security, cleaning services, and other potential profit centers. Research may also reveal any economies of scale that may be realized through centralized property management and suppliers, in-house designers and planners, and other portfolio-oriented cost advantages.

For example, in the context of office or warehouse properties, a portfolio of 50 buildings in a single market may require no more than two or three on-staff managers to oversee operations. Because the REIT can be an owner-operator (unlike, say, a pension fund owner), the REIT saves money in the first instance by avoiding the costs and fees associated with third-party management. Because many properties are concentrated in one area, the REIT further saves money through the economy of scale of a handful of staff covering multiple buildings.

The total salary expense for this management staff will be a small fraction of the fees that any other investor would pay for a third-party management company to oversee 50 buildings, or sometimes just a single large property. Depending on the type of properties in which the particular REIT specializes, this concentration of properties will have a similar effect on all manner of supplies and costs related to the operations of the real estate, such as insurance, repair and maintenance items.

This added premium value for management services is quantifiable, and often generates a greater "investment value" for a given property to the REIT than the general market value of the property. The hypothetical pro forma comparison below (Figure 1) demonstrates how the value of self-management can be isolated by adjusting only

Figure 3



management fees to derive an estimate of a portion of the intangible value that may be attributed to REIT-ownership.

Additionally, the economy of sale principle lends itself to the operation of the ancillary businesses that can be operated by the REIT mentioned above, all of which can turn an ordinary property with a limited cash flow into one with multiple profit centers not available to the ordinary investor. Such services may include a wide variety of items such as security, trash collection, providing heat and light, and cleaning services. Distilling the value of such profit centers and the "intangible" value of a major sophisticated management operation is not much different in methodology from that which is often employed in the valuation of regional and superregional shopping centers. Rent differentials and operating expense ratios among comparable properties may be helpful indicators of the degree of additional value attributable to non-market factors. These profit centers are considered in the REIT's determination of its investment value in a given property or portfolio.

DIVERSITY EFFECTS ON THE PORTFOLIO VALUE OF REAL PROPERTY

Generally a property valued in a portfolio is less risky than the same property valued alone.[10] By combining one property with others the risk of the single asset is reduced, and the portfolio effect is "the extent to which the variation in return on a combination of assets (a 'portfolio') is less than the sum of the variations of the individual assets."[11] REITs are a classic example of portfolio owners.

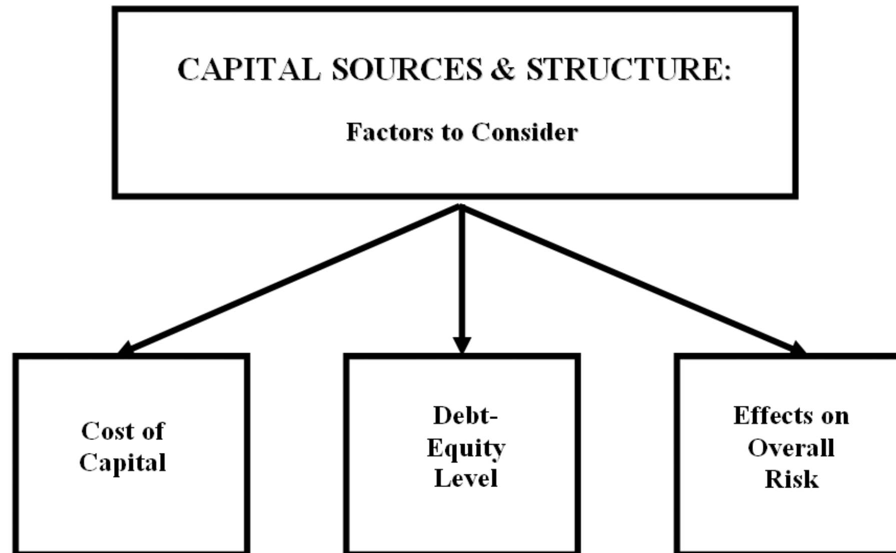
Even in a single property this principle can be achieved through lease term diversification: different termination dates would even out the cash flow of the portfolio compared with the cash flows of the individual properties. Viewed as a whole, the portfolio owner's properties contain a broad array of leases with differing terms.

We term this concept generally as "Diversity Effects," which may be further divided into two distinct types of Diversity Effects: (1) the Regional Diversity Effect (RDE), and (2) the Local Diversity Effect (LDE) (Figure 2).

REGIONAL DIVERSITY EFFECT

Aside from overall growth of income from a portfolio, much of a REIT's core business strategy and objective is focused on the moderation of overall risk to the company and its total cash flow. A single-asset real estate investor faces a relatively greater level of risk, even in the ownership of a top-notch, fully-leased Class A building, when compared with the overall level of risk experienced by an investor who owns multiple properties, even if each of those properties are less than ideal.

Figure 4



By applying the RDE to their advantage, REITs typically own multiple properties in several distinct markets throughout the country, often owning properties thousands of miles apart, as opposed to owning multiple properties in only one area. Where an entire region may experience an economic downturn, perhaps due to a major local employer's decision to downsize, other portions of the REIT's portfolio may be situated in regions that continue to experience growth. The overall risk and performance level of the portfolio may remain virtually unchanged.

As a result of the RDE, the REIT may be able to employ a risk tolerance that is atypical of most other players in the particular real estate market. This is generally not a market factor but rather a question of investment value for the particular REIT, indicating that the purchase price is unnaturally skewed.

LOCAL DIVERSITY EFFECT

The Local Diversity Effect (LDE) has at least two major components, some of which has already been touched upon here:

ECONOMIES OF SCALE

As discussed above, in any one market a REIT may own many buildings of similar use within a relatively small radius. One office REIT that we examined owns over 50 properties with a radius of about four to five miles of each other. This high concentration of assets creates tremendous economies of scale in the operation and oversight of the real estate, as well as a significant impact on the local portfolio's risk level. The subsequent addition of a full office park or only one or two additional properties within the local market may not require any significant addition of staff to perform management functions. This local concentration of properties creates a variety of cost savings advantages for the REIT over other property owners and it also significantly reduces overall risk.

TENANT TRANSFERABILITY

The second major component of LDE is a reduction of local risk to the portfolio, which is a direct result of Tenant Transferability. In the example above in which an office REIT owns more than 50 properties within a small geographic area, the REIT holds leases with some 200 office and warehouse tenants renting space in blocks of anywhere from 500 square feet to 200,000 square feet. Buildings fall within a broad range of Class C to Class A space. Because of the close proximity of one building to another (many are adjacent to or across the street from others in the portfolio), the REIT has a major advantage over the single-building owner, because the REIT's tenants can be moved into other REIT-owned buildings as the tenants' space needs change over time. This reduces the overall vacancy rate of the portfolio, thereby reducing risk

and maintaining cash flow, and is an attractive feature to incoming tenants who may be attracted by—and pay more for—the knowledge that they can be accommodated as their needs change. Furthermore, the costs of a leasing broker may often be omitted entirely or significantly reduced.

A COMPARISON OF DISCOUNTED CASH FLOW (DCF) FACTORS

It is important to consider and contrast the way in which REITs and non-REITs may formulate DCF models (in those cases in which appraisals are prepared). Discounted cash flow analysis is a useful tool in the income approach because it makes explicit the factors and assumptions that go into the investment decision, whereas direct capitalization only implies these factors. As a result, DCF can often provide a revealing look at what an investor was thinking when it determined that a particular property met its investment criteria, would produce a desired return, and was worth bidding a particular purchase price. We provide below just a few points in which, in our experience, it appears that a typical REIT DCF analysis might differ from that of the non-REIT investor (Figure 3).

The REIT is primarily interested in long-term cash flow rather than the return on sale. A longer holding period means that a REIT has a greater opportunity to meet its desired level of return while possibly accepting less-than-stellar performance in the early years of an investment.

HOLDING PERIOD

REIT executives we interviewed indicate that REITs tend to project longer holding periods for particular properties than many other investors. The REIT is primarily interested in long-term cash flow rather than the return on sale. A longer holding period means that a REIT has a greater opportunity to meet its desired level of return while possibly accepting less-than-stellar performance in the early years of an investment. This type of approach would not be apparent if the appraiser were to look only at the sale price and first year's NOI. A long holding period also tends to smooth out overall risk caused by real estate cycles. For example, if an investor purchased a property in 1988 and held it for only five years, the investor would have sold it near the bottom of the market in 1993. In contrast, if an investor were to purchase the same property on the same date, and hold it for 10 years, the investor would have enjoyed the recovery of the market in the late 1990s, and owned a more valuable property in 1998 with higher rents.

INTERNAL RATE OF RETURN/DISCOUNT RATE

Anecdotal evidence indicates that REITs typically accept an apparently lower internal rate of return on a given investment for a given set of projected cash flows than ordinary real estate investors. A lower discount rate for a given set of cash flows will produce a higher initial investment, or purchase price. This appears to be acceptable to the REIT again due to the REIT's ability to maximize the profit potential of each below-the-line dollar in a way most others cannot duplicate. There are at least two ways in which the REIT accomplishes this:

- The REIT as a tax-favored entity: the REIT is a tax-favored entity for federal tax purposes. The REIT's taxable income is only taxed at the shareholder level, in contrast to other corporations, and therefore a dollar of before tax NOI carries greater value for a REIT than it would for an ordinary owner. The REIT can meet or exceed returns obtained by other property owners who might pay substantially less for the investment.

- The REIT enjoys a lower level of risk and favorable position in the capital markets: as will be discussed below, the level of risk enables many REITs to maintain a concomitantly lower debt level and cost of capital than typical real estate investors, which means that more cash flow accrues directly to the benefit of the REIT and its shareholders.

FORECAST INCOME AND EXPENSES

As a result of the Local Diversity Effect that produces a variety of economies of scale, discussed above, a REIT's DCF for a given property will likely indicate lower costs for many expense items than would be projected by non-REIT investors, again allowing the REIT to offer a higher price and still produce the desired return. Additionally, with its typically dominant local market position, a given

REIT may be able to negotiate better rentals with tenants and derive additional income from some of the potential profit centers noted above, thus generating greater revenue out of a property than the ordinary investor would obtain. The average market participant will likely be more conservative in its forecasts of future income and expenses.

GOING-OUT OR TERMINAL CAPITALIZATION RATE

The remaining DCF factor that is worthy of attention is the terminal capitalization rate used by the REIT. This is the capitalization rate the investor estimates for the sale of the property at the end of the holding period. Because the REIT will tend to hold its assets for a longer holding period, as discussed above, this is a more remote consideration than the other DCF factors, but it nevertheless will impact the REIT's return on investment and the price the REIT will pay. With higher rents, lower expenses, and reduced overall risk, to a certain extent the REIT will have set in place the factors necessary to raise the terminal value of the property.

CAPITAL STRUCTURE AND CAPITAL SOURCES IN REIT TRANSACTIONS

In the 1990s, REITs had extreme flexibility in obtaining new equity for acquisitions through stock offerings. Today, REITs are often in stiff competition with other institutional purchasers and some of the ease with which REITs raised capital is gone. Foreign investors today enjoy significant advantages in their access to low-cost capital. However, REITs still enjoy significant advantages over many other real estate investors in cost of capital, access to capital markets, and capital structure. At least three issues related to the sources and use of capital are relevant to our discussion: (1) the cost of capital, (2) debt/equity level, and (3) effects on risk (Figure 4).

As a general investment principle, so long as an investor can access capital cheaper and on a less risky basis than other investors, that investor will be able to spend more while still achieving a desired return.

Like most publicly traded corporations, REITs access capital from a variety of sources not generally available to private real estate investors. Today's REITs may obtain capital from a combination of sources that may include commercial lenders, pension funds that are willing to lend money in a mortgage transaction, major lines of credit, and the issuance of debt in the public markets. A REIT may typically buy and sell multiple properties in a single transaction, perhaps accessing a billion or more dollars and, depending on the credit of the REIT, enjoying preferred terms in comparison to other investors. At times, when REITs also enjoy a favorable reputation among stockholders, many REITs readily issue stock to raise large sums of cash with few strings attached. The transaction costs that REITs incur tend to be significantly lower than those charged to non-REIT investors.

The cost of capital in such transactions is frequently measured against LIBOR, with preferred borrowers enjoying interest rates closer to LIBOR than other borrowers. As compared with other investors, large REITs will in many cases borrow capital at 150 to 200 basis points below more conventional real estate borrowers.

As a general investment principle, so long as an investor can access capital cheaper and on a less risky basis than other investors, that investor will be able to spend more while still achieving a desired return.

Another difference in the use of capital by many REITs is the debt-equity level in a REIT transaction. Most conventional real estate loans today are in the range of 70 percent of value. A REIT, in contrast, will tend to borrow at the entity level rather than at the property level. Consequently, debt is often kept well below ordinary loan-to-value ratios, and the capital market and credit rating agencies typically require most REITs to operate at relatively low loan-to-value ratios. In addition to lowering overall risk, the result is also lower debt service payments that would reduce the below the line cash flow.

PURCHASES OFTEN INVOLVE MORE THAN JUST REAL ESTATE

The foregoing concentrates on a variety of factors that may affect the investment value of specific properties or an entire portfolio to a REIT, primarily as that value relates to the cash flow characteristics of those properties. An entirely different factor that has historically been found in many REIT purchases is the value paid for items having virtually no direct relationship to the real estate at all.

Currently, mergers and acquisitions involving REITs seem to have diminished from the levels seen in the late 1990s,

with the exception of several sectors. However, when these transactions do occur, the acquiring REIT typically pays a lump sum to obtain the entire business operations and assets of the acquired real estate company. In short, the REIT is buying the assets of another REIT, and along with those assets are many intangibles typically associated with any large corporation. The acquirer inherits many of the general and administrative expenses of the acquired company with the hope of a successful integration and resulting economies of scale. The amount paid often includes tens of millions of dollars relating to the immediate vesting of stock options, changing of control, payments under employment contracts, refinancing of debt, fees for investment bankers, auditors, attorneys, and a host of other major transaction costs that may be buried within a multi-billion dollar deal. If, as is frequently the case, the total purchase price of the transaction is simply allocated among the buildings comprising the acquired portfolio based upon square footage, it is apparent such an allocated purchase price will not be equivalent to the market value of the individual properties; the stated price is composed of a significant amount of non-realty value.

The investment value of a given property to a REIT may or may not be the same as for an ordinary investor and consequently may not always equate to market value. It should be apparent that these transactions often require far greater analysis and investigation than those involving more "ordinary" investors.

This is perhaps one of the most straightforward examples capitalized economic profit forming a portion of the purchase price. In examining a particular sale for property tax assessment purposes, one must thoroughly investigate the circumstances of the sale before concluding that the sale is equivalent to market value. Where an acquisition of another company has occurred, the purchase is not necessarily viewed as simply the acquisition of real estate, but rather an ongoing business.

When reviewing a reported sale to a REIT, particularly where it is known that the sale involved a merger or acquisition, a good place to start—what may also be referred to as a "sanity check"—is to compute the direct capitalization rate of the transaction. While there are many genuine realty-related factors that might skew this rate (such as a large vacancy that is anticipated to be absorbed quickly), an extraordinarily low first-year capitalization rate is often the first indication that the purchase money went to more than just the real estate value.

While REITs may often pay institutional investor capitalization rates for many of the reasons discussed earlier in this article, there is a point at which the indicated rate becomes so extraordinarily low that it cannot be considered indicative of the real estate market, at least not an indication of what ordinary local investors are paying in a particular market.

CONCLUSION

Though the REIT industry has changed, adapted, and matured in recent years with general economic trends, REITs continue to attract attention among property tax practitioners and to play a dominant role in many real estate markets. In some jurisdictions in which property tax appeals may remain unresolved for many years at a time, such as New York, REIT purchases made in the late 1990s are still directly at issue. Moreover, REITs remain distinguished from many other, more traditional real estate investors in their approach to buying and operating real estate. As such, the investment value of a given property to a REIT may or may not be the same as for an ordinary investor and consequently may not always equate to market value. It should be apparent that these transactions often require far greater analysis and investigation than those involving more "ordinary" investors. The analyst must inspect and understand the pro forma in far greater depth than with other transactions, research the characteristics of the REIT purchaser as a company, including the size, scope, and geographical location of its portfolio, its capital sources, and its general risk characteristics, among many other factors. One must also investigate thoroughly the components of the transaction itself to determine whether the REIT has paid for intangible and other assets of another business that are incorporated into the purchase price but which may have nothing to do with the underlying real estate for tax assessment purposes.

ENDNOTES

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7. Quoted in William N. Kinnard, Jr. and Mary Beth Geckler, "There is REIT Value and Pension Fund Value, but Neither is Market Value (Usually)" (Paper presented at 1995 ABA/IPT Advanced Property Tax Seminar, New Orleans, March 1995), 4-5.

8. See Note 4.

9. Id.

10. Brigham, Eugene F., *Fundamentals of Financial Management* (Chicago: The Dryden Press, 1983), 157.

11. Id. 805.

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