



UPDATE: FURTHER TRENDS IN REIT M&A (2018)

One year ago we released our advisory alert “Trends in Public REIT M&A: 2012–2017”, chronicling select metrics across the 50+ REIT M&A transactions announced during the 2012-2017 period. We noted that while the largest number of transactions during this period occurred in the residential sector, there was robust activity in the retail, healthcare and office sectors as well, with an aggregate transaction value across all deals in the REIT sector exceeding \$165 billion.

Since January 2018, a further 15 REIT M&A transactions have been announced with an aggregate transaction value of approximately \$75 billion. A full listing of these transactions is included at the end of this article.

SELECTED DATA

Of the 15 new REIT M&A transactions announced since January 1, 2018:

- 4 (27%)** were go-private transactions
- 11 (73%)** were public-to-public transactions
- 6 (40%)** provided for all-cash consideration
- 5 (33%)** provided for all-stock consideration
- 4 (27%)** provided for mixed cash and stock consideration
- 4 (67%)** of the 6 all-cash transactions restricted target from paying regular cash dividends post-signing
- 8 (88%)** of the 9 all-stock or mixed-consideration transactions provided for payment of dividends to target shareholders through closing
- 21.7%** = the average premium to unaffected share price
- 16.0%** = the median premium to unaffected share price
- 6 (40%)** were related-party transactions, involving the acquisition of a REIT by its sponsor or other affiliated entity
- 5 (33%)** included a “go shop”
- 4 (27%)** otherwise included a two-tier termination fee structure whereby a substantially lower termination fee is payable during an initial “window shop” period

WHAT CHANGED IN 2018?

While the REIT M&A transactions announced since January 1, 2018 are largely of the same general fabric as prior deals in the sector, 2018 ushered in some notable changes to both the legal tenor and general context of REIT M&A. Some of these changes relate to the essential catalysts often necessary to spur REIT M&A. In theory, there are numerous reasons for a public REIT to trade, including a compelling offer too good to refuse, a highly synergistic strategic fit, looming succession concerns, persistent underperformance, a perceived oversupply of similar companies in the public markets, and activist investor pressures. In practice, however, companies often do not trade unless and until a catalyst comes along that compels change from the status quo. We address below some of those catalysts that were – and were not – at play in 2018.

- **Some Things Did Not Change.** While the 2018 sample set is relatively small, it is interesting to note that many of the data points set forth above are largely right on par with the same data points we calculated last year for the larger 2012-2017 sample set. The mix of go-private vs. public-to-public deals, cash vs. stock deals, the average and median premiums to unaffected share price – all of these were within a short stone's throw of the same metrics reported for the 2012-2017 transactions. This suggests that 2018's transactions were largely in line with historical precedent and did not represent a meaningful departure in structure or approach. In a broad sense, we would expect the same to continue in 2019.
- **Dividend Treatment.** The 2018 transactions continued a trend noted in our 2017 alert whereby cash buyers are increasingly reluctant to permit a target to continue paying cash dividends once the merger agreement had been signed. Over our cumulative data

set of 69 public REIT M&A transactions in the 2012-2018 period, approximately 31% of the all-cash deals restricted dividend payments post signing¹. If we look at just the last three years, however, 2016-2018, 80% of the all-cash deals restricted dividend payments post signing². We believe that the shift towards restricting post-signing dividend payments is likely a secular trend in privatization transactions and not necessarily correlated with pricing in the later stages of the real estate cycle.

Conversely, all but one of the all-stock or mixed-consideration transactions announced since January 1, 2018 generally provided for continued receipt by target shareholders of regular quarterly dividends, often in coordination with acquirer where applicable. A small minority of these deals provided for a limit on the maximum number of quarters for which dividends could be paid and/or stipulated that dividends would not be paid for the most recently completed quarter. The outlier was the LaSalle-Pebblebrook transaction, where the merger agreement prohibited LaSalle from paying regular quarterly cash dividends to its stockholders in the period between signing and closing, though this may have been informed in part by a similar no-payment provision that was in the merger agreement LaSalle initially signed with Blackstone, a cash buyer, before that agreement was terminated in favor of Pebblebrook's higher mixed-consideration offer.

- **Go-Shops and Window-Shops.** A notable exception to uniformity in the select data points we measured as between the 2012-2017 period and the 2018 period, is the increase in 2018 of transactions incorporating a two-tiered termination fee structure, whether by way of a go-shop provision or a

¹In virtually all deals the transaction agreement permits target to pay dividends as necessary to maintain its REIT qualification and/or avoid imposition of income or excise taxes. In many versions of this provision, the agreement goes on to provide that the merger consideration payable to target shareholders will be decreased dollar-for-dollar in the event any such REIT qualification dividends are paid.

²In at least one of these transactions, the agreement stipulated that target could resume paying regular cash dividends if closing was delayed beyond a stated outside date.

liberal “window shop” provision, pursuant to which a substantially lower termination fee is payable by the company if it terminates the agreement to pursue a superior proposal from a bidder that engaged during the go-shop or an initial lower break-up fee “window-shop” period. Even given the small 2018 sample size, it is noteworthy to observe that 60% of all deals announced during this period provided for some form of two-tiered termination fee³. This continues a trend the development of which we also noted in our 2017 alert, whereby parties to REIT M&A transactions are increasingly leaving the door open, sometimes fairly wide open, to possible competing bids that might maximize shareholder value.

We expect to see increasing use of the two-tiered window shop structure in future REIT M&A transactions, particularly where the target’s board reasonably believes a better offer is a distinct possibility yet does not want to lose an opportunity to transact quickly with a suitor by conducting a pre-announcement market check. The recent data also highlights the logical use of go-shop structures in related-party or affiliated transactions⁴.

- **Buy What You Know.** Among the 15 REIT M&A transactions announced since January 1, 2018, a common theme (40%) was that the buyer either already owned a significant amount of the target or was otherwise an affiliate of the target. For example, five of 2018’s deals involved the combinations of companies externally managed by the same sponsor/advisor. In the non-traded REIT space, combinations of similarly-focused companies under the same management could signal a desire for rationalizing and streamlining operations ahead of a possible

liquidity event. We would expect these types of “buy what you know” transactions to continue in 2019 and beyond.

- **Shareholder Activism.** Shareholder activism continued to be a recurring theme in the REIT sector during 2018, with a total of 21 activist campaigns launched or expanded during the year. Of the 2018 REIT M&A transactions that involved unaffiliated buyers and sellers, at least three transactions (one third) were partially influenced by shareholder activist campaigns at the target companies. The past five years has seen over 135 activist campaigns in the public REIT sector, due in part to the fact that perceived NAV transparency makes underperformers conspicuous and vulnerable to campaigns. In addition, recent campaigns waged by high profile activists have paved the way for others seeking to unlock shareholder value in the sector. Moreover, substantial capital flows into activist-dedicated funds have enabled activists to take more positions and pursue more campaigns. We expect activism in the sector to continue in 2019 and beyond, leading inevitably in some cases to sale or combination transactions as activists clamor for short-term value.
- **Is the Discount Real?** Valuations of commercial real estate typically begin with a determination of net asset value, or NAV. For a public REIT, NAV is generally the current market value of its assets, less the current market value of its liabilities and obligations. When the cumulative equity market capitalization of a REIT exceeds its NAV, the REIT is said to trade at a premium to NAV; conversely, when NAV is higher than current equity market capitalization, the REIT is said to trade at a discount to NAV.

³Note that this includes four related-party deals where go-shops are much more common in any event.

⁴Conversely, it may not always make sense to provide for either a go-shop or a window shop termination fee structure in a pre-emptive deal. For example, in connection with Brookfield’s 2016 acquisition of Rouse Properties, the company’s proxy statement enumerated the reasons why the special committee elected not to pursue a go-shop, each of which might equally apply to a two-tiered termination fee structure: (i) lack of interest on the part of other potential bidders since Brookfield’s earlier announcement of an acquisition proposal, (ii) Brookfield’s existing ownership stake in the company, (iii) an unsuccessful process to sell the company had in fact recently been conducted, (iv) deteriorating REIT equity market conditions, and (v) the fact that Brookfield had repeatedly emphasized that its offer was its “best and final”.

Since 1990, public REITs have traded at an average 2.1% premium to NAV and, since 2007, have traded on average at par with NAV. Currently, however, REITs are trading at a reported average discount to NAV⁵ in excess of 12%⁶. In some sectors, such as commercial office, reported discounts to NAV are substantially higher. Conventional wisdom would suggest that if there are high-quality commercial assets available for purchase at deeply discounted prices in the form of public REIT shares, that there would be buyers⁷. But the buying thus far has generally failed to materialize in certain deeply discounted sectors. For example, none of the 15 most recently-announced REIT M&A transactions involved commercial office assets, despite the sector's deeply discounted current valuations.

Why this is the case may depend on who you ask. Market purists insist that if there are no buyers it must mean that the reported discount to NAV is not real, meaning that buy-siders do not believe a given REIT's assets truly have the current market valuation given to them in widely-circulated NAV calculations. High-quality NAV estimates typically require significant expertise and effort so it does not seem unlikely that reasonable minds might disagree as to most current valuations. Alternatively, even if NAV estimates are taken more-or-less at face value, many potential buyers in the current market may not have the investment time horizon necessary to see share prices revert to their historical norm relative to NAV. So they are staying on the side until the equity markets do some catching up.

Whatever the real cause of investors' lack of enthusiasm for ostensibly highly discounted assets on the screen – the truth is likely somewhere in the middle – the steep

discounts to NAV did not appear to serve as a catalyst to REIT M&A activity in 2018, though this may change in 2019 and beyond if steep discounts persist notwithstanding respectable GDP numbers.

- **The “Big Two” Effect.** Among the nearly 70 REIT M&A transactions announced since 2012, 8 of them, or 11.6%, have been transactions involving either Blackstone or Brookfield, which, not surprisingly, doubles to 22.5% when weighted by transaction value. Among all go-private transactions announced during this period, approximately 37% were Blackstone or Brookfield deals, which grows to a staggering 54% when weighted by transaction value⁸. These two organizations are not monolithic, there are material differences between them both in terms of strategic objectives, sector focus and vision – but they share the common denominators of being supremely sophisticated commercial real estate investors, nimble, and with ready access to capital historically unmatched in the industry. When it comes to REIT M&A, there are few, if any, other players who can write the checks that a Blackstone or Brookfield can, or as quickly.

The “Big Two Effect” influences many facets of the REIT M&A landscape in today's market, sometimes consciously and sometimes otherwise, and often impacts at least the early stages of the bidding process. For example, where a Blackstone and/or Brookfield are potential buyers in a pending transaction, competing buyers or interlopers may be dissuaded from throwing their hats into the ring at the same time simply based on competitive size and leverage. Conversely, where Blackstone and/or Brookfield have passed on a given acquisition opportunity, remaining potential bidders may (but do not

⁵Source: Green Street Advisors (www.greenstreetadvisors.com/insights/avgpremnnav).

⁶Lazard Global Real Estate Securities, US Real Estate Indicators Report, October 2018 (http://www.lazardnet.com/docs/sp0/4915/Lazard_USRealEstateIndicatorsReport_201403.pdf)

⁷Or, as a certain principal at Blackstone once said, “If real estate is cheaper on the screen than it is on the street, then we'll buy it on the screen”.

⁸These numbers count Brookfield's Rouse, Associated Estates and Forest City transactions as go-privates, but not the GGP/BPR transaction given that the public company (GGP/BPR) remained an issuer of publicly traded securities.

always) question the true value of the target assets, simply because the “duopoly” passed on the opportunity. The reverse can also be true for a different subset of private-equity investors, where the absence of a Blackstone or Brookfield at the time of bidding can arguably make the target a more rather than less attractive opportunity.

We expect continued REIT M&A activity in 2019 and beyond, including further privatization transactions given the amount of available capital in the sector and the efficiencies associated with deploying that capital in take-privates. 

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DATE ANNOUNCED	TARGET	ACQUIRER	SECTOR
Mar 2018	GGP, Inc.	Brookfield Property Partners	Retail
Apr 2018	DCT Industrial Trust	Prologis, Inc.	Industrial
Apr 2018	Quality Care Properties	Welltower	Healthcare
May 2018	Gramercy Property Trust	Blackstone Group	Industrial
May 2018	MTGE Investment Corp.	Annaly Capital Management	Mortgage
Jun 2018	Education Realty Trust	Greystar Real Estate Partners	Residential (Student Housing)
Jun 2018	CPA 17	W.P. Carey	Diversified
Jul 2018	Forest City Realty Trust	Brookfield Asset Management	Diversified
Jul 2018	Phillips Edison Grocery Center REIT II	Phillips Edison & Company, Inc.	Retail
Aug 2018	LaSalle Hotel Properties	Pebblebrook	Lodging
Sep 2018	Select Income REIT	Government Properties Income Trust	Office
Oct 2018	Strategic Storage Trust II	Strategic Storage Growth Trust	Storage
Oct 2018	InfraREIT, Inc.	Oncor Electric Delivery Company	Specialty
Dec 2018	Griffin Capital Essential Asset REIT II	Griffin Capital Essential Asset REIT	Office/Industrial
Jan 2019	MedEquities Realty Trust	Omega Healthcare Investors	Healthcare