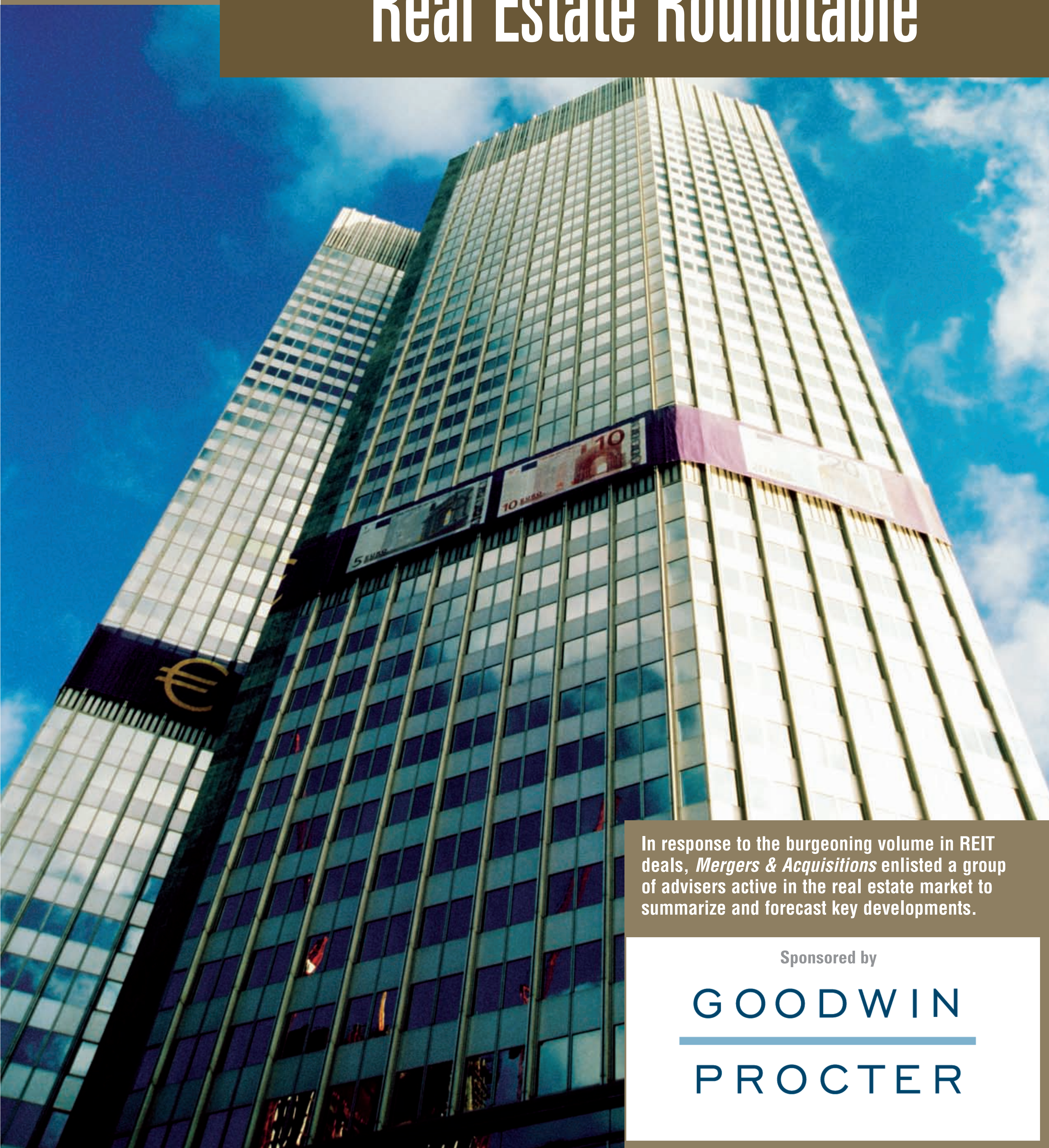
Real Estate Roundtable



In response to the burgeoning volume in REIT deals, *Mergers & Acquisitions* enlisted a group of advisers active in the real estate market to summarize and forecast key developments.

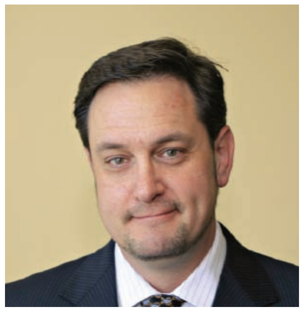
Sponsored by

GOODWIN PROCTER

AMASSING HARD ASSETS VIA REIT MERGERS

Dennis Irvin,
Senior Managing Director, CIT Group

Gilbert Menna,
Partner, Goodwin Procter



Michael Hoffman,
President and Partner, Probitas Partners

John Schoenfeld,
Managing Director,
Houlihan Lokey Howard & Zukin

Gregory Wright,
Managing Director, Merrill Lynch

Martin Sikora,
Editor, Mergers & Acquisitions

Real estate and private equity experts blend exotic finances with strategic drivers to engineer huge combinations of property owners.

Mergers of real estate investment trusts have virtually exploded, creating some of the largest and highest-profile deals in the past year. To identify the economic and operational payoffs that have caught the eye of both financial and strategic buyers, Mergers & Acquisitions called on a unique group of skilled professionals to analyze the trends.

Sikora: Why have we been seeing an increase in M&A among REITs recently, with rather large companies coming together?

Hoffman: Probitas Partners is a placement organization that raises money for PE funds and real estate funds and we invest 10% to 30% of our fee in these deals. We've been involved in a number of PE funds, including KSL, that invested in large hotel assets that had generated quite exceptional returns.

In terms of M&A, it's been pretty typical over the last 20 years that private equity, as in many areas, led the way and real estate followed, starting with the opportunity funds that grew pretty dramatically in the mid-to-late '90s.

Today, we're seeing the growth of very large buyout funds, such as $15 to $20 billion, and potentially $25 billion, that are aggressively pursuing public companies and taking them private. There's the benefit of scale in the REIT business, both from a defensive standpoint as well as making the assets more attractive. As capital flows from the private side impact the public markets, we're seeing a natural early precursor of that.

Menna: I think the modern era actually began with Kimco's IPO in 1991, and we all appreciate the flows of capital into the real estate space from the private side.

As we look at the REIT industry since 1991, there has been an amalgamation of portfolios that are hard to duplicate and there's been a lot of energy and human capital put into assembling quality portfolios. It's one-stop shopping, to some extent, for a big PE firm to be able to buy a lodging portfolio, for example.

Wright: We should talk about the liquidity and unprecedented capital flows that we're seeing in the space, which are leading the private market to the public market. The liquidity

(Continued on page 36)

(Continued from page 34)
is unparalleled when you look at capital flows and everything coming into the REIT business today.

I recall that back in 2001, the technology and telecom and media spaces were most favored. I could suggest a 14% or 15% return in some other field and they laughed. They said, “I can get 20% or 30% by doing this tech/telecom deal.” After that market melted down, REITs became more attractive for a couple of reasons. One is that we have hard assets that generate true cash flow in terms of yield.

We also started to see the acceptance of real estate as an asset class on a portfolio theory basis. When you look at the efficient frontier and all that stuff and you start to put real estate into the mix, investors other than the typical dedicated REIT investors began to come into the sector.

From the public market’s perspective, multiples are at an all-time high. You have low-cost debt and equity right now. What you’re really doing is betting on future growth, because these private investors are looking for a good product.

No one knows whether the private market is right or wrong yet, but they think they’re going to be able to create efficiencies, whether by increased cash flows or something else. They may be betting on a certain sector or on a certain geographic area, but they’re willing to make a bet on the future growth prospects of that portfolio or company.

Irvin: I think it’s sort of a perfect storm right now in the industry. I don’t think it’s a secular change but more of an evolution of a market that’s still relatively young. But REITs are going through consolidation, which people expected for a fairly long time.

Of the $120 billion in deals that were done by REITs in the last two years, close to 70% has been in privatizations.

We see the confluence of a couple of things that are supporting that and we’re at the tip of the iceberg. I think it’s going to be the beginning of a trend. With the pension fund allocations being under-funded, I think that will lead to another finance trend and pent-up demand that’s going to fuel more privatization. When you look at the difficulty in placing that kind of capital, you have to look at the REIT world.

We’re primarily a debt balance sheet lender, and I see that as being the other driver because there’s so much liquidity in the CMBS world. Just do the math. Take an entity or portfolio that’s on average 50% to 60% leverage, take it into the CMBS world, and you can get to the 80% to 85% levels of leverage. It’s tough not to have a successful deal. I don’t see the debt liquidity going away and I only see fundamentals in the market improving.

Schoenfeld: There are a couple of other factors also. One is leverage. If you’re a private buyer and REITs are at 50% leverage, you can go out and finance 80% or 85%. Your yield goes way up.

Also, as we grow internationally, we’re going to see global real estate companies. When you talk about a Blackstone and you look at the REITs that are coming into place in Europe and Asia, I think we’ll see what amounts to global real estate companies trading potentially in the U.S.

Another interesting thing is that traditional real estate funds are doing asset plays and pure PE funds are doing operating company plays. We’re increasingly getting into the asset-level business but we’ve increasingly spent a lot of time in what we call real estate operating companies, whether it’s hotels, ski resorts, or assisted living companies, where traditional real estate players are getting in with the understanding that they have to value a company on some premium to split it off.

Sikora: Blackstone is buying Equity Office Properties in office real estate. Where do you think we’ll see the most M&A

(Continued on page 38)

(Continued from page 36)
activity as far as real estate niches or spaces are concerned?

Irvin: I think it will be in the office sector. In addition to perfect conditions in the capital markets, we have underlying fundamentals that pretty much nationally support a bet that we're going to have 1.8% to 2% job growth, which will fuel fewer vacancies and increased rents.

Wright: There have been seven office M&A deals in the past year, and there are 23 companies left. The office sector has shown some volatility that perhaps other sectors haven't shown. So I think that's where you get some of the disparity in public-market asset values versus private-market values.

We've seen activity in offices, hotels, and retail this year, but I think we're going to continue to see it across all sectors.

Schoenfeld: On the basis of NAV, office real estate has the lowest premium to NAV of all of the sectors. By our numbers, it's about a 6% premium versus strip retail, which is 120% or so. Yet, we can get those deals done with a very high-cap rate.

I think fundamentally it's more opportunistic than it is a specific sector. I think it will come down to the individual PE fund's strategy, not just domestically but globally. When you look at the business and you look at lodging and leisure, you look at people that are amassing assets. We're seeing people building basic building companies privately that will ultimately be sold publicly anywhere, depending on where the multiples are.

In the securitization of debt and equity that we're doing now, we're splitting up the old structures in which the company owned, say, all of its hotels and the management business at the same time. It doesn't make sense because the company's hotel business is traded at 15 or 16 times or so and the other business trades higher. You can re-deploy the capital. So you have a multiple arbitrage. In Europe, it's the opposite. Property trades higher so they can anticipate multiples going up.

Sikora: Is there a future for mixed REITs where you have hotels and malls, for example, in the same company, or will REITs continue to be specialized?

Wright: I think most public-market buyers and investors still make the argument that they can diversify more cheaply than you can.

If you're a principal and you have all your eggs in one basket, diversification may not be bad. But we haven't seen a sprint toward diversification because what you're ultimately investing in, besides the assets and the product type, is the management team. I think people are buying in terms of gaining opportunistic management teams in different property types rather than just saying they would rather have diversification.

Menna: Even on the private equity side, it's interesting to note that there aren't too many PE firms that cross different property types. Those that do have been in the business for quite some time. We rarely represent a sponsor that might have been involved in real estate over many generations and that accesses institutional capital for the first time that's trying to diversify the types of real estate that it invests in.

Schoenfeld: I think most of the bigger funds do, but they still make the distinction between operating a business and owning assets.

Menna: We've tracked how much PE capital we've raised over the last 15 years. In the last three years we raised more PE capital than we had in the last eight years combined. In each of those contexts, we've taken out relatively small sponsors and they've generally stayed in their targeted field, although with some, over time, you would see a convergence. A hotel firm might go into leisure properties, for example.

Schoenfeld: We're seeing corporate guys like D.E. Shaw and Angelo Gordon set up real estate shops. They have the ability to cross over, and that's where you may not get into pure-play real estate. Somebody that's historically been a pure play in hotels may get into gaming.

Even with the pension funds, it's now an accepted form of alternative investment. They have dedicated REIT staffs and dedicated direct placement staffs, and now the corporate guys are saying, "We need to be in this because we can buy an operating company."

Irvin: We focus heavily on middle-market finance. We didn't have a real estate group until 15 months ago, and what we went after from day one was that crossover market. We felt we could bring in an asset-backed loan, a rollover, or a debtor-in-possession (DIP) instrument with our experience. In a DIP situation, we can become an adviser to the institution because of value that may be locked up in the real estate.

When you scour companies' balance sheets and find anything more than 30% of book value in real estate, you're going to see investors look at those companies and start to show interest. Hedge funds and others are aggressively eyeing deals. They're coming to us all the time to lever up these assets as much as possible.

Menna: Equity capital has actually gotten cheaper but on the private side, traditional private equity capital hasn't seen hurdle rates go south to any significant degree. I wonder, whether some players are looking at corporate real estate because at the end of the day, it's pretty hard to buy a large public REIT and make your hurdles unless you're just doing an asset investment play.

Schoenfeld: There is a disconnect. No one has been able to answer this question for me. When you have the REIT dividend yield at 3-1/2% and you have the 10-year Treasury at 4.4%, which is the risk-free rate?

Wright: Look at the protections going forward. Who knows if you're right or

wrong? On average, the markets are expecting 7-1/2% cash flow growth for the whole REIT universe. The question is what happens with multiples? If multiples stay at 7-1/2% leveraged cash flow growth, combine it with a dividend, and that's not bad.

Menna: It used to be that the cost of equity capital was always higher for a REIT than the cost of debt capital. At some point in the last five or six years, that crossed over.

Sikora: Why has there been an upsurge in PE funds in the real estate market? It used to be that real estate was equated with existing leverage, and that was supposed to turn off private equity. Why the shift?

Wright: I think it's leverage. Most of these deals that are being done involve funds taking public companies private. I think what's driving it is that a REIT that is 40% or 50% leveraged can very comfortably go to 75% or 85%.

If you look at these unleveraged returns they may not be the greatest. But when you take a look at the leveraged return, you're getting 85% leverage with decent prospects for industry fundamentals and interest rates at all-time lows.

There are still a lot of situations where, with capital expenditures, improvements, and leasing commissions, you're still at negative leverage going in. But there's a combination of low interest rates and PE buyers betting on future growth.

Menna: It also works because of the inverted yield curve. I remember restructuring old mortgage REITs where they didn't match assets and liabilities. You can do that in today's capital markets and effectively mesh your terms. Then you don't create the potential problem where you have floating rate debt with a long-term liability.

Irvin: There's discipline, but I think we're seeing the discipline starting to get weaker in tranches. Where we see underwriting challenges is in the B note to the preferred equity, and when you look at what the markets are willing to pay to take on that level of risk today, you're 300 basis points inside of where you were 18 months to two years ago.

The CBO phenomenon that's created liquidity in some investment tranches has added to the fuel of debt liquidity. We see a real discipline in the A tranche, but once you leave that world, it's crazy.

Hoffman: When buyer funds are being REITs, though, they're not buying assets with the traditional debt underwriting that goes along with lending from real estate lenders. It goes out the window. Today, on the private equity side, you have zero covenants in lending, and it's fully participated in. So the originator has no interest in maintaining higher standards, and when this happens you have a five-year bullet but no recourse.

Sikora: In many large deals, REITs have teamed up with operating buyers to split real estate from operations, such as

Vornado in Toys 'R' Us. Will we see more convergence of operating-business buyers and hard-asset buyers? And what kinds of deal structures can we expect?

Hoffman: We once had a difficult fundraising job because the fund wasn't real estate and it wasn't private equity. Fundamentally, it segmented hard assets from more valuable cash flows that they were able to use to securitize markets and pull value out.

When we started, there was 80% real estate and 20% private equity investors. Now it's flipped and it's a private equity vehicle. We've kind of gone back to the future. We're looking at many of the same strategies to unlock what's appropriate in the market today. Toys 'R' Us is just one example.

Menna: Real estate EBITDA is the way I think about it. It's basically trying to get earnings from real estate, and whether it's housed in Toys 'R' Us, Starbucks, or wherever, you're going to have people underwriting that cash flow.

Schoenfeld: From a pure corporate standpoint, if you're buying a Toys 'R' Us, a grocery store, or a retailer, you have to look at the real estate, but you have to look at the deal from the corporate perspective as well.

That's why you don't see a lot of pure real estate guys partnering up. Yet, you have crossover firms that really understand how to underwrite a corporate credit and how to underwrite a real estate asset. We won't see real estate guys taking an operating company, because that's not their business, but they may partner with someone and take part of it.

Hoffman: As private equity buys a lot more public companies that have large real estate components, there's no question that they'll look at teaming up.

Schoenfeld: I think the biggest opportunity is outside of the U.S. because companies in Latin American and Europe, and to a certain extent Asia, have always valued holding the hard assets along with the operating business. As the markets become more efficient and REIT structures develop globally, we're going to see that spin off.