

EQUITY REIT IPOs, 1991-1993

by

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ABSTRACT

This paper first familiarizes the reader with the concept of real estate investment trusts (REITs), then presents some theories on the costs and issues associated with initial public offerings (IPOs) in general, and finally, tests the applicability of those IPO theories against a sample of equity REIT IPOs.

The sample consists of 13 equity REIT IPOs which took place between November, 1991 and June, 1993. Sources of information include the prospectuses, New York Stock Exchange trading statistics, publications in journals and newspapers, and interviews with various investors, advisors, and issuers of equity REIT IPOs.

The paper determines that a previous study on IPOs substantially underestimates the direct costs of equity REIT IPOs. It concludes that the underwriter's reputation or prestige is not a determining factor in the "success" of an equity REIT IPO. It also confirms that a trading strategy of "flipping" equity REIT IPO shares will result in superior returns for institutional investors, who because of their size and volume of business are the preferred customers of underwriters, and therefore receive a disproportionate share of "good" equity REIT IPOs. Observations are also made regarding other issues such as information disclosure, hot IPO markets, trading volume, and liquidity of equity REIT IPOs.

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TABLE OF CONTENTS

	<u>Page</u>
<u>Chapter 1 REITs</u>	6
1.1 Background	6
1.2 Types of REITs	6
1.3 Qualifying As a REIT	7
1.4 Why REITs Are Attractive To Investors	9
1.5 Limitations of the REIT Structure	13
1.6 The Place for REITs in a Pension Fund Portfolio	16
1.7 Prior Research on the Performance of REITs	18
1.8 What Does the Future Hold for REITs	18
1.9 NAREIT	21
<u>Chapter 2 IPOs</u>	22
2.1 Basics of the IPO Process	22
2.2 Theories About IPOs	25
2.2.1 Costs of Going Public	25
2.2.2 Asymmetry of Information	26
2.2.3 Underwriter's Reputation and Prestige	29
2.2.4 Signaling	31
2.2.5 Hot Markets	32
2.2.6 Other Underpricing Theories	33

2.3	The Over-Allotment Option	34
2.4	Underwriting Discounts	37
2.5	"Flippers"	37
2.6	The Current IPO Boom	37
2.7	Closing Comments on IPOs	40
Chapter 3	Equity REIT IPOs, 1991-1993	43
3.1	Lack of Previous Research	43
3.2	Sample Data	44
3.3	Analysis and Observations	45
3.3.1	Costs	45
3.3.2	Asymmetry of Information	52
3.3.3	Underwriter Prestige	59
3.3.4	Signaling	60
3.3.5	Hot Markets	61
3.3.6	Insurance	63
3.3.7	Flippers	63
3.3.8	Insiders	64
3.3.9	Trading Volume, Liquidity, and Range	65
3.3.10	Over-Allotment Option	69
3.4	Underwriter & Investor Criteria	69
3.5	Surviving the Underwriting Process	71

3.6 Effect of Media Coverage on Initial Returns	.	.	73
3.7 Final Comments on equity REIT IPOs	.	.	76
<u>Conclusion</u>	.	.	81
<u>Appendix A</u> Daily Stock Price Information	.	.	84
<u>Bibliography</u>	.	.	89

CHAPTER 1 - REITs

1.1 Background

The real estate investment trust (REIT) industry was started in 1960 when President Eisenhower signed into law the Real Estate Investment Trust Act.¹ This act provided changes in the tax code that would allow all investors, rather than just the extremely wealthy, to participate in the ownership and financing of large commercial real estate projects.² A REIT is essentially a real estate mutual fund that pools the financial resources of many investors, and issues them shares of stock. Each investor owns a pro rata share of the REIT's interest in a property or pool of properties.

1.2 Types of REITs

There are three major types of REITs; **equity** REITs, **mortgage** REITs, and **hybrid** REITs. Equity REITs invest at least 75 percent of their assets in the ownership of real estate or other equity interests in real estate. Mortgage REITs invest at least 75 percent of their assets in mortgages secured by real estate. Hybrid REITs are a combination of equity and mortgages. REITs can

¹National Association of Real Estate Investment Trusts, REIT Formation and Operation: Opportunities in Today's Real Estate Capital Markets, *The REIT Concept*, Washington, D.C., 1993, p.9.

²National Association of Real Estate Investment Trusts, *Frequently Asked Questions About REITs*, Washington, D.C., February, 1993, p.5.

be further classified as finite life, open-ended, etc. For the remainder of this paper I will be referring only to publicly traded equity REITs, unless otherwise noted.

1.3 Qualifying As A REIT

There are certain basic qualifications that a REIT must meet in order to be recognized as a REIT for tax purposes. The tax treatment of a REIT is one of its most attractive features, since a REIT pays no federal income tax. Income is only taxed at the shareholder level, when dividends and capital gains are distributed. The basic qualifications are:

- a) The REIT must be a corporation or business trust. It cannot be a form of a partnership.
- b) The REIT must be managed by a board of directors or trustees, the majority of whom are independent from the REIT.
- c) REIT shares must be freely and fully transferrable.
- d) There must be at least 100 shareholders of the REIT. This is often referred to as "widely held".
- e) No group of five or fewer individuals may own directly or indirectly more than 50 percent of the REIT's shares during the last half of each taxable year.
- f) A REIT must invest at least 75 percent of its total assets in real

estate assets.

- g) A REIT may not own more than 10 percent of the voting shares of another company (other than another REIT).
- h) No more than 5 percent of the REIT's total assets may be invested in the shares of one company (other than another REIT).
- i) At least 75 percent of the REIT's gross revenues must come from rents from real property, interest on mortgages on real property, gains from the sale of real property, dividends or gains from investments in other REITs.
- j) At least 95 percent of the REIT's gross revenues must come from sources listed in item (i) above, plus gains from the sale of securities, dividends and interest from other investments.
- k) No more than 30 percent of the REIT's gross revenues may come from the sale or disposition of real property held for less than four years, (with some exceptions for foreclosures), securities held for less than six months, or certain other "prohibited transactions". In other words, REITs are in the investment and management business, not the brokerage business.
- l) The REIT must distribute at least 95 percent of its taxable income as dividends, excluding capital gains.³

³*Ibid.*, pp.35-36.

For a more complete description of the requirements for qualification as a REIT, including asset tests, income tests, distribution requirements, disclosure requirements, operational requirements, etc., contact the National Association of Real Estate Investment Trusts, Inc. (NAREIT), 1129 Twentieth Street, N.W., Suite 705, Washington, D.C., 20036. The telephone number is 202-785-8717.

1.4 Why REITs Are Attractive to Investors.

In addition to the tax advantages previously mentioned, there are a number of other attributes which make REITs attractive to both retail and institutional investors. They include the following:⁴

- a) REITs provide **liquidity** to investments in real estate. For example, if the owner of an apartment building suddenly needed a substantial amount of money and had no assets other than the apartment building, she might be forced to sell the property at a substantial discount in order to raise the money she needed. Furthermore, this process would take several days at a minimum, and probably several months. On the other hand, if she had instead owned a number of shares in a REIT, she would be able to quickly sell as many shares as needed to raise the money. Since

⁴Primary references include: David A. Lecander, "Real Estate Securities in a Pension Fund Investment Program," (Unpublished), May 11, 1993; John P. McCann, "REITs Gain Stature As Vehicles for Real Estate Investments," *Lawyers Title News*, Winter, 1993; and National Association of Real Estate Investment Trusts, "Real Estate Investment Trusts: Frequently Asked Questions...".

REIT shares are traded on the major stock exchanges, investors are always prepared to either buy or sell them, hence providing liquidity.

- b) **Experienced, dedicated managers** of REITs are able to maximize profits by implementing skills and strategies acquired through many years in the real estate industry. These managers generally own shares in the REIT as well, and therefore their interests are aligned with the shareholders. Conflicts of interest are minimized because the REIT manager's only real estate investments are usually those of the REIT. Separate accounts, commingled funds, and partnerships on the other hand, potentially expose an investor to many more conflicts of interest. For example, when real estate investment managers/advisors have several clients, how do they determine which client will get the next good deal. Is it the biggest client, the one who pays the highest fee, the golfing partner, or what?
- c) REITs provide a relatively high level of **current income**. The 95 percent distribution rule, as well as management's recognition that REIT investors are income-oriented, ensures stability and consistency in the payment of dividends. In private investment, the manager has more discretion over whether or not to distribute any earnings at all.

- d) REITs are **priced continuously**. Since stocks are traded on a daily basis, an investor can simply open up the newspaper to see what his investment is worth on a particular day. On the other hand, the appraisal method used to value privately owned real estate involves making assumptions about growth and subjective estimates of values. Furthermore, properties are often appraised on an annual basis, and even less frequently than that.
- e) **Portfolio diversification** can be achieved even with a small investment. Some REITs contain only certain property types (i.e. retail, industrial, office, apartments, hotels, etc.), while others concentrate more on the geographical location (i.e. northeast, midwest, southern California, etc.). And of course, some REITs are diversified as to both property type and geographical location. REIT investors can simply pick and choose which types of REITs they want to invest in. To achieve any degree of diversification in private ownership of commercial real estate, an investor must have an incredible amount of capital. One property alone can cost millions of dollars.
- f) **Performance monitoring** by the REIT's independent directors, analysts, auditors, and the financial news media provides investors with up to date information on the REITs financial condition. Often in private real estate

it is too late to do anything by the time this information is made available.

- g) REITs have performed well as **long term investments**. NAREIT officers prefer to emphasize the performance of REITs over the last ten years, which averaged an annual return of more than 15 percent.⁵ Other studies of REITs over short periods have differing conclusions about the performance of REITs depending upon the time period studied. However, a study of the long term performance of REITs indicated that "the performance of REIT portfolios (which included all types of REITs) was consistent with the security market line for the 1970-1989 period. In other works, REITs are not 'inferior' investment vehicles."⁶ This study noted further that "In general, the equity REIT portfolios performed much better than the mortgage REIT portfolios."⁷ Therefore, it might be reasonable to infer that equity REIT portfolios have been "superior" long term investment vehicles. Looking forward, there is certainly no reason to consider them "inferior" investments.

⁵McCann, p.19.

⁶Jun Han, "The Historical Performance of Real Estate Investment Trusts," Working Paper, #38, M.I.T. Center for Real Estate, November, November, 1991, p.4.

⁷*Ibid.*, p.24.

- h) REIT stocks are **less volatile** than the market portfolio. The sample of REITs in the Value Line Investment Survey have a beta between .4 and .8.⁸ This means that if the overall stock market dropped 10 percent in value, the REIT would only drop between 4 and 8 percent in value.

- i) The REIT investor's **liability is limited** to the amount of money invested in the particular REIT. If a disaster occurs at one of the REIT's properties, financial compensation for damages can only be taken from the REIT's assets, not the personal assets of the shareholder. This same protection is not always available in private ownership of real estate.

1.5 Limitations of the REIT Structure

Most of the limitations which are described in this section apply to investment in REITs by large shareholders, such as wealthy individuals, mutual funds, or pension funds.⁹

- a) The REIT industry has a relatively **small market capitalization**. The market capitalization of all equity REITs is around \$20 billion. The total of all pension fund assets are estimated at \$2.5 trillion. Pension funds

⁸Robert Belzer, *The Value Line Investment Survey, Part 3, Ratings & Reports*, Vol. XLVIII, No. 34, May 7, 1993, pp.1172-1183.

⁹Lecander, pp.6,7,53.

allocate approximately 5 percent of their assets to real estate, or about \$125 billion. Even if REIT offerings continue at the extraordinary pace of \$5 to \$10 billion a year, it will take at least a decade to build a supply of shares large enough just to satisfy pension funds.

- b) **Lack of diversification opportunities** may be a problem for large investors. During times when certain property types are not attractive investments, such as hotels and office buildings are now, these types of properties will become under-represented in the REIT industry. New issues will come primarily from the strongest sectors of the real estate industry. In fact, 85 percent of the new offerings studied in this paper were from the retail and residential sectors. Without a strong representation of all property types and geographic regions, diversification within the REIT industry may be difficult.

- c) **Lack of liquidity** may be a problem for large shareholders due to limited trading volume. On a typical day only about 2 percent of the outstanding shares of a REIT are traded.¹⁰ If, for example, a pension fund owned 10 percent of a REIT's shares, it would be difficult, if not impossible to sell off a large portion without forcing the share price down to bargain levels. The pension fund would have to try to negotiate a swap or sale

¹⁰"New York Stock Exchange Composite Transactions", *The Wall Street Journal*, June, 1993.

with another large investor, or sell off small blocks of their shares in the public market over a longer period of time.

- d) REIT stocks may have **lower expected returns** than privately owned real estate, due to the fact that privately owned real estate is less liquid than publicly owned REIT stocks. If a pension fund can expect a higher return on its direct investment in real estate, after taking management fees and expenses into consideration, than from a REIT, the pension fund may feel that it would be better to retain their in-house real estate management staff. If, however, the cost of the in-house staff is equal to or greater than the difference in returns between the two investment options, the more liquid REIT stocks might be a better choice.

- e) A REIT portfolio may include **lower quality properties**. These properties may have been acquired before or after the REIT was created. For any number of reasons such as changing regional economics, failure of a major tenant, or unforeseen environmental conditions, the investment may have gone bad. In any event, the shareholder is stuck with the lower quality properties until they are either disposed of, or expenses are incurred to improve their condition.

1.6 The Place for REITs in a Pension Fund Portfolio

Pension consultants seem to be in agreement that REITs are not the same as direct investment in real estate when it comes to a pension fund's multi-asset class portfolio.¹¹ A multi-asset class portfolio might include equities (stocks), fixed income (bonds), real assets (real estate, timberland, oil and gas, others), and high yield securities (corporate and junk bonds). The consultants argue that investments in REITs should be implemented through the pension's equity investment manager rather than its real estate manager. In fact, three, five, and ten year studies show that the NAREIT equity REIT index is 94, 85, and 93 percent respectively correlated with the three, five, and ten year performance of the Russell 2000 small cap stock index, and only -24, 3, and -23 percent correlated with the Russell/NCREIF property index (portfolio of institutionally owned properties).¹² Based upon this evidence, the consultants argue that REITs should not be included in the pension portfolio as a proxy for direct investment in real estate. They further explain that inclusion of REITs in the pension portfolio simply has the effect of "doubling down" on REIT stocks. Since equity investing by pensions is often indexed, REITs are already included in their portfolio. The pension fund's reason for investing in "real estate" to

¹¹Primary references include: Richard M. Ennis, "Investment Policy Considerations in Making a Pension Allocation to Real Estate," (Unpublished), May 10, 1993; Nori Gerardo, "REITs: No Substitute for Private Real Estate," *PREA Quarterly*, Vol. 6, No. 2, April, 1993, pp.32-36; and Lecander, "Real Estate Securities in a Pension Fund Investment Program".

¹²Gerardo, p.33.

begin with is to increase portfolio diversification. The consultants argue that replacing direct investment with REITs will eliminate the real estate diversification effect, and consequently reduce the overall diversification of the portfolio. Substituting REITs for direct investment would therefore remove real estate from the "real asset" class of the multi-asset class portfolio, and move it to the "equities" class as an industry.

There may, however, be some error in the methodology of this comparison. For instance, the properties in the Russell/NCREIF property index are only appraised once a year, while REITs and other stocks are priced continuously. We will refer to this as a deficiency in appraisal data. This deficiency, coupled with appraisal bias, as described in section 1.4d, leads to a "smoothing" of values of the Russell/NCREIF index. If it were not cost-prohibitive to appraise the properties on a daily basis, the correlations reported above might be quite different. Would a property acquired by a REIT from the Russell/NCREIF portfolio suddenly acquire different investment characteristics? Since it is in fact the same property, it is unlikely that this would happen.

Taking a different perspective, one might refer to the 2-4 year lags, which are often cited, of the Russell/NCREIF property index to the stock market. If pension funds are long term investors, then does such a relatively short term lag have an appreciable effect on the pension fund's entire portfolio? Again, it seems unlikely.

1.7 Prior Research on the Performance of REITs

A number of studies have been done comparing the performance of REITs over time to other investment vehicles including stock indexes, bonds, property indexes, etc. The primary objective of this paper is to study the performance and characteristics of equity REIT IPOs during the period of 1991-1993.¹³

1.8 What Does the Future Hold for REITs?

The REIT industry will have its ups and downs as every industry does. REITs are currently enjoying a boom both in initial and secondary public offerings. One of the primary reasons for the current boom is that REITs offer a more attractive yield than is currently available from other types of investments. Paul Pearson of Kidder Peabody warns however that "the challenge is to start educating investment dollars that REITs are not a pure interest rate play. As interest rates increase we do not want the excitement of REITs to decline."¹⁴

Another major reason for the current boom in REITs is the current real estate liquidity crisis. Banks, life insurance companies, pension funds, and

¹³For more information on the historical performance of REITs contact NAREIT at the address and telephone provided earlier, or call M.I.T.'s Center for Real Estate at 617-253-4373 and ask for a copy of Jun Han's working paper WP #38 published in November, 1991.

¹⁴Comments made by Paul Pearson of Kidder Peabody, Inc., a panelist at the "REIT Formation Workshop" in Boston, April 21, 1993.

foreign investors have all suffered heavy financial losses in real estate over the past few years and have essentially halted further investments in U.S. real estate. Existing REITs, which have usually been conservatively leveraged, have been able to acquire good properties at low costs from distressed sellers.¹⁵

REITs are also being used as a refinancing strategy for property owners looking to get out from under a pile of debt. Rather than sell in the private market at a 10 or 11 percent capitalization rate, they are taking their portfolios public through a REIT at a 7 or 8 percent capitalization rate. Real estate values are derived by dividing the net operating income (NOI) by the required return (capitalization rate). This means that the real estate will be valued higher in the public markets. For example, if the NOI of a property was \$2,000,000 the value derived in the private markets in order to receive a return of 10 percent would be $\$2,000,000 / .1$ which equals \$20,000,000. In the public markets, however, investors are willing to accept a return of 7 percent, which results in a derived value of $\$2,000,000 / .07$ or \$28,571,429. For a large portfolio this could amount to tens of millions of dollars, which, after an IPO could be used to reduce debt, renovate properties, acquire new properties, etc.

NOI should not be confused with Funds From Operation (FFO). FFO is the performance measure for equity REITs. It is defined by NAREIT as follows:

¹⁵McCann, p.9.

Funds From Operations means net income (computed in accordance with generally accepted accounting principles) excluding gains (or losses) from debt restructuring and sales of property plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

Fred Carr and John Pattillo of the Penobscot Group, an investment advisory firm in Boston, MA, offered some insights on the outlook of the REIT industry.. They see many REITs growing in size by merging with or acquiring other REITs with "sleepy management", most likely older REITs. "By more aggressively managing the properties there could be an immediate 20 percent increase in the value of the properties."

Barry Greenfield, Fidelity's real estate mutual fund manager, feels that the current REIT boom will continue for some time. He said, "We're in the second inning of a nine inning game...."¹⁶

The manager of a syndicate desk at Merrill Lynch, one of the leading underwriter's of REIT offerings, also feels that REITs will continue to be a hot item with investors. He commented, "We're about one third of the way through the boom, due for a correction in prices (downward), but in the long term REITs will be successful."

From the evidence presented, it appears that the REITs will play an important role in the securities industry for at least the foreseeable future.

¹⁶Barry Vinocor, "REIT Shares Take Some Lumps," *Barron's*, Vol. 73, No. 18, May 3, 1993, p.48.

1.9 NAREIT

The National Association for Real Estate Investment Trusts, Inc. is a not for profit organization. Its duties include:

- educating potential REIT managers, investors, advisors, lawyers, etc. about the REIT industry through seminars and publications.
- representing the REIT industry in discussions and lobbying efforts with the government.
- Keeping members informed of the latest developments within the industry.

Most recently NAREIT has been working to eliminate the "five or fewer" rule and to pass legislation which would make it easier for partnerships to convert to REITs without incurring a capital gains tax on the transaction. It appears as though congress will pass these laws sometime in the near future, making REITs an even more attractive real estate investment vehicle.

CHAPTER 2 - IPOs

2.1 Basics of the IPO Process¹⁷

When a company decides to "go public," it issues shares of common stock for sale to the general public for the first time. This is called the initial public offering (IPO). There are a number of decisions which the issuing company must make that will affect the success of its IPO.

First, the company must choose an **underwriter** to guide it through the IPO process.¹⁸ The underwriter's knowledge of the industry in which the company is involved, its reputation as an underwriter, its size, and its ability to sell shares, are all important factors for the company to consider when choosing an underwriter. Often two or more underwriters are chosen to co-manage the IPO, with one being designated as the lead underwriter. The underwriter's duties can be summed up as follows, "first they provide the company with procedural and financial advice, then they buy the issue, and finally they resell it to the public."¹⁹

¹⁷Primary references include: Richard A. Brealey and Stewart C. Myers, Principles of Corporate Finance, Fourth Edition, McGraw-Hill, Inc., New York, N.Y., 1991, pp.343-354; and Richard Wurman, Alan Siegel, and Kenneth Morris, *The Wall Street Journal Guide to Understanding Money & Markets*, Accesspress Ltd., and Siegel & Gale, Inc., New York, N.Y., 1990, p.8.

¹⁸Technically a company can underwrite the IPO itself. With the exception of an investment bank, however, a large company will probably not have the knowledge of the SEC filing process and the investor relations to successfully self-underwrite the IPO.

¹⁹Brealy and Myers, p.343.

After an underwriter is chosen, the next several weeks, or months if necessary, are spent gathering and analyzing information about the issuing company. Eventually a **registration statement** is filed with the Securities and Exchange Commission (SEC) describing the company, its history, its business plans, etc. A preliminary prospectus, or **red herring**, is prepared as part of the registration statement, and distributed to all interested investors.

While waiting for the SEC's final approval of the registration statement, the company and the underwriters embark on a series of **road shows**, making presentations to institutional investors, while attempting to get a feel for interest in the issue. During these road shows, only information provided in the prospectus may be discussed or referred to, otherwise an amendment must be filed with the SEC and distributed to everyone who received the red herring.

After reviewing the registration statement, the SEC may request additional or modified information. If this is the case an amended statement is filed with the SEC and a **final prospectus** is printed and distributed.

The final prospectus will be slightly different than the red herring. It will incorporate the changes required by the SEC and it will include the offering price, the underwriting discount, and other pertinent information as described below.

The **offering price** is determined by negotiations between the issuing company and the underwriter. Many studies have been done on how this price is actually determined. These studies will be discussed later in this chapter. In

general, however, the offering price depends upon the current economy, prices of "comparable companies'" stock, and demand for the issue by investors.

After determining the offering price, the company and the underwriters negotiate the **underwriting discount**, or **spread**. This is the profit per share that the underwriter will earn. If the offering price is \$22.50, and the underwriting discount is \$1.50, the net proceeds to the issuing company would be \$21.00 per share.

There are two types of underwriting contracts. In a **firm commitment** contract the underwriter is obligated to purchase all of the shares being offered, at the offering price less the underwriting discount. In the example above, if 5 million shares are being offered, the issuing company would receive a check from the underwriter for \$105 million (less certain other allowed expenses). With a **best efforts** contract, the proceeds of the sale would be held in escrow until a predetermined number of shares are sold. If the required number of shares are not sold within a specified time period, the issue is called off and the investors' money is returned to them. Throughout the remainder of this paper I will be referring to firm commitment contracts, unless noted otherwise. As we will see, this is the type chosen by most companies of significant size.

The final item to be determined is the **over-allotment option**, or "**green shoe**". The issuing company may give the underwriter the option to purchase up to an additional 15 percent of the number of shares being offered (i.e. 750,000 additional shares in the example above). These may be purchased at

the original offering price, within a specified time frame, for purposes of "stabilizing the price."

Many studies have examined the issues and motives behind the pricing of the stock, the spreads, over-allotment options, etc. These theories and studies will be discussed throughout the remainder of this chapter.

2.2 Theories About IPOs

2.2.1 Costs of Going Public

There are both direct costs and indirect costs associated with an IPO. **Direct costs** can be determined with much more certainty than indirect costs. The direct costs of an IPO include the underwriting discount, legal expenses, accounting fees, printing costs, road show costs, and other miscellaneous expenses. A fairly accurate dollar value can be affixed to these direct costs. **Indirect costs**, on the other hand, are much more difficult to determine with precision. They primarily include the cost of "**underpricing**" an issue. Underpricing can be thought of as the difference between what the initial offering price should have been to provide the greatest benefit to the issuing company, and what it actually was. Studies on this topic have looked at the difference between the closing price of the stock on the first day of trading, and the original offering price. This is referred to as the **initial return**. Some researchers argue that there must be some degree of underpricing to provide an incentive for investors to buy the IPO stock, otherwise investors would buy

only "seasoned" stocks (those which have been trading for some time) whose values are already known. Others argue that there should be no underpricing at all. Nonetheless, one study of IPOs from 1977-1982 (Ritter's study) reports that the average underpricing was 14.8 percent. This same study estimates direct costs as \$250,000 + 7 percent of the gross proceeds of the issue. The study also estimates total transaction costs as 21.22 percent of the gross proceeds.²⁰ Another study of IPOs from 1960-1987 (Ibbotson's study) indicates average underpricing of 16.4 percent of gross proceeds.²¹

These underpricing costs can amount to millions of dollars per IPO. It is no wonder then, that underpricing has been and continues to be researched so extensively. Several theories about why underpricing occurs will now be described.

2.2.2 Asymmetry of Information

Probably the most often cited study on this theory is that of Kevin Rock.²² His theory states that there are two types of investors. Some investors are "uninformed" while others are "informed". To become informed one must incur a substantial cost. However, an informed investor knows which

²⁰Jay R. Ritter, "The Costs of Going Public," *Journal of Financial Economics*, Vol. 19, 1987, pp.272-273.

²¹R.G. Ibbotson, J.C. Sindelar, and J.R. Ritter, "Initial Public Offerings," *Journal of Applied Corporate Finance*, Summer, 1988.

²²Kevin Rock, "Why New Issues Are Underpriced," *Journal of Financial Economics*, Vol. 15, March, 1986, pp.187-212.

IPOs are "good" (underpriced) and which ones are not. Informed investors will therefore only want to buy shares of the good IPOs. Furthermore, since the cost to become informed is substantial, only wealthy individuals or institutional investors can bear that cost. That means that the uninformed group consists of less wealthy, retail investors.

The theory argues that when informed investors know an issue is underpriced, they will place large orders for shares of that issue, resulting in an over-subscribed issue. In this case the underwriters have to decide how they will allocate the number of shares being offered. Since the large institutional clients generate a lot of business for the underwriters, they are the underwriter's preferred customers. They will tend to get most or all of the shares they have asked for. Small and uninformed investors, on the other hand, will get only a fraction, if any, of the good shares they order.

In the case when an issue is not underpriced, institutional investors will order few, if any shares. Small investors do not know that it is a "bad" issue, so they continue to place their usual order. This time the small investors will get all of the shares they asked for. This is known as the "winner's curse". If you win the shares, something must be wrong. Needless to say, the small investor will "win" more bad shares than good shares so on average their return will be lower than that of the institutional investor.

The theory has two other important assumptions. The first is that wealthy investors cannot buy up all of the shares of an IPO. The second is that

uninformed investors are rational and intelligent. These assumptions imply that uninformed investors recognize their disadvantage, and know that they will receive a disproportionate number of bad shares. In order for underwriters to keep the uninformed investors in the IPO buying game, they will have to allocate some of the good shares to them. The theory concludes that in order to attract the uninformed investors, the IPO must be underpriced to compensate them for the disproportionate number of overpriced shares they receive. The equilibrium level of underpricing, it says, is that which will just guarantee full subscription to the issue.

A recent article seems to confirm Rock's theory.²³ The article explains that SEC rules prohibiting any written material about an offering other than that provided in the prospectus, create a disadvantage for retail investors. A former SEC commissioner states that "the laws and regulations are very well-intentioned, designed to prevent fraud and abuse, but they do chill the flow of useful and valuable information; they prevent information from getting out there to the retail investor."²⁴ The laws also apply to non-written information such as overly optimistic or pessimistic verbal projections of a company's future. If the projections are not consistent with the information provided in the prospectus, they are prohibited. It is unlikely that the prospectus will contain such projections, since the issuing company and underwriter could be subject to

²³Tom Pratt, "The IPO Information Gap," *Investment Dealers' Digest*, Vol. 58, No. 20, May 18, 1992, pp.14-18.

²⁴*Ibid.*, p.14.

lawsuits if the projections don't pan out. The article maintains that "All Street firms still routinely provide estimates, and help with earnings models, to their largest institutional clients...firms simply don't have the option of not providing help with estimates if they want the big players to participate in an IPO...retail investors simply don't receive as much information."²⁵

Two possible solutions are suggested in the article: either crack down on the oral information, or modify the laws. The first solution would be difficult to implement. The second might be worth considering.

2.2.3 Underwriters' Reputation and Prestige

Most empirical studies conclude that prestigious underwriters underprice less.²⁶ That is, so-called prestigious investment banking firms more accurately price IPOs than less prestigious firms. In these studies prestigious underwriters are those with either a large capital base, the highest number of IPOs issued, the largest dollar volume of IPOs issued, or some combination of the above. The important point is that these firms do not want to taint their reputation with either clients or investors, and therefore they price IPOs more accurately. One study concluded, "Prestigious underwriters, to maintain their reputations, only

²⁵*Ibid.*, p.17.

²⁶James M. Johnson and Robert E. Miller, "Investment Banking Prestige and the Underpricing of Initial Public Offerings," *Financial Management*, Summer, 1988, p.20.

market IPOs of low dispersion firms."²⁷ In other words, prestigious underwriters pick and choose which firms they will take public, reducing the chance that one of their IPOs will fail. The corollary to this is that in order for an issuing company to appear less risky so that it will attract more investors in an IPO, it will be willing to underprice an issue in order to be able to work with a prestigious underwriter. There is also the case of the company that knows it is a low risk firm, and in order to convey that fact to the investment community, it contracts with a prestigious underwriter.²⁸

Another study on this theory takes a different view, concluding that "both sides of the IPO market are in equilibrium: issuers have no incentive to favor high prestige underwriters, and investors have no incentive to favor issues offered by low prestige bankers."²⁹ It argues that any savings for an issuer in terms of underpricing will be offset by higher underwriting fees and discounts. Also, a higher expected return to investors is a tradeoff with higher uncertainty of the true value of the issuing firm.

²⁷Richard B. Carter and Steven Manaster, "Initial Public Offerings and Underwriter Reputation," *Journal of Finance*, Vol. 45, No. 4, September, 1990, p.1062.

²⁸*Ibid.*, p. 1050.

²⁹Johnson and Miller, p.20.

2.2.4 Signaling

One signaling theory states that issuing companies which plan to come back to the market with a secondary offering sometime in the near future, want to leave a "good taste" in the investor's mouth so they underprice the IPO.³⁰

Variations of this theory imply that "firms that underprice more will experience a more positive market reaction (i.e. rise in stock price) to a dividend increase than firms that do not underprice."³¹ In other words, by underpricing the IPO, the issuer hopes to signal to investors through higher dividends and dividend yields later, that the value of the firm is high, resulting in an increase in the price of the stock.

Another variation of the signaling theory implies that the greater the underpricing and the higher the percentage of shares held by "insiders" (i.e. the issuing firm's management and employees), the more highly valued the stock will become later.³² The higher percentage held by insiders implies that management's objectives are more closely aligned with those of the shareholders.

³⁰Roni Michaely and Wayne H. Shaw, "The Pricing of Initial Public Offerings: Tests of the Adverse Selection and Signalling Theories," (Unpublished), April 28, 1993, p.26.

³¹*Ibid.*, p.22.

³²*Ibid.*, p.29.

2.2.5 "Hot Markets"

Some researchers argue that at certain times investors are more hungry for IPOs than at other times. In other words, they are willing to accept less of a return on new issues, so new issues are underpriced less. As a recent article stated, "It stands to reason. When the market is high and demand for new issues is insatiable, underwriters reach down into the bottom of the barrel for material, and they price it richly. But when no one wants to buy stocks, the dealmakers offer only their best candidates, and offer them at attractive prices (by underpricing)."³³ In other words the theory says that IPOs are priced higher during periods of heavy IPO activity, resulting in higher net proceeds to the issuing firm.

A recent study agrees. It explains that issuing firms try to time their offerings to coincide with periods of heavy IPO activity. In doing so, it argues, issuing firms can reduce their cost of capital, which includes underpricing costs, by 8 percent, to an average of 12 percent. In other words, by timing the IPO to coincide with periods of heavy IPO activity, the total costs of going public, including underpricing and direct costs, can be reduced by up to 8 percent. This is because investors are willing to pay more for the IPO shares, which results in less underpricing of the issue.³⁴ The issuing company benefits at

³³Warren Midgett and Scott DeCarlo, "New Issues Roulette," *Forbes*, Vol. 149, No. 2, Summer, 1992, p.160.

³⁴Tim Loughran and Jay R. Ritter, "The Timing and Subsequent Performance of IPOs: The U.S. and International Evidence," (Unpublished), April 6, 1993, pp.1-27.

the expense of the investor.

The advice offered by these researchers is obvious; invest only in IPOs issued during years of slow IPO activity.

2.2.6 Other Underpricing Theories

It would be impossible to describe and differentiate all of the studies performed on IPO underpricing, so I will conclude by mentioning just a few more:

- The publicity generated about an underpriced issue will lead to an increase in the stock price in the aftermarket, which is in the best interest of the issuing firm.³⁵
- Investment bankers have bargaining power over issuing companies, particularly smaller ones, so they pressure them to underprice the IPO.³⁶
- Underpricing is a form of insurance for issuing companies and underwriters against the possibility of lawsuits arising out of a poorly performing IPO.³⁷

³⁵Thomas J. Chemmanur, "The Pricing of Initial Public Offerings: A Dynamic Model With Information Production," *Journal of Finance*, Vol. 48, No. 1, March, 1993, pp. 285-304.

³⁶Seha M. Tinic, "Anatomy of Initial Public Offerings of Common Stock," *Journal of Finance*, Vol. XLIII, No. 4, September, 1988, pp.791.

³⁷*Ibid.*, p.818.

The theories presented above have been studied by a number of researchers. In many cases the results of the studies contradict each other. This usually occurs when the sampling constraints differ such as with the time period studied, the size of the issues, the industries included in the sample, etc. Perhaps there is not just one simple answer. In any event it is likely that the research and the debates will continue, and it will be up to the reader to decide which theories to believe.

2.3 The Over-Allotment Option

SEC rules permit an issuing company to allow the underwriter to purchase up to an additional 15 percent of the number of registered shares of an IPO, as the over-allotment option. This option is also referred to as the "green shoe", named after the Green Shoe Company (now called Stride-Rite) who was the first issuer ever to use the over-allotment option.³⁸

The purpose of the over-allotment option is to help the underwriter stabilize the price of the stock, preventing heavy losses to the underwriter in cases where the stock price drops shortly after it starts trading.³⁹ Price stabilization works like this: During the months after the red herring is

³⁸Frank A. Klepetko and David A. Krinsky, "Raising Equity Capital - Untying the Knots in the Green Shoe," *Journal of Business Strategy*, Vol. 12, No. 4, p.57.

³⁹Judith S. Ruud, "Another View of Underpricing of Initial Public Offerings," *Federal Reserve Bank of New York Quarterly Review*, Vol. 16, No. 1, Spring, 1991, pp.83.

distributed and prior to the commencement of trading, the underwriters get tentative orders for the stock from prospective investors. As the offering date approaches, a final offering price is determined, causing some investors to reconsider and cancel their orders. To protect themselves from a large number of canceled orders (remember, the underwriter is obligated to purchase all of the shares in an offering), and the possibility that a large number of shares will be dumped back in their lap shortly after trading starts, the underwriter will commit to selling more shares than are actually being offered. This creates a "short" position for the underwriter. If the stock price drops after trading starts, the underwriter will not have to exercise the over-allotment option. It can simply buy back shares in the open market at or below the original offering price. If the price rises in the aftermarket, the underwriter can cover the short position by exercising the green shoe option. Without a green shoe, the underwriter would have to cover its short position by buying shares in the open market at higher prices.⁴⁰

Some researchers argue that the over-allotment option creates and incentive for the underwriter to excessively underprice the issue.⁴¹

Nonetheless, the SEC allows this method of price stabilization provided that it is disclosed in the prospectus. In fact, most prospectuses contain the clause, "In

⁴⁰Richard B. Carter and Frederick H. Dark, "The Use of the Over-Allotment Option in Initial Public Offerings of Equity: Risks and Underwriter Prestige," *Financial Management*, Vol. 19, No. 3, Autumn, 1990, pp. 56.

⁴¹*Ibid.*, p.56.

connection with this offering, the underwriters may effect transactions which stabilize or maintain the market price of the common stock of the company at a level above that which might otherwise prevail in the open market. Such stabilization, if commenced, may be discontinued at any time."⁴²

One study concluded that underwriters exercised 83.71 percent of the optionable shares,⁴³ while another reported that "66% of firm commitment offerings in 1983-1987 exercised over-allotment options."⁴⁴ Another points out that the green shoe is good for an underwriter's relationship with its investors because the investor can get a larger percentage of its original order for good shares filled.⁴⁵ Note also, that since the green shoe will almost always be exercised when the stock price increases above the IPO price (i.e. when underpricing has occurred), then exercising the option to buy more shares further increases the cost of underpricing to the issuer. One final study concluded that "both the issuer and the underwriter stand to benefit from the exercise of the Green Shoe,..."⁴⁶ primarily due to the benefits of economies of scale from the increased number of shares sold.

⁴²Ruud, p.83.

⁴³Chris J. Muscarella, John W. Peavy III, and Michael R. Vetsuypens, "Optimal Exercise of the Over-Allotment Option in IPOs," *Financial Analysts Journal*, Vol. 48, No. 3, May/June, 1992, p.80.

⁴⁴Loughran and Ritter, p.12 (refers to a 1992 study by Hanley).

⁴⁵Carter and Dark, p.57.

⁴⁶Klepetko and Krinsky, p.58.

2.4 Underwriting Discounts

The difference between the IPO offering price and the price at which the underwriter buys each share from the issuing company is called the discount. It is also referred to as the spread. It represents the commission which the underwriter will earn for each share sold. The discount is shown on the front page of the prospectus. Since every penny of a discount represents a penny per share that the issuing company will not receive and vice versa, it is no wonder that heated discussions can arise while negotiating the amount of the discount. When Microsoft went public in 1986 each penny represented \$31,000. The underwriter argued that it deserved a healthy compensation for its extraordinary marketing effort. The company knew what a recent competitor gave its underwriter and felt that Microsoft's discount should be lower since it was a much less risky firm.⁴⁷

Size of the issue, riskiness of the firm, quality of the underwriter, and recent transactions will all come into play during the negotiation of the spread.

2.5 "Flippers"

Investors who make a practice of buying shares of IPOs and selling them for a quick profit shortly after trading commences, are known as flippers. In an effort to minimize flipping, underwriters have begun to penalize brokers for selling to flippers. The contract with the broker will state that commissions will

⁴⁷Bro Uttal, "Inside the Deal That Made Bill Gates \$350,000,000.", *Fortune*, July 21, 1986, pp.32-33.

not be paid for shares sold to flippers if the flipper sells the shares back to the underwriting syndicate. There are two reasons why underwriters want to minimize flipping. First, flipping creates a lot of price fluctuation while underwriters are trying to stabilize the price. Second, underwriters do not want to have to buy back all of the shares that flippers will dump back on them. This dumping would cause the stock price to fall. The underwriter would then own a lot of low priced stock.⁴⁸ The penalty for selling to flippers "may be in force for five trading days, although some have stretched out over an amazing 30 days."⁴⁹

As the head of an equity syndicate desk at Merrill Lynch explained, "It is easy to identify the flippers. If I see that an investor no longer owns any of the 50,000 shares of XYZ stock that we sold him last week, then I am not going to sell him 50,000 shares of the stock he wants today. I can also look at the attendance records of the road show presentations. An investor who never showed up is obviously not interested in the long term performance of the stock." He did admit, however, that an investor who buys often and in large quantities (i.e. institutional investors) will receive preferential treatment when shares are allocated. Flippers, on the other hand, are not stupid either. They instruct their brokers not to sell their shares to members of the underwriting

⁴⁸Thomas N. Cochran, "Year of the IPO: New Stock Offerings Set a Record in 1992," *Barron's*, Vol. 73, No. 1, January 4, 1993, p.21.

⁴⁹Anthony J. Correra, "Bolck That Sale: War On IPO Flippers Hurts Little Guy," *Barron's*, Vol.72, No. 22, June 1, 1992, p.43.

syndicate.

2.6 The Current IPO Boom (1991-1993)

The slow pace of IPOs in the first quarter of 1991, if it continued, would have resulted in the worst year for IPOs in a decade. However, things picked up during the second quarter and throughout the remainder of the year at such an amazing pace that the \$24.8 billion raised by IPOs in 1991 was the highest total ever by over \$500,000,000.⁵⁰ As 1992 progressed, underwriters became cautious about the quality of firms going public. William Paternotte, director of research at Alex Brown & Sons, the leading underwriter of IPOs for 1991 with almost \$6 billion raised, stated "We want analysts to screen out companies that are not good long term investments."⁵¹ This supports the reputation theory, but contradicts the comment that underwriters "pull material out from the bottom of the barrel".

During the last quarter of 1992, several articles were written which showed optimism for a continued IPO boom. These articles cited selectivity by underwriters and reasonable pricing of the IPOs as the reasons for their optimism.⁵² Total capital raised by IPOs in 1992 established a new record at

⁵⁰Robert A. Mamis, "Inc. 100: The Year in IPOs," *Inc.*, Vol. 14, No. 5, May, 1992, p.134.

⁵¹Debbie Galant, "Going Public," *Institutional Investor*, Vol. 26, No. 4, April, 1992, p.127.

⁵²Keith Goggin, "IPO Blowouts Are Back Again AS Investors Pay for Quality," *Investment Dealers' Digest*, Vol. 58, No. 39, September 28, 1992, and Keith Goggin, "The Weather's Getting Colder

\$39.9 billion. Merrill Lynch was the leading IPO underwriter for the year with almost \$7.9 billion raised.⁵³

The boom has continued so far during 1993. In the first quarter alone IPOs raised \$11.5 billion,⁵⁴ and the total increased to \$25 billion by the end of the first half.⁵⁵ If the pace keeps up new records will be set in 1993.

2.7 Closing Comments On IPOs

The theories have been presented and the market has been described. Perhaps the best way to judge the success of an IPO is to ask the issuing companies for their opinions. So how satisfied are the issuing firms with the work done by the underwriters they chose? Well, here are the results of a survey of firms that went public during 1992:⁵⁶

But IPOs Are Getting Hotter," *Investment Dealers' Digest*, Vol. 58, No. 49, December 7, 1992, p.12.

⁵³Keith Goggin, "Wall Street Gets Paid... and paid... and Paid...", *Investment Dealers' Digest*, Vol.59, No. 6, February 8, 1993, p.24.

⁵⁴Thomas N. Cochran, "IPOs Everywhere: New Issues Hit A Record in the First Quarter," *Barron's*, Vol. 73, No. 16, April 19, 1993, p.14.

⁵⁵Sara Calian, "Analysts Expect Sizzling IPO Pace to Continue in Second Half of 1993," *The Wall Street Journal*, June 28, 1993, p.C1.

⁵⁶Tom Pratt, "Survey Says Most Issuers Satisfied With 1992 IPOs," *Investment Dealer's Digest*, Vol. 59, No. 3, January 18, 1993, p.14.

- How would you rate your underwriter's performance?

Excellent	51%
Good	40%
Fair	9%
Poor	0%

- Would you use the same underwriter to manage a second deal?

Yes	75%
No	14%
Undecided	11%

- Rate the quantity of research coverage by your lead investment banker after the IPO.

Excellent	18%
Good	42%
Fair	22%
Poor	18%

- Rate the quality of research coverage by your lead investment banker after the IPO.

Excellent	29%
Good	49%
Fair	7%
Poor	15%

- Rate the extent of research coverage by other firms.

Excellent	10%
Good	31%
Fair	27%
Poor	31%

It appears as though the underwriters have passed the test for the 1992 boom. The factors that were named the most important by issuing firms in

choosing an underwriter included 1) establishing a personal relationship, 2) industry expertise, and 3) the track record of other IPOs.⁵⁷

⁵⁷*Ibid.*, p.14.

Chapter 3 - Equity REIT IPOs, 1991-1993

3.1 Lack of Previous Research

In this chapter evidence is presented which demonstrates that we are in the midst of an equity REIT IPO boom period. Research on equity REIT IPOs would be extremely valuable for companies considering going public, as well as potential investors in a new offering. I was amazed to discover that not much research has been performed on this topic. In fact, the only information I found was a reference to a study of 87 REIT IPOs for which the average initial return was -2.82 percent.⁵⁸ It is not stated whether this sample included equity, mortgage, and/or hybrid REITs. Furthermore, it is not clear as to the time period covered by the study.

In chapter two I described a number of studies on IPOs in general. One might think that these studies would be somewhat useful as a proxy for research on equity REIT IPOs. However, all of the studies which I referenced either specifically excluded REITs from their sample, or did not mention whether or not they were included. Because of their exclusion, one might surmise that those researchers feel that REITs behave differently than other IPOs. That is what we will try to determine in this chapter.

⁵⁸Michaely and Shaw, pp.15-16.

3.2 Sample Data

With the help of a REIT analyst at the investment management firm of Cohen & Steers, I obtained copies of prospectuses for "all equity REIT IPOs from 1991 to 1993." I recognize that there may be some sampling bias toward institutional grade equity REIT IPOs given the source of sample data. I would argue, however, that including just these types of equity REIT IPOs will make this study much more meaningful. In section 3.4 we see that these are essentially the only types of REIT IPOs that investors and underwriters are interested in at this time.

The sample consists of the 13 firms listed below. (Note that Vornado, Inc. was excluded because it was already a publicly traded real estate company prior to converting to a REIT. Healthcare REITs are also excluded.)

Sample of Equity REIT IPOs

<u>Company</u>	<u>Date of IPO</u>
Kimco Realty Corporation	11/22/91
Kranzco Realty Trust	11/12/92
Taubman Centers, Inc.	11/20/92
Wellsford Residential Property Trust	11/20/92
Developer's Diversified Realty Corp.	02/02/93
Carr Realty Corp.	02/09/93
Manufactured Home Communities, Inc.	02/25/93
General Growth Properties, Inc.	04/07/93
Marks Centers Trust	05/26/93
TriNet Corporate Realty Trust, Inc.	05/26/93
Tanger Factory Outlet Centers, Inc.	05/27/93
Factory Stores of America, Inc.	06/03/93
Holly Residential Properties, Inc.	06/11/93

Analyses were performed on information provided in the prospectuses, the "New York Stock Exchange Composite Transaction" section of *The Wall Street Journal*, and the NYSE Daily Stock Price Record, published by Standard & Poors, Inc. (Appendix A lists the daily trading information obtained about each company from the NYSE sources). Results are compared to those of previous IPO studies as referenced in chapter two.

3.3 Analysis and Observations

3.3.1 Costs

Exhibit 3.1 is a summary of selected information provided in the prospectuses. Several comparisons can be made between this exhibit and Ritter's study of IPOs from 1977-1982 (see Exhibit 3.2)⁵⁹

Ritter's study divides the sample into five ranges of **gross proceeds** (size of IPO assuming no exercise of over-allotment option); \$100,000-\$1,999,999; \$2,000,000-\$3,999,999; \$4,000,000-\$5,999,999; \$6,000,000-\$9,999,999; and \$10,000,000-\$120,174,195. In our study the range of gross proceeds is \$87,000,000-\$363,000,000. The average size of an IPO in our study is \$160,217,308, which is substantially larger than the upper range of Ritter's study. Compare this as well to the average size of an IPO in Ibbotson's study which was less than \$10 million even after excluding the smallest 2,000 or so IPOs valued at less than

⁵⁹Ritter, pp.272-273.

Exhibit 3.1

COMPANY	Underwriter	# shares issued	Green Shoe	IPO Price	Div. Yield	Gross Proceeds	Underwriter Discount	Con-cession	Re- Allowance	Estimated Expenses	Advisory Fee	Property Type
Kimco	Merrill Lynch Smith Barney Dean Witter	6,400,000	960,000 15.00%	\$20.00	8.8%	\$128,000,000	\$1.30 6.50%	\$0.78 3.90%	\$0.10 0.50%	\$3,105,000 2.43%	\$600,000 0.47%	Shopping Center
Kranzco	Smith Barney Oppenheimer PaineWebber Kemper LeggMason	6,400,000	600,000 9.38%	\$20.00	9.2%	\$128,000,000	\$1.40 7.00%	\$0.85 4.25%	\$0.10 0.50%	\$3,950,000 3.09%	\$1,500,000 1.17%	Shopping Center
Taubman	Morgan Stanley Alex Brown Dean Witter	26,800,000	4,020,000 15.00%	\$11.00	8.0%	\$294,800,000	\$0.578 5.25%	\$0.35 3.18%	\$0.10 0.91%	\$19,500,000 6.61%	\$2,211,000 0.75%	Shopping Center
Wellsford	Merrill Lynch Kidder	4,000,000	600,000 15.00%	\$21.75	7.7%	\$87,000,000	\$1.47 6.76%	n/a	n/a	\$1,897,874 2.18%	\$350,000 0.40%	Residential
Developer's Diversified	Dean Witter Alex Brown Prudential McDonald	8,000,000	1,200,000 15.00%	\$22.00	7.3%	\$176,000,000	\$1.49 6.77%	\$0.88 4.00%	\$0.10 0.45%	\$1,650,000 0.94%	none found 0.00%	Shopping Centers
Carr	Merrill Lynch Lehman LeggMason	6,800,000	1,020,000 15.00%	\$22.00	7.7%	\$149,600,000	\$1.375 6.25%	\$0.82 3.73%	\$0.10 0.45%	\$3,578,000 2.39%	\$800,000 0.53%	Office Building
Manufactured Home Comm.	Merrill Lynch Lehman	4,400,000	660,000 15.00%	\$25.75	7.8%	\$113,300,000	\$1.80 6.99%	\$1.08 4.19%	\$0.10 0.39%	\$2,000,000 1.77%	none found 0.00%	Residential
General Growth	Goldman Sachs Kidder Lehman PaineWebber Salomon	16,500,000	2,475,000 15.00%	\$22.00	6.7%	\$363,000,000	\$1.43 6.50%	\$0.90 4.09%	\$0.10 0.45%	\$5,400,000 1.49%	\$2,000,000 0.55%	Shopping Center
Mark Centers	Kidder PaineWebber	7,750,000	1,162,500 15.00%	\$19.50	7.4%	\$151,125,000	\$1.37 7.03%	\$0.85 4.36%	\$0.125 0.64%	\$3,200,000 2.12%	\$980,000 0.65%	Shopping Center
TriNet	Merrill Lynch PaineWebber	5,160,000	774,000 15.00%	\$24.25	9.0%	\$125,130,000	\$1.63 6.72%	\$0.97 4.00%	\$0.10 0.41%	\$1,992,500 1.59%	\$1,312,825 1.05%	Commercial Leases
Tanger	Merrill Lynch Bear Stearns	4,100,000	615,000 15.00%	\$22.50	7.5%	\$92,250,000	\$1.46 6.49%	\$0.87 3.87%	\$0.10 0.44%	\$1,900,000 2.06%	\$530,438 0.58%	Factory Outlet
Factory Outlet	Smith Barney Prudential Rob Humphrey	5,300,000	795,000 15.00%	\$23.00	7.8%	\$121,900,000	\$1.61 7.00%	\$0.95 4.13%	\$0.10 0.43%	\$1,750,000 1.44%	none found 0.00%	Factory Outlet
Holy	Oppenheimer Bear Stearns First Boston Prudential Piper Jaffrey	6,640,000	996,000 15.00%	\$23.00	7.7%	\$152,720,000	\$1.58 6.87%	\$0.90 3.91%	\$0.10 0.43%	\$2,625,000 1.72%	\$3,241,250 2.12%	Residential
Averages		8,326,923	1,221,346 14.57%	\$21.29	8.6%	\$160,217,308	\$1.42 6.63%	\$0.85 3.97%	\$0.10 0.50%	\$4,042,183 2.29%	\$1,040,424 0.64%	

Exhibit 3.2

272

J. R. Ritter, Costs of going public

Table 2

1977-1982 initial public offers categorized by gross proceeds and contract type.

Gross proceeds (\$) ^a	All offers	Firm commitment offers	Best efforts offers	Fraction best efforts offers
100,000-1,999,999	243	68	175	0.720
2,000,000-3,999,999	311	165	146	0.469
4,000,000-5,999,999	156	133	23	0.147
6,000,000-9,999,999	137	122	15	0.109
10,000,000-120,174,195	181	176	5	0.028
All offers	1028	664	364	0.354

^a The gross proceeds categories are based on the nominal values; no price level adjustments have been made.

Table 3

Direct expenses of going public as a percentage of gross proceeds, 1977-1982.

Gross proceeds (\$) ^a	Number of offers	Underwriting discount (%) ^b	Other expenses (%) ^c	Total cash expenses (%)
<i>Firm commitment offers</i>				
100,000-1,999,999	68	9.84	9.64	19.48
2,000,000-3,999,999	165	9.83	7.60	17.43
4,000,000-5,999,999	133	9.10	5.67	14.77
6,000,000-9,999,999	122	8.03	4.31	12.34
10,000,000-120,174,195	176	7.24	2.10	9.34
All offers	664	8.67	5.36	14.03
<i>Best efforts offers</i>				
100,000-1,999,999	175	10.63	9.52	20.15
2,000,000-3,999,999	146	10.00	6.21	16.21
4,000,000-5,999,999	23	9.86	3.71	13.57
6,000,000-9,999,999	15	9.80	3.42	13.22
10,000,000-120,174,195	5	8.03	2.40	10.43
All offers	364	10.26	7.48	17.74

^a Gross proceeds categories are nominal; no price level adjustments have been made.

^b The underwriting discount is the commission paid by the issuing firm; this is listed on the front page of the firm's prospectus.

^c The other expenses figure comprises accountable and non-accountable fees of the underwriters, cash expenses of the issuing firm for legal, printing, and auditing fees, and other out-of-pocket costs. These other expenses are described in footnotes on the front page of the issuing firm's prospectus. None of the expense categories include the value of warrants granted to the underwriter, a practice that is common with best efforts offers.

47

J. R. Ritter, Costs of going public

273

Table 4

Average percentage cash expenses and initial returns, and total transaction costs as a percentage of realized market values, 1977-1982.

Gross proceeds (\$) ^a	Number of offers	Cash expenses (%) ^b	Avg. initial returns (%) ^c	Avg. total costs (%) ^d
<i>Firm commitment offers</i>				
100,000-1,999,999	68	19.48	26.92	31.73
2,000,000-3,999,999	165	17.43	20.70	24.93
4,000,000-5,999,999	133	14.77	12.57	20.90
6,000,000-9,999,999	122	12.34	8.99	17.85
10,000,000-120,174,195	176	9.34	10.32	16.27
All offers	664	14.03	14.80	21.22
<i>Best efforts offers</i>				
100,000-1,999,999	175	20.15	39.62	31.89
2,000,000-3,999,999	146	16.21	63.41	36.28
4,000,000-5,999,999	23	13.57	26.82	14.49
6,000,000-9,999,999	15	13.22	40.79	25.97
10,000,000-120,174,195	5	10.43	-5.42	-0.17 ^e
All offers	364	17.74	47.78	31.87

^a Gross proceeds categories are nominal; no price level adjustments have been made.

^b The cash expenses are those reported in table 3.

^c The initial returns are computed as $(v - OP) \div OP$, multiplied by 100%, where v is the closing bid price on the first day of trading and OP is the offer price. These are not annualized returns.

^d Total costs are computed as 100% minus the net proceeds as a percentage of the market value of securities in the aftermarket. Consequently, total costs are not the simple sum of cash expenses and the average initial return.

^e For best efforts offers of \$10 million or more, the negative average total costs are due to the price declines suffered by several offers. For three of the five firms in this category, net proceeds exceeded the post-offer market value of the securities issued.

\$1.5 million each.

In Ritter's overall sample only 64.6 percent of the **underwriting contracts** are of the firm commitment type. In his largest sector (\$10,000,000-\$120,174,195), which most closely resembles our study, the percentage increases to 97.2. In our sample all 13 companies (100 percent) chose the firm commitment contract.

Ritter breaks down the costs of his firm commitment contracts, again into the five sectors. The average overall **underwriting discount** observed by Ritter was 8.67 percent, with 7.24 percent for his largest sector alone. This compares to the 6.63 percent average of our sample. Note that the .61 percent difference amounts to \$977,325.58 for our average size IPO. This is obviously a significant figure to consider in negotiating an underwriting contract.

"Other expenses" for Ritter's overall sample were 5.35 percent of gross proceeds, but only 2.10 percent for his largest sector. This compares to 2.93 percent for our sample, including estimated expenses, advisory fees, and other miscellaneous expenses described in the prospectuses.

Total direct costs, which is just the sum of the underwriting discount and other expenses, totalled 14.03 percent for Ritter's overall study, and 9.34 percent for his largest sector. In our sample we got 9.56 percent. These figures might seem exorbitant, but the accounting and legal fees can add up quickly. A privately owned real estate firm, which is not required to file periodic statements or to use Generally Accepted Accounting Principles for its

bookkeeping, can be very costly to prepare for a public offering. Properties owned in partnership might require significant legal expenses in preparation for conversion to a public REIT. Also, a few IPOs in our sample issued mortgage certificate or loan offerings in conjunction with their REIT offering. The underwriting fees associated with these mortgage related offerings were included in our direct costs. Exhibit 3.3A compares the observed total direct costs of our sample to Ritter's estimate (7% of Gross + \$250,000).

Exhibit 3.3A

COMPANY	Observed	Ritter's Estimate	Difference
Kimco	\$12,025,000	\$9,210,000	\$2,815,000
Kranzco	\$14,410,000	\$9,210,000	\$5,200,000
Taubman	\$37,201,400	\$20,886,000	\$16,315,400
Wellsford	\$8,127,874	\$6,340,000	\$1,787,874
Developer's Divers.	\$13,570,000	\$12,570,000	\$1,000,000
Carr	\$13,728,000	\$10,722,000	\$3,006,000
Manfrd. Home	\$9,920,000	\$8,181,000	\$1,739,000
General Growth	\$30,995,000	\$25,660,000	\$5,335,000
Marks Centers	\$14,797,500	\$10,828,750	\$3,968,750
TriNet	\$11,716,125	\$9,009,100	\$2,707,025
Tanger	\$8,416,438	\$6,707,500	\$1,708,938
Factory Outlet	\$10,283,000	\$8,783,000	\$1,500,000
Holly	\$16,357,450	\$10,940,400	\$5,417,050

Ritter's equation underestimates the actual costs observed in our sample by \$1 million to over \$16 million, or by 8 to 78 percent. The average underestimate is 33 percent. We conclude therefore that Ritter's estimate is not a useful tool for our equity REIT IPOs from 1991-1993.

We have performed a simple regression to estimate our own equation to predict the direct costs involved in an equity REIT IPO from 1991-1993. As Ritter did, we used the actual observed total direct costs as the independent variable and gross proceeds of the offering as the independent variable. We came up with the following equation:

$$\text{Total Direct Costs} = \$820,427 + 10.19 \% \text{ of Gross Proceeds}$$

The coefficient of determination (R-squared) for our equation is .88. This means that using gross proceeds as the independent variable to predict the total direct costs reduces the total variation of our estimate by 88 percent, or it explains 88 percent of the total direct costs.

Exhibit 3.3B

COMPANY	Observed	Kern's Estimate	Difference
Kimco	\$12,025,000	\$12,211,143	(\$186,143)
Kranzco	\$14,410,000	\$12,211,143	\$2,198,857
Taubman	\$37,201,400	\$29,215,938	\$7,985,462
Wellsford	\$8,127,874	\$8,043,765	\$84,109
Developer's Divers.	\$13,570,000	\$17,111,731	(\$3,541,731)
Carr	\$13,728,000	\$14,421,908	(\$693,908)
Manfrd. Home	\$9,920,000	\$10,723,400	(\$803,400)
General Growth	\$30,995,000	\$36,164,649	(\$5,169,649)
Marks Centers	\$14,797,500	\$14,577,286	\$220,214
TriNet	\$11,716,125	\$11,928,726	(\$212,601)
Tanger	\$8,416,438	\$8,578,673	(\$162,235)
Factory Outlet	\$10,283,000	\$11,599,630	(\$1,316,630)
Holly	\$16,357,450	\$14,739,796	\$1,617,654

As shown above in Exhibit 3.3B, the predictions made by our equation are off from between $-\$5,169,649$ and $+\$7,985,462$ which really does not seem that impressive. In terms of percentages we are off from between -21 percent and +27 percent, with estimates being off by an average of 9.5 percent. Although these numbers are not all that comforting they do provide a better estimate than Ritter's equation.

Now let's move on to the **indirect costs**. As stated in chapter two, these are primarily **underpricing** costs, which are measured by the initial return. The initial return is the difference between the closing price of the stock on the first day of trading and the original offering price. The initial return, as well as the cumulative returns for days 2 through 10, are shown in Exhibit 3.4, for all the REITs in our sample.⁶⁰

Exhibit 3.4										
Cumulative Return to End of Trading Day as a Percent of IPO Price										
COMPANY	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6	Day 7	Day 8	Day 9	Day 10
Kimco	0.00%	0.00%	0.00%	0.00%	0.00%	-0.63%	-0.63%	-0.63%	-0.63%	-1.25%
Kranzco	0.00%	0.63%	1.25%	0.63%	1.25%	1.25%	1.25%	0.00%	0.00%	0.63%
Taubman	5.68%	4.55%	3.41%	5.68%	4.55%	4.55%	4.55%	4.55%	6.82%	6.82%
Wellsford	3.45%	0.57%	3.45%	3.45%	3.45%	2.30%	2.87%	2.87%	2.87%	2.30%
Developer's	10.80%	12.50%	12.50%	10.80%	11.93%	10.80%	11.36%	12.50%	11.36%	9.09%
Carr	13.07%	12.50%	10.80%	10.80%	10.23%	10.80%	10.80%	9.66%	8.52%	8.52%
Mnfrd Home	8.74%	10.19%	10.68%	9.22%	9.71%	12.14%	13.59%	16.50%	19.42%	25.24%
Gen Grwth	11.93%	14.20%	16.48%	17.05%	15.34%	14.20%	14.77%	14.20%	15.91%	15.34%
Mark Ctrs	0.64%	1.28%	0.00%	4.49%	1.28%	1.28%	0.00%	0.00%	0.64%	0.64%
TriNet	-2.06%	-1.55%	-1.03%	0.00%	-1.55%	-2.58%	-4.64%	-6.70%	-5.67%	-3.61%
Tanger	2.22%	0.00%	-1.11%	-0.56%	-1.11%	-1.11%	-1.11%	-1.67%	-1.11%	-1.11%
Factory	6.52%	4.35%	2.17%	0.54%	1.63%	2.17%	2.72%	3.26%	3.80%	3.26%
Holly	0.00%	-2.17%	-3.26%	-2.72%	-3.26%	-3.26%	-3.26%	-3.80%	-3.26%	-3.26%
Average	4.69%	4.39%	4.26%	4.57%	4.11%	3.99%	4.02%	3.90%	4.51%	4.82%

⁶⁰Sources include "The New York Stock Exchange Composite Transactions", *The Wall Street Journal*, and Standard and Poors, Corp., NYSE Daily Stock Price Record, McGraw-Hill, New York, N.Y., 1991-1993.

We see that the initial (Day 1) returns ranged from -2.06 percent to 13.07 percent, with an average initial return of 4.69 percent. This contrasts Ritter's study where the average initial return was 14.8 percent overall, and 10.32 percent for the largest sector.⁶¹ The result of our study also contrasts Ibbotson's study mentioned in chapter two of IPOs from 1960-1987, where an average initial return of 16.4 percent was observed. Our result is also different than the study of REIT IPOs mentioned at the beginning of this chapter, which had an average initial return of -2.82 percent.

3.3.2 Information Disclosure

SEC regulations require issuers to disclose all material information in the prospectus, but what is "material" may be subject to judgement. A recent article describes how the chairman of a california-based computer software provider died shortly after the IPO. The cause of death was an illness which he had for a long time but which was not disclosed in the prospectus. The stock price dropped radically. The prospectus did have, however, the standard warning that the loss of any key employees or top executive could adversely affect the company's business.⁶² It will be interesting to see what the SEC ruling is on this case.

⁶¹Ritter, p.273.

⁶²William Power, "In IPOs, Some Data Seem to Be Overlooked By Issuers as in Case of Santa Cruz Operation," *The Wall Street Journal*, July, 27, 1993, p.C2.

Many agree that prospectuses are not telling the whole story. Fred Carr of the Penobscot Group commented that the laws are designed for full disclosure, but in reality the prospectuses are being used to obscure information. He added that investors are not happy about it. One consultant stated that typical prospectuses contain information "that most investors would consider immaterial and ancient history."⁶³

My opinion is that, in general, the prospectuses provide a great deal of valuable information. This information, however, is much more valuable to a small, uninformed, investor who is not an expert in the real estate industry, than it is to a large institutional investor who most likely employs someone with an expertise in the field.

Reproduced in exhibit 3.5 is the Table of Contents for the Tanger Factory Outlet Centers, Inc. We see that the section on "Risk Factors" is broken down into 17 subsections. A closer look at the prospectus reveals that these subsections are broken down even further. For instance, the subsection on "Risks Related to the Factory Outlet Center Industry" is broken down further into sub-subsections titled *The Relatively Short History of Factory Outlet Centers May Not Be Indicative of Future Periods*, *Dependence on Key Tenants*, *Competition From Other Factory Outlet Centers*, and *Tenant Lease Expirations*. The subsection "General Real Estate Investment Risks" is broken down into sub-subsections *Economic Performance and Value of Centers Dependent on*

⁶³Pratt, "The IPO Information Gap", p.16.

Exhibit 3.5

TABLE OF CONTENTS

	<u>Page</u>		<u>Page</u>
PROSPECTUS SUMMARY	4	BUSINESS AND PROPERTIES	45
The Company	4	General	45
Risk Factors	5	Location of Properties	46
Business and Properties	6	Description of Properties	47
Formation of the Company	9	Planned Development	52
Tax Status of the Company	13	Site Selection	53
Distributions	14	Development Process	53
The Offering	14	Construction	53
Summary Selected Combined Financial		Relationships with Municipalities	54
Data	15	Leasing Activities	54
RISK FACTORS	17	Marketing	55
Risks Related to the Factory Outlet Center		Property and Asset Management	56
Industry	17	Competition	56
General Real Estate Investment Risks	18	Corporate and Regional Headquarters	57
Adverse Impact on Distributions of Failure		Insurance	57
to Qualify as a REIT	19	Employees	57
Dilutive Effects of the Offering	20	Legal Proceedings	57
Dependence on Income from Projects		FORMATION OF THE COMPANY	58
Under Construction in Making		Purposes of the Formation	58
Distributions	20	MANAGEMENT	63
Distributions to Stockholders	20	Directors and Executive Officers	63
Dependence on the Operating Partnership		Directors Nominated for Election	
to Make Distributions	21	Following the Offering	63
Qualification of the Operating		Executive Officers and Key Employees	64
Partnership as a Partnership for		Committees of the Board of Directors	64
Federal Income Tax Purposes;		Compensation of Directors	65
Impact on REIT Status	21	Executive Compensation	65
Lack of Arm's-Length Negotiation in the		Employment Contracts	66
Allocation of Benefits to the Tanger		Stock Option Plan and Unit Option Plan	67
Family Partnership and Stanley K.		Indemnification	68
Tanger in the Formation of the		Certain Relationships and Related	
Company	22	Transactions	68
Conflicts of Interest	22	POLICIES WITH RESPECT TO	
Ownership Limit; Exception for Messrs.		CERTAIN ACTIVITIES	70
Tanger and Related Persons	22	General	70
Limitations on Acquisition and Change in		Investment Policies	70
Control	23	Financing Policies	71
No Limitation in Organizational		Equity Capital	72
Documents on Incurrence of Debt	23	Working Capital Reserves	72
Ability of the Company's Board of		Other Operating Policies	72
Directors to Change Policy Without		Conflict of Interest Policies	72
Shareholder Approval	24	Reports to Stockholders	73
Reliance on the Tangers	24	PRINCIPAL AND SELLING	
Effect of Market Interest Rates on Share		STOCKHOLDERS OF THE COMPANY	
Price	24	AND PRINCIPAL PARTNERS IN THE	
Shares Available for Future Sale	24	OPERATING PARTNERSHIP	73
No Prior Market for Common Stock	25	CAPITAL STOCK OF THE COMPANY	74
DILUTION	26	General	74
THE COMPANY	28	Restrictions on Transfer	74
The Factory Outlet Concept	28	Restrictions on Sale of Shares Received in	
The Company's Factory Outlet Centers	29	Formation of the Company	76
Business History	30	SHARES AVAILABLE FOR FUTURE	
Business and Operating Strategy	30	SALE	77
Capital Strategy	31	FEDERAL INCOME TAX	
DISTRIBUTIONS	32	CONSIDERATIONS	79
CAPITALIZATION	34	Taxation of the Company	79
USE OF PROCEEDS	35	Failure to Qualify	83
SELECTED COMBINED FINANCIAL		Taxation of Taxable Domestic Stockholders	83
DATA	36	Backup Withholding	83
MANAGEMENT'S DISCUSSION AND		Taxation of Tax-Exempt Stockholders	84
ANALYSIS OF FINANCIAL		Taxation of Foreign Stockholders	84
CONDITION AND RESULTS OF		Tax Aspects of the Operating Partnership	85
OPERATIONS	38	Other Tax Consequences	88
General Overview	38	UNDERWRITING	89
Results of Operations	40	EXPERTS	91
Liquidity and Capital Resources	43	LEGAL MATTERS	91
Mortgages and Interest Rate Protection		ADDITIONAL INFORMATION	92
Agreements	44	GLOSSARY	93
Economic Conditions	44	INDEX TO FINANCIAL STATEMENTS	F-1

Many Factors, Risks of Development Activities, Dependence on Rental Income From Real Property, Illiquidity of Real Estate Investments, Consequences of Inability to Service Mortgage Debt, Short Operating History for Certain Properties, Uninsured Loss, and Environmental Risks. These sub-subsections are well-written and easy to understand even for an investor without prior real estate knowledge. Furthermore, they are showered with warnings such as "there can be no assurance that such relationships (with key tenants) will continue..." and "there can be no assurance that this (factory outlet) segment of the retail business will continue to grow in the future." If anything, I would argue that the prospectus is filled with so many warnings about the inability to predict the future of the REIT, that a small investor without much real previous real estate knowledge, would either be foolish to invest in a REIT, or has a preference for risk-taking.

Institutional investors, on the other hand, are very much aware of the risks associated with real estate investments. Many of them have in-house research departments, or subscribe to such services from outside sources. Therefore, the information provided in these sections may be of little value to them. Some information may be useful, such as the percent of the total gross leasable area of the REITs properties that is leased by one tenant, but this type of information is described in much greater detail elsewhere in the prospectus. It is probably fair to say that the entire section on "Risk Factors" provides little valuable information to a well-informed institutional investor, but important

information for any investor in real estate to understand.

In the "Business and Properties" section, statistics are given on the percentage of each property that is currently leased, base rent, outstanding mortgage debt, major tenants, lease expiration, date constructed, local population demographics, proximity to major roadways, etc. This type of information is essential in order to make fairly educated projections of cash flows, and institutional investors expect it to be provided in the prospectus. I would argue that without this type of information, as well as information on management's experience, investment strategies, financing policies, etc., which is also provided in the prospectus, institutional investors should not, and probably would not, invest in REITs.

Small investors without real estate knowledge should be capable of understanding the level of detail just described, but any degree of detail greater than this might overwhelm the small investor, or perhaps it will simply be disregarded. Institutional investors, however, would welcome additional information on each property such as results of in-depth structural and environmental studies on each property, comments by tenants and brokers who toured the property but chose not to lease space there, a more comprehensive photo package for each property, etc.

To sum up my opinion on the amount of information provided in the prospectus of an equity REIT IPO, I would say that for institutional investors who invest substantial capital in REIT stocks, it is not unreasonable to expect

information at the highest level of detail possible. The costs and time required to produce this information, however, may prove to be prohibitive. Small investors, on the other hand, who do not have much capital at stake, and who have little prior knowledge about the real estate industry, are well-served by information in prospectuses, and will not necessarily benefit from a more detailed description of the properties, especially if there is an additional cost to produce this information.

I would support, however, modifications to existing SEC rules that would facilitate the inclusion of a section in the prospectus titled "Underwriter's Projections." As mentioned in section 2.2.2, because of the liability issues and current SEC regulations, such projections are not provided in the prospectus. Consequently, small investors do not receive such information from the underwriters, while institutional investors do.

When investors know or feel that they do not have complete information they will either pass over a deal or require a higher rate of return in order to be compensated for risking their investment. Lynne Sagalyn, professor at Columbia University's Graduate School of Business, believes that complete disclosure of information is the key to the long term appeal and success of the REIT industry. She explains...

Developing a stronger basis for projecting future portfolio cash flows requires information on rental income, occupancy rates and operating expenses disaggregated by property type and expanded upon with lease expiration schedules, pending lease transactions and scheduled rent increases...These are the components that form the financial basis for informed trading activity in real estate

equities...As the market for publicly traded real estate grows, the skill and resourcefulness with which information flows are used to attract and service these (institutional) investors, is likely to become a differentiating criteria among REIT managements...Disclosure is the key tool in marketing not only the initial stock offering but the ongoing management of a real estate portfolio...Without advances in this arena, several years hence, today's strong activity in real estate equity securitization is likely to appear just as another spike of sporadic growth.⁶⁴

Fred Carr of the Penobscot Group agrees. He advises potential issuers that he expects a good real estate story which explains how money will be earned given growth limitations. He wants it documented with property level detail. He explains that "More information will lead to better trust and understanding. If you don't tell it, how do we know that you understand it?"⁶⁵ Mr. Carr pointed out later, however, that issuers who have been trying to provide very detailed information in a prospectus are getting grief from the SEC.

Perhaps the ideal solution would be some modifications of securities liabilities laws, which would encourage and facilitate complete, detailed, and up-to-date information from REIT managers.

⁶⁴Lynne B. Sagalyn, "Working Through the Kinks of Market Growth: Information and the Securitization of Real Estate," *Property*, Vol. 3, No. 3, Spring 1993, p.5.

⁶⁵Frederick Carr and John Pattillo, (Unpublished paper), Boston, MA, April 21, 1993.

3.3.3 Underwriter Prestige

Observing the initial returns in Exhibit 3.4, and matching them to the underwriters shown in Exhibit 3.2, one can only conclude that the underwriter's reputation is not a good predictor of underpricing of equity REIT IPOs. Merrill Lynch was the lead underwriter on 6 of the 13 IPOs in our sample. They managed the IPOs with the highest and lowest average initial returns, with a scattering of results in between. There is no consistency whatsoever in their level of underpricing. Considering that they were the top ranked underwriter for 1992, and ranked second in 1991, this does not make sense. The average initial return of the IPOs they managed was 4.23 percent, slightly less than the 4.69 percent average of our entire sample. One could say that on average they underprice a little bit less. I learned recently though, that Merrill Lynch has two different teams of investment bankers. One is located in New York and the other is located in California. The TriNet deal, which had an initial return of -2.06 percent was done by the California team. Although I do not attempt to do it in this paper, a closer look at the results of various teams within each investment banking firm might produce some interesting results.

Smith Barney managed 2 IPOs with average initial returns of 3.26 percent, and co-managed another which had an initial return of 0 percent. They were ranked ninth in both 1992 and 1991 in terms of volume of IPOs underwritten.

Oppenheimer managed just one IPO and co-managed another. Both

had initial returns of 0 percent. Oppenheimer was not ranked in either the top 15 for 1992 or the top 10 for 1991 in terms of IPOs underwritten. Finally, Goldman Sachs managed only the General Growth IPO, which had the second highest initial return of our sample, at 11.93 percent.

For our sample one could not conclude that prestigious underwriters underprice less. In fact, in our sample, the IPOs which were underpriced the most were underwritten by the top ranked underwriters. Furthermore, in our sample, even the underwriters who were not ranked highly in terms of volume underwritten, are well-known firms in the securities industry. So based on the small size of our sample and their relatively high level of prestige in general, it is not possible to draw meaningful conclusions about the effects of underwriters' reputations on the underpricing of equity REIT IPOs.

3.3.4 Signaling

Due to the short time period studied it is not practical to draw conclusions about the applicability of the "good taste" or dividend theories. We can however, test the short term (i.e. 10 days) applicability of the "publicity causes a run up in prices" theory by analyzing Exhibit 3.4. Observing the five IPOs with the highest initial returns we see that Carr Realty returns dropped 4.55 percent by day 10, General Growth increased 3.41 percent, Developer's Diversified dropped 1.71 percent, Manufactured Home Communities increased 16.5 percent, and Factory Stores dropped by 3.26 percent. Manufactured

Home Communities is the only IPO in the sample which experienced a significant short term run up in price, therefore we must conclude that our data does not support the theory for the short term 10 day period.

In order to properly test the applicability of the signaling theories we need to analyze data from a much longer period of time. Perhaps future studies of equity REIT IPOs during this time period will test for the validity of the signaling theories.

3.3.5 Hot Markets

There is no doubt that we are in the midst of an equity REIT IPO hot market. In the first half of 1991 there were no equity REIT IPOs. During the second half of 1991 there was the Kimco deal which raised \$128 million. In the first half of 1992 \$165 million was raised, followed by \$507 million during the second half. In the first half of 1993 we saw IPOs valued at \$657 million. For the second half of 1993 over \$1 billion worth of new equity REIT IPOs has already been filed with the SEC.⁶⁶

The theory states that issuing firms time IPOs to coincide with heavy IPO periods, when investors are hungry for new issues, and underpricing is less. The evidence provided above may be explained by the theory. However, there are other forces which contribute to the hot market. Not only are investors seeking high yields currently provided by REITs, but issuing companies see

⁶⁶"Overview of the REIT Market," (Unpublished)

REITs as a great opportunity to refinance their existing real estate portfolios when not too many other options exist. I would argue that many of the new REITs did not "time" their IPOs, but that the REIT vehicle was the best or only viable option available to them at the time.

One might also question what effect a hot market might have on the underwriting discount. It would seem that if underwriters were producing so much more volume they would not demand such a high spread. However, as the president of NAREIT points out that "Competition for investment bankers' time...and for the best tax and accounting talent, is fierce."⁶⁷ The head of global equity transactions at Prudential Securities, commented that "IPO issuers usually try to find an underwriting team with strong research capabilities, and this emphasis has led to larger management teams and, consequently, higher costs."⁶⁸ For 1992, the average spread on all equity offerings was 5.09 percent, versus 6.03 percent for all IPOs (equity and debt).⁶⁹ As mentioned earlier, the average spread for our sample was 6.63 percent. It is probably fair to say that although the competition for underwriting talent and the demand for more research capabilities have driven the underwriting discounts upward, the competition among the underwriters themselves for these fees has provided downward pressure, resulting in a sort of new equilibrium underwriting discount.

⁶⁷NAREIT, "Bigger and Better," *The REIT Report*, Vol. XIII, No. 3, Summer, 1993, p.11.

⁶⁸Goggin, "Wall Street Gets Paid...", p.23.

⁶⁹*Ibid.*, p.23.

3.3.6 Insurance

If underpricing is a form of insurance for IPOs whose price might fall below the IPO price shortly after trading, then TriNet might be the only one which did not have a policy. They were the only firm in our sample that started out with a negative initial return (-2.06 percent). That number had grown to -6.70 percent by day 8, but recovered to -3.61 percent by day 10. Kimco, Tanger and Holly also showed slightly negative returns within a few days of the IPO. The low level of "over-pricing" will probably not lead to lawsuits for any of the firms in our sample, but if it did there might be reason to support this theory.

3.3.7 Flippers

In chapter two we learned that the strategy of flippers is to sell the shares of an IPO, which they have bought at the offering price, by the end of the first trading day in order to profit on the initial return. Observing the data in exhibit 3.4 provides some interesting insights.

In our sample the mean initial return is 4.69 percent. An investor who purchased an equal number of shares in each of our sample companies at the offering price, would have only increased that return by .13 percent to 4.82 percent if they held the shares until day 10. Note that if it were not for the extraordinary run up in the return of Manufactured Home Communities stock from less than 10 percent to over 25 percent, the average return would have

dropped to 3.12 percent by day 10. This tells us that for our sample, flipping the stock by the end of the first day would be an excellent strategy! It might be a good idea to give the underwriters all of the tools they need to stabilize the price.

Now lets consider a typical retail investor who was not able to purchase shares at the offering price, but instead bought shares at the end of day one. Since there is no appreciable increase in the average return within the first ten days of trading, and there are transaction costs to consider, we must conclude that small investors will not earn positive returns by flipping shares of equity REIT IPOs which they can only buy after the first day of trading.

3.3.8 **Insiders**

The percentage of ownership of shares outstanding by the REIT's management is important because it implies that the interests of management and the shareholders becomes the same, or at least "more fully aligned." In our sample the percentage of shares held by the directors, officers, managers, and employees (insiders) of the companies ranged from 11.7 to 50 percent, assuming all options to purchase shares were exercised.

As time progresses it would be interesting to see what effect the percentage of insider shares would have on the price of the stock in the future.

3.3.9 Trading Volume, Liquidity, and Range

As mentioned in the first chapter, one of the most attractive features of REITs versus direct investment in real estate is their liquidity. But as we shall see, liquidity is all relative.

In exhibit 3.6A we see the trading volume for the first ten days of trading for each company in our sample. In raw numbers, all but one of the firms had a first day trading volume in the millions. The second day volume dropped to the mid six figure range, and within a few days the average trading volume was down to around 100,000 shares. As of July 23, 1993 the trading volume of our firms ranged from 6,000 to 79,900 shares, and averaged just 33,900, or .41 percent of the average number of shares issued. Noting that the firms in our sample are among the largest equity REITs existing in terms of market capitalization (# shares outstanding x price per share), it is interesting to compare their trading volume to that of seasoned firms in other industries such as computers, automobiles, and airlines. For example, *The Wall Street Journal* reported the following information about trading for July 23, 1993:

<u>COMPANY</u>	<u>TRADING VOLUME</u>	<u>PERCENT OF SHARES OUTSTANDING⁷⁰</u>
Intel	2,811,400	.77%
Ford Motor	805,200	.18%
Delta	370,800	.75%

⁷⁰Percentages are estimated based on the number outstanding shares as reported in the companies' 1991 annual reports. Intel's estimate is adjusted to reflect a 2-for-1 stock split which occurred since the printing of that annual report.

Exhibit 3.6A - Trading Volume Per Day

COMPANY	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6	Day 7	Day 8	Day 9	Day 10
Kimco	1,449,500	193,100	36,700	20,800	33,700	93,400	34,400	42,100	38,600	60,100
Kranzco	392,200	60,800	70,200	59,500	32,000	44,100	32,400	306,500	98,700	151,600
Taubman	4,673,900	658,500	493,200	454,900	74,900	190,200	184,700	145,800	150,200	114,400
Wellsford	1,242,900	233,400	157,500	60,500	27,000	85,300	37,200	46,100	30,800	60,000
Developer's	3,401,400	610,000	312,800	253,400	95,700	150,000	142,600	128,400	94,300	250,600
Carr	3,559,300	538,600	203,100	111,300	418,600	171,300	72,200	63,600	61,700	71,300
Mnfrd Home	3,298,600	358,500	219,600	93,300	110,100	79,500	60,900	55,100	69,000	146,300
Gen Grwth	5,194,300	705,200	717,700	390,400	277,100	244,800	322,500	161,400	225,200	152,800
Mark Ctrs	2,838,900	603,100	455,200	616,400	216,900	58,600	148,400	169,800	225,800	78,000
TriNet	2,101,600	357,600	165,800	176,300	101,700	77,100	81,500	60,100	30,200	22,700
Tanger	2,331,200	149,700	69,200	44,800	35,500	43,800	51,100	22,300	46,500	13,500
Factory	2,670,800	431,500	197,300	202,800	165,600	88,600	66,100	98,900	64,800	54,300
Holly	2,331,200	149,700	69,200	44,800	35,500	43,800	51,100	22,300	46,500	13,500
Average	2,729,677	388,438	243,654	194,554	124,946	105,423	98,854	101,723	90,946	91,469

Exhibit 3.6B - Trading Volume Per Day As A Percentage of IPO Shares Issued

COMPANY	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6	Day 7	Day 8	Day 9	Day 10
Kimco	22.65%	3.02%	0.57%	0.33%	0.53%	1.46%	0.54%	0.66%	0.60%	0.94%
Kranzco	6.13%	0.95%	1.10%	0.93%	0.50%	0.69%	0.51%	4.79%	1.54%	2.37%
Taubman	17.44%	2.46%	1.84%	1.70%	0.28%	0.71%	0.69%	0.54%	0.56%	0.43%
Wellsford	31.07%	5.84%	3.94%	1.51%	0.68%	2.13%	0.93%	1.15%	0.77%	1.50%
Developer's	42.52%	7.63%	3.91%	3.17%	1.20%	1.88%	1.78%	1.61%	1.18%	3.13%
Carr	52.34%	7.92%	2.99%	1.64%	6.16%	2.52%	1.06%	0.94%	0.91%	1.05%
Mnfrd Home	74.97%	8.15%	4.99%	2.12%	2.50%	1.81%	1.38%	1.25%	1.57%	3.33%
Gen Grwth	31.48%	4.27%	4.35%	2.37%	1.68%	1.48%	1.95%	0.98%	1.36%	0.93%
Mark Ctrs	36.63%	7.78%	5.87%	7.95%	2.80%	0.76%	1.91%	2.19%	2.91%	1.01%
TriNet	40.73%	6.93%	3.21%	3.42%	1.97%	1.49%	1.58%	1.16%	0.59%	0.44%
Tanger	56.86%	3.65%	1.69%	1.09%	0.87%	1.07%	1.25%	0.54%	1.13%	0.33%
Factory	50.39%	8.14%	3.72%	3.83%	3.12%	1.67%	1.25%	1.87%	1.22%	1.02%
Holly	35.11%	2.25%	1.04%	0.67%	0.53%	0.66%	0.77%	0.34%	0.70%	0.20%
Average	38.33%	5.31%	3.02%	2.36%	1.75%	1.41%	1.20%	1.39%	1.16%	1.28%

Exhibit 3.6C - Range of Trading Prices Per Day (Hi Price Minus Low Price) \$

COMPANY	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6	Day 7	Day 8	Day 9	Day 10
Kimco	0.250	0.125	0.000	0.125	0.125	0.250	0.250	0.125	0.000	0.125
Kranzco	0.000	0.125	0.250	0.250	0.125	0.375	0.250	0.250	0.125	0.125
Taubman	0.375	0.125	0.250	0.125	0.125	0.250	0.000	0.125	0.375	0.125
Wellsford	0.500	0.750	0.500	0.250	0.250	0.375	0.250	0.250	0.125	0.250
Developer's	1.500	0.500	0.750	1.000	0.250	0.375	0.125	0.250	0.500	0.625
Carr	1.375	0.625	0.500	0.250	1.250	0.500	0.375	0.250	0.500	0.375
Mnfrd Home	1.250	0.500	0.375	0.500	0.375	0.750	0.625	0.750	1.125	1.125
Gen Grwth	0.750	0.500	0.750	0.250	0.375	0.375	0.375	0.125	0.500	0.375
Mark Ctrs	0.625	0.375	0.125	0.875	0.500	0.250	0.250	0.125	0.250	0.250
TriNet	0.625	0.625	0.625	0.625	0.750	0.250	0.875	0.375	0.375	0.625
Tanger	0.625	0.500	0.250	0.500	0.250	0.125	0.125	0.250	0.250	0.125
Factory	1.125	1.000	1.000	0.625	0.250	0.250	0.250	0.125	0.375	0.250
Holly	0.625	0.500	0.250	0.500	0.250	0.125	0.125	0.250	0.250	0.125
Average	0.740	0.481	0.433	0.452	0.375	0.327	0.298	0.250	0.365	0.346

There are obviously many more buyers and sellers of stock in these firms on a given day than for the stock of an equity REIT. The fact that the trading volume is from 10 to 80 times larger for these stocks than for equity REITs is an indication of the difference in liquidity.

Perhaps a more meaningful indication of relative liquidity of equity REITs is shown in exhibit 3.6B. We see that on the first day of trading, on average more than 38 percent of the shares issued in the IPO are traded. Flippers undoubtedly play a part in this. On the second and third days the percentage traded falls to 5.31 and 3.02, respectively. And from day five onward, the volume of shares traded falls to below two percent of the shares outstanding. For an institutional investor to be willing to purchase \$20 million worth of stock in a particular company is not uncommon. At our average size of \$160,217,308 this represents roughly 12.5 percent of the outstanding shares. Since on any particular day less than 2 percent of the outstanding shares of an equity REIT are traded (less than .5 percent on July 23, 1993), it would be unlikely that the investor would be able to liquidate (sell) all of its shares in the open market. It might take several weeks or months to fully liquidate the holdings. In any event, the price of the stock would certainly be driven down by the sell-off. For such large investors, the attractiveness of the liquidity feature of REITs is therefore largely reduced.

On the other hand, at a price of roughly \$50 per share on July 23, 1993, the value of the Intel stock traded on that day was \$140,570,000. This is

almost equal to the average size of an equity REIT IPO. Considering that this represented less than 1 percent of the outstanding shares of Intel, it just further emphasized the meaning of relative liquidity. The investor who owned \$20 million worth of Intel stock would be probably be able to sell off its entire holdings on a particular day without driving the stock price down.

Finally we come to the daily spreads of trading prices for our stocks. Traders continuously buy and sell stocks throughout the day, hoping to buy when the price is low and sell when the price is high. The profits (or losses) they earn for their firm is the difference between these two prices. In exhibit 3.6C we notice that the average spread on the first day for our sample firms is \$.74 and drops to \$.375 from day 5 onward. This means that from day 5 onward, a trader would have to buy at the low price and sell at the high price many times over just to make a small profit. Combining the small trading range with the fact that trading volume is small for equity REITs, and the fact that most traders can only effectively follow a limited number of stocks at a time on a daily basis, there may not be a lot of potential for profits in trading equity REIT stocks.

3.3.10 Over-Allotment Option

In chapter two we explained that the intent of the green shoe was to facilitate price stabilization by the underwriter. We also mentioned that some believe it provides an incentive for the underwriter to underprice the issue so that the entire issue will sell out, including the green shoe, thereby maximizing profit for the underwriter. Referring back to exhibit 3.1 we see that twelve of our thirteen sample firms gave the underwriter the maximum allowable 15 percent over-allotment option. The other firm (Kranzco) gave an option of 9.38 percent. It appears that most of our sample firms believe the "price stabilization" explanation over the "incentive to underprice" theory.

The average green shoe option in our sample was 14.57 percent. Neither Ritter's nor Ibbotson's study reported on this statistic. The average percent of options exercised in the equity REIT IPO sample was 63, similar to the 66 percent reported in the 1983-1887 IPO study.

3.4 Underwriting & Investor Criteria, 1991-1993

Fred Carr of the Penobscot Group explained that the REIT offerings of the early '70's were fee-driven, whereas today's equity REIT IPOs are more sophisticated. With 20 additional years of portfolio management experience, and a much wider selection of investment opportunities, investors can now dictate what they want to see in a security. Needless to say, Wall Street investment banking firms provide exactly what is called for, otherwise they

would soon be out of business. The following list includes those characteristics demanded of an equity REIT IPO today by investors and underwriters:⁷¹

- a) Market capitalization should be at least \$100 million.
- b) Debt/equity ratio should be no greater than one to one.
- c) The REIT should be self-managed.
- d) The REIT should be focused on a particular property type with management located in close geographic proximity to the properties.
- e) The REIT management team should be experienced in real estate, and have a solid track record of creating value.
- f) There must be a strategic plan for enhancing growth potential.
- g) The REIT managers should be among the largest of the REIT shareholders.
- h) Little or no "cashing out" of prior owners.
- i) The REIT is not an exit vehicle for troubled properties. Proper due diligence must be carefully performed on each property.
- j) Proceeds from the stock offering are to be used to retire debt or acquire properties.

⁷¹Primary sources include: Carr and Pattillo; and Kidder, Peabody, Inc., "Real Estate Investment Trusts", Boston, MA, April 21, 1991.

- k) Projected total returns must be 12-15 percent annually for three years.

An inspection of exhibit 3.1 and a review of the individual prospectuses indicates that most or all of these demands have been met by the firms in our sample.

3.5 Surviving the Underwriting Process

Larry Miller, President of Bradley Real Estate Trust, the oldest REIT in the country, and Senior Vice President of NAREIT, described the underwriting process from the viewpoint of the issuing company. He said "Dealing with the SEC rules, the IRS rules, and all the accountants and lawyers can be extremely difficult and frustrating. But when the roadshows are over, the stock is trading, and the deal is closed, you realize that it was all worth it."⁷²

The entire process, from the decision to go public to the start of trading, takes about 160 days, according to Dean Witter Reynolds, Inc. Their "Summary Timetable for Equity REIT Initial Public Offering" is reproduced below:⁷³

⁷²Comments made at the REIT Formation Workshop in Boston, MA on April 21, 1993.

⁷³NAREIT, "The Underwriting Process", REIT Formation : Getting the Deal Done.

<u>Days Prior to Offering</u>	<u>Task</u>
160	Decision to proceed with offering
159-150	Review and select lead manager
145-135	Negotiate deal terms and resolve open business issues
130	Finalize deal terms and summary financial models-lawyers begin drafting registration statement
120-115	Due diligence meetings and property tours
110	First draft of registration statement distributed to issuer
100	First draft of registration statement distributed to working group
95-91	Continue drafting registration statement
90	Second draft of registration statement circulated to working group-select co-managers
85-81	Continue drafting registration statement
80	Third draft of registration statement circulated to working group
75-71	Property due diligence tour with co-managers
70-66	Final drafting sessions of the registration statement begin
65	File registration statement with the SEC
30	Receive SEC comments to registration statement-begin conforming document to SEC comments
25	File first amendment of the registration statement with the SEC and print red herrings
20	Invite underwriting syndicate
18-3	Roadshow
1	Price offering (typically after the market closes)
0	SEC declares effectiveness-trading begins-print final prospectus
-5	Closing and settlement

Of course the actual length of time it takes will vary from firm to firm depending upon the number of partnerships involved, the condition of the accounting records, the number and types of properties to be appraised, legal proceedings in progress, etc. Chris Lucas, director of research for NAREIT, warns that during the underwriting process it may be discovered that legal or partnership issues will be difficult or impossible to overcome. He also points out that up front costs can amount to several hundreds of thousands of dollars.

For these reasons he advises potential issuers to load the important tasks to the front of the timetable, especially the ones which could cause problems. Since an issuer can stop the underwriting process at any point, it would be wisest to identify the trouble spots as early as possible, prior to incurring substantial costs.⁷⁴

3.6 Effect of Media Coverage on Initial Return

Publicity about any topic can shape the opinion of its audience regardless of the validity of the information published. The equity REIT IPOs covered by this paper have received their share of publicity.

Despite being the first equity REIT IPO in a few years, Kimco received positive media coverage. Analysts wrote of its reputation as a "top-flight company" and noted its positive attributes of being self-administered and focused both geographically and by property type.⁷⁵ Referring back to exhibit 3.4 we see that the stock price returns held steady after the IPO.

The Taubman deal got more mixed reviews. One article said "Taubman has good properties, good management and a proven track record." The same article referred to the UPREIT structure, which Taubman was the first to utilize, as "convoluted", and pointed out that there were incestuous relationships which

⁷⁴Comments made at REIT Formation Workshop in Boston.

⁷⁵Betsy Treitler, "Kimco Realty Heads to Market as First REIT IPO in Years," *Investment Dealers' Digest*, September 23, 1991, pp.18-19.

could lead to conflict of interest.⁷⁶ In exhibit 3.4 we see that the initial return was 5.68 percent which only moved up and down by about 1 percent in the two weeks that followed. Its success was probably due to a combination of proper pricing, positive publicity, and the fact that Kimco was trading at almost \$28, up 40 percent from its IPO price of \$20 just one year earlier.

Then Carr Realty did the unthinkable by creating an office building REIT at a time when you could not give away such properties. Once again though, reviews mentioned the "great organization" and "first class properties in one of the country's two best office markets," as well as the potential for substantial growth in income in a couple of years.⁷⁷ Investors were probably a little over-anxious, and maybe the flippers were all up to their tricks, causing the initial return of 13.07 percent. This fell to 8.52 percent within a couple of weeks.

By the time General Growth went public, just the term "REIT" alone would get investors excited. One article referred to the potential conflict of interest in the UPREIT⁷⁸ structure, and the fact that nobody saw much growth potential in the offering. This article however, quoted a portfolio manager as

⁷⁶Eric J. Savitz, "Shopping For a Mall? Mr. Taubman Has Just the Thing (Maybe) For You," *Barron's*, August 10, 1992, pp.14-15.

⁷⁷Barry Vinocur, "The REIT Market Shifts Into Overdrive," *Barron's*, February 1, 1993, p.60.

⁷⁸UPREIT stands for Umbrella Partnership REIT. It is similar to a master limited partnership. In an UPREIT property is exchanged for "units" of the Operating Partnership. Units are essentially equal in value to shares of common stock. Issuers who choose the UPREIT structure are able to defer recognition of an otherwise taxable transfer of property.

saying "As hot as these stocks are right now,...You really cannot afford to sit on the sidelines." The article mentioned that Carr was the "worst" performing equity REIT IPO of the previous six months, up only 21 percent since the IPO.⁷⁹ Another institutional money manager commented "We used to steer clear of REIT IPOs because you could always buy the stock six months or a year later at a lower price...That's no longer true."⁸⁰ General Growth increased both the size of its offering and the IPO price by 10 percent, sold all shares including the entire green shoe, and saw an initial return of 11.93 percent. By the end of the first two weeks the price had jumped even higher to a return of 15.34 percent.

Stock performance of equity REIT IPOs came back to reality for the last five firms in our sample. As a group they averaged less than a 1.5 percent initial return, which decreased to -.8 percent within two weeks. There appeared to be no media hype prior to these offerings. Barry Greenfield of Fidelity later commented, "Prices are going higher but not at nearly the same pace as we saw between November of 1992 and March of this year." He also said "There's no question that some underwriters aren't doing a very good job of serving as gatekeepers...I'm just focusing more on existing companies than IPOs right

⁷⁹Barry Vinocur, "Where's the Growth? It's Lacking in a Mall IPO," *Barron's*, April 5, 1993, p.16.

⁸⁰Barry Vinocur, "How Property Shares Fared In the Quarter," *Barron's*, April 12, 1993, p.69.

now."⁸¹ When such major players in the REIT industry make less than optimistic remarks, there is bound to be some effect on the performance of subsequent IPOs.

One equity REIT IPO which has yet to be offered is Crown American Realty Trust. Kidder, Peabody, the lead underwriter, and the issuing company are expecting it to be the biggest equity REIT IPO ever, with gross proceeds exceeding \$400 million. However, recent articles have had nothing good to say about the offering. They point out that it has financially troubled tenants, no property acquisition strategy or plans, too much debt, conflicts of interest because the REIT managers also own the REITs major department store tenant, an inexperienced "heir" to the CEO position, the usual potential conflicts associated with the UPREIT structure (although most of the recent REIT IPOs and over 90 percent of those in registration have used the UPREIT structure), and too high of an estimated IPO price range.⁸² If ever an equity REIT IPO was doomed to fail, it appears that this would be the one.

3.7 Final Comments On Equity REIT IPOs

The REIT industry is expected to grow substantially over the next few decades. Mark Decker, the President of NAREIT, compares it to the mutual

⁸¹Barry Vinocur, "REITs Rebound After Spring Slump," *Barron's*, July 19, 1993, p.36.

⁸²Barry Vinocur, "Big Debt Poses Risk to Big REIT," *Barron's*, July 26, 1993, p.45, and Suzanne Woolley, "A Deal That's Looking Dubiouser and Dubiouser," *Business Week*, July 26, 1993, pp.68-69.

fund industry. He explains that after 30 years the mutual fund industry had grown to \$40 billion in total assets. That was in 1966. Now its assets are more than \$1.7 trillion. The REIT industry, Decker says, had assets of \$44.4 billion (roughly half of that was equity REITs) by its thirtieth birthday in 1990. He writes, "While it is not likely that the REIT industry will progress to a trillion dollars total asset industry, I believe it will likely reach the \$200 - \$500 billion asset threshold in the next 10 - 20 years."⁸³

Undoubtedly equity REIT IPOs will play a large part in this growth, especially over the next couple of years. However, there are a couple of events which will occur concurrently during this time period.

First, it is likely that the "five and fewer" rule will be eliminated as described in section 1.9. This will enable institutional investors to acquire a significant ownership stake in an equity REIT, and consequently they will be able to exert substantial control over the performance of the REIT's management. Currently there are provisions in most REITs' charters which limit beneficial ownership by an individual to a maximize percentage of the total shares outstanding. Although the stated purpose of this provision is to "preserve the company's status as a REIT," it also serves as an anti-takeover provision for the company's existing management. It is possible that the legitimacy of such clauses will be opposed in court once the five and fewer rule is eliminated. If such clauses are ruled illegal and unenforceable, REITs will no

⁸³NAREIT, "Bigger and Better", p.11.

longer be as attractive to potential issuers. The ability to defer taxable gains on the sale of property, such as through the UPREIT structure, will be overshadowed by the presence of large shareholders who will demand that certain properties be disposed of regardless of the tax implications to the prior property owners. Perhaps other clauses could be incorporated into the REIT's charter preventing such sales, or providing for additional compensation to prior owners upon such sales, but those clauses will reduce the value of the stock. The government is not likely to consider waiving tax recognition of gains on sales of those properties.

Second, interest rates will likely increase sometime in the near future. Pure yield-oriented investors, such as mutual funds, will transfer their assets from REITs to other less risky, high-yielding investments, and prices of income-oriented REITs may fall. At that time the importance of pension funds as investors in REITs will become pronounced. Pension funds are longer term investors than mutual funds because they attempt to match income from their investments with projected payments to beneficiaries. This strategy might have a time horizon of several decades. Again, with the five and fewer rule eliminated, pension funds will acquire large stakes in REITs only if they will have the control required to ensure top performance by the REIT's management, thus maintaining or increasing the value of their investment.

Potential issuers of equity REIT IPOs must understand the implications of these events in order to properly address the decision of whether or not to

go public.

To conclude our analysis of equity REIT IPOs from 1991-1993 we asked all of our sample firms the same survey questions that were discussed at the end of chapter 2. Responses were received from 11 out of the 13 firms in the sample. Wellsford did not return any phone calls, and Manufactured Home Communities declined to comment (perhaps this has something to do with the 25.24 percent cumulative return to end of day 10 trading). Anyway, of the responses we received the results are as follows:

· How would you rate your underwriter's performance?

Excellent	55%
Good	36%
Fair	0%
Poor	0%
Some parts excellent, others were poor	9%

· Would you use the same underwriter to manage a second deal?

Yes	91%
No	0%
Undecided	9%

· Rate the QUANTITY of research coverage by your lead investment banker after the IPO.

Excellent	23%
Good	32%
Fair	9%
Poor	0%
Too soon to judge	27%

- Rate the QUALITY of research coverage by your lead investment banker after the IPO.

Excellent	32%
Good	41%
Fair	0%
Poor	0%
Too soon to judge	27%

- Rate the extent of research coverage by other firms.

Excellent	18%
Good	45%
Fair	0%
Poor	9%
Too soon to judge	27%

As with all 1992 IPOs, over 90% of equity REIT IPO issuers rated the underwriter's performance as either good or excellent. All but one (91 percent) of the sample firms responded that they would use the same underwriter to manage a second deal, compared to 75 percent of the 1992 IPOs. In fact, Kimco and Wellsford have already done so. And if we disregard the "too early to judge" responses for the last three question, over 85 percent of the remaining responses rated the quantity, quality, and extent of research coverage to be either good or excellent.

From the viewpoint of the issuers of equity REIT IPOs from 1991-1993, the overwhelming consensus is that the underwriters have done their job well. And since investors continue to buy them up, and underwriters are earning substantial fees, it appears that equity REIT IPOs from 1991-1993 are a good deal for everyone.

CONCLUSION

This paper analyzed the costs associated with an equity REIT IPO. Using a sample of 13 such offerings which took place between November, 1991 and June, 1993, an equation was generated to predict the total direct costs involved in an equity REIT IPO. The resulting equation estimates those costs at \$820,427 plus 10.19 percent of the gross proceeds of the offering. For the sample firms, the total costs predicted by this equation varied from the actual costs by an average of 9.5 percent. This compares to a study by Ritter of IPOs in general which took place between 1977 and 1982. Ritter estimated the total direct costs of an IPO to be \$250,000 plus 7% of the gross proceeds of the offering. Applying this equation to the sample firms yields estimates which vary from the actual costs by an average of 33 percent.

Statistics for the first 10 days of trading for each equity REIT IPO in our sample were collected, analyzed, and tested against other IPO theories. It was observed that the underwriter's reputation is not a determining factor of the success of an equity REIT IPO, as measured by the initial return. However, a future study comparing the performance of separate "teams" within an investment banking firm is recommended. An investment banker at Merrill Lynch implied that their west coast team was responsible for their worst performing equity REIT IPOs, while the east coast team had much greater success.

An analysis of the cumulative returns to the end of trading for each of the first 10 days concludes that "flipping" equity REIT IPO shares results in superior returns for an investor who is able to obtain shares at the offering price. An investor who must buy in the aftermarket will pay an average premium of 4.69 percent, only to watch their investment gradually decline in value. In other words, if you can not buy equity REIT IPO shares at the offering price, then you should not buy them at all. Of course we recognize throughout the paper that the limited sample size and time period studied preclude us from being able to make some very general conclusions about the performance of equity REIT IPOs.

Many investors and advisors complain that the information provided in a prospectus is incomplete and of little value. A review of the prospectuses of the equity REIT IPOs in our sample revealed that much of the information provided is more of an explanation of the real estate industry in general than a description of the issuing firm. Although a lot of specific information on the operation of the company is also provided, investors want more. The trouble is that current SEC regulations prohibit and discourage issuers from providing valuable information, despite the fact that the law requires full disclosure of all material information. This leads to information asymmetry, as described by Kevin Rock. The result is that institutional investors, because of their size and wealth, are able to obtain valuable information about an equity REIT IPO from the underwriters. This information is otherwise unavailable to small investors.

Surveys of IPOs in general, and of the equity REIT IPOs in the sample, show that issuers are overwhelmingly satisfied with the performance of their investment bankers.

Finally, the future of equity REITs may hinge on proposed legislative changes to the rules governing REITs. For instance, elimination of the "five and fewer" rule will allow investors to acquire a larger percentage of ownership in a REIT, and thereby empower the investor with more control over the REIT's management. Whether or not this will discourage potential issuers of equity REIT IPOs or encourage larger investment in them remains to be seen.

Appendix A

Daily Stock Price Information - Equity REIT IPOs, 1991-1993

COMPANY:	Kimco	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	11/22/91	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$20.00							
	Day 1	1,449,500	20.125	19.875	20.000	---	0.250	0.00%
	Day 2	193,100	20.000	19.875	20.000	0.000	0.125	0.00%
	Day 3	36,700	20.000	20.000	20.000	0.000	0.000	0.00%
	Day 4	20,800	20.000	19.875	20.000	0.000	0.125	0.00%
	Day 5	33,700	20.000	19.875	20.000	0.000	0.125	0.00%
	Day 6	93,400	20.000	19.750	19.875	-0.125	0.250	-0.63%
	Day 7	34,400	20.000	19.750	19.875	0.000	0.250	-0.63%
	Day 8	42,100	20.000	19.875	19.875	0.000	0.125	-0.63%
	Day 9	38,600	19.875	19.875	19.875	0.000	0.000	-0.63%
	Day 10	60,100	19.875	19.750	19.750	-0.125	0.125	-1.25%
AVERAGES		200,240	19.988	19.850	19.925	-0.028	0.138	-0.38%

COMPANY:	Kranzco	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	11/12/92	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$20.00							
	Day 1	392,200	20.000	20.000	20.000	---	0.000	0.00%
	Day 2	60,800	20.125	20.000	20.125	0.125	0.125	0.63%
	Day 3	70,200	20.375	20.125	20.250	0.125	0.250	1.25%
	Day 4	59,500	20.250	20.000	20.125	-0.125	0.250	0.63%
	Day 5	32,000	20.250	20.125	20.250	0.125	0.125	1.25%
	Day 6	44,100	20.375	20.000	20.250	0.000	0.375	1.25%
	Day 7	32,400	20.375	20.125	20.250	0.000	0.250	1.25%
	Day 8	306,500	20.250	20.000	20.000	-0.250	0.250	0.00%
	Day 9	98,700	20.125	20.000	20.000	0.000	0.125	0.00%
	Day 10	151,600	20.125	20.000	20.125	0.125	0.125	0.63%
AVERAGES		124,800	20.225	20.038	20.138	0.014	0.188	0.69%

COMPANY:	Taubman	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	11/20/92	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$11.00							
	Day 1	4,673,900	11.625	11.250	11.625	---	0.375	5.68%
	Day 2	658,500	11.625	11.500	11.500	-0.125	0.125	4.55%
	Day 3	493,200	11.625	11.375	11.375	-0.125	0.250	3.41%
	Day 4	454,900	11.625	11.500	11.625	0.250	0.125	5.68%
	Day 5	74,900	11.625	11.500	11.500	-0.125	0.125	4.55%
	Day 6	190,200	11.625	11.375	11.500	0.000	0.250	4.55%
	Day 7	184,700	11.500	11.500	11.500	0.000	0.000	4.55%
	Day 8	145,800	11.625	11.500	11.500	0.000	0.125	4.55%
	Day 9	150,200	11.875	11.500	11.750	0.250	0.375	6.82%
	Day 10	114,400	11.875	11.750	11.750	0.000	0.125	6.82%
AVERAGES		714,070	11.663	11.475	11.563	0.014	0.188	5.11%

Appendix A (cont.)

Daily Stock Price Information - Equity REIT IPOs, 1991-1993

COMPANY:	Wellsford	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	11/20/92	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$21.75							
	Day 1	1,242,900	22.625	22.125	22.500	---	0.500	3.45%
	Day 2	233,400	22.625	21.875	21.875	-0.625	0.750	0.57%
	Day 3	157,500	22.500	22.000	22.500	0.625	0.500	3.45%
	Day 4	60,500	22.625	22.375	22.500	0.000	0.250	3.45%
	Day 5	27,000	22.625	22.375	22.500	0.000	0.250	3.45%
	Day 6	85,300	22.625	22.250	22.250	-0.250	0.375	2.30%
	Day 7	37,200	22.500	22.250	22.375	0.125	0.250	2.87%
	Day 8	46,100	22.625	22.375	22.375	0.000	0.250	2.87%
	Day 9	30,800	22.500	22.375	22.375	0.000	0.125	2.87%
	Day 10	60,000	22.500	22.250	22.250	-0.125	0.250	2.30%
AVERAGES		198,070	22.575	22.225	22.350	-0.028	0.350	2.76%

COMPANY:	Developer's Divers.	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	2/2/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$22.00							
	Day 1	3,401,400	25.000	23.500	24.375	---	1.500	10.80%
	Day 2	610,000	24.750	24.250	24.750	0.375	0.500	12.50%
	Day 3	312,800	25.250	24.500	24.750	0.000	0.750	12.50%
	Day 4	253,400	25.000	24.000	24.375	-0.375	1.000	10.80%
	Day 5	95,700	24.625	24.375	24.625	0.250	0.250	11.93%
	Day 6	150,000	24.750	24.375	24.375	-0.250	0.375	10.80%
	Day 7	142,600	24.500	24.375	24.500	0.125	0.125	11.36%
	Day 8	128,400	24.750	24.500	24.750	0.250	0.250	12.50%
	Day 9	94,300	24.750	24.250	24.500	-0.250	0.500	11.36%
	Day 10	250,600	24.375	23.750	24.000	-0.500	0.625	9.09%
AVERAGES		543,920	24.775	24.188	24.500	-0.042	0.588	11.36%

COMPANY:	Carr	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	2/9/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$22.00							
	Day 1	3,559,300	25.500	24.125	24.875	---	1.375	13.07%
	Day 2	538,600	25.125	24.500	24.750	-0.125	0.625	12.50%
	Day 3	203,100	24.750	24.250	24.375	-0.375	0.500	10.80%
	Day 4	111,300	24.500	24.250	24.375	0.000	0.250	10.80%
	Day 5	418,600	24.250	23.000	24.250	-0.125	1.250	10.23%
	Day 6	171,300	24.625	24.125	24.375	0.125	0.500	10.80%
	Day 7	72,200	24.625	24.250	24.375	0.000	0.375	10.80%
	Day 8	63,600	24.375	24.125	24.125	-0.250	0.250	9.66%
	Day 9	61,700	24.375	23.875	23.875	-0.250	0.500	8.52%
	Day 10	71,300	24.125	23.750	23.875	0.000	0.375	8.52%
AVERAGES		527,100	24.625	24.025	24.325	-0.111	0.600	10.57%

Appendix A (cont.)

Daily Stock Price Information - Equity REIT IPOs, 1991-1993

COMPANY:	Mnfrd Home Comm	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	2/25/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$25.75							
	Day 1	3,298,600	28.750	27.500	28.000	---	1.250	8.74%
	Day 2	358,500	28.500	28.000	28.375	0.375	0.500	10.19%
	Day 3	219,600	28.625	28.250	28.500	0.125	0.375	10.68%
	Day 4	93,300	28.625	28.125	28.125	-0.375	0.500	9.22%
	Day 5	110,100	28.375	28.000	28.250	0.125	0.375	9.71%
	Day 6	79,500	28.875	28.125	28.875	0.625	0.750	12.14%
	Day 7	60,900	29.625	29.000	29.250	0.375	0.625	13.59%
	Day 8	55,100	30.000	29.250	30.000	0.750	0.750	16.50%
	Day 9	69,000	30.875	29.750	30.750	0.750	1.125	19.42%
	Day 10	146,300	32.375	31.250	32.250	1.500	1.125	25.24%
AVERAGES		449,090	29.463	28.725	29.238	0.472	0.738	13.54%

COMPANY:	General Growth	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	4/7/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$22.00							
	Day 1	5,194,300	25.000	24.250	24.625	---	0.750	11.93%
	Day 2	705,200	25.250	24.750	25.125	0.500	0.500	14.20%
	Day 3	717,700	26.000	25.250	25.625	0.500	0.750	16.48%
	Day 4	390,400	25.750	25.500	25.750	0.125	0.250	17.05%
	Day 5	277,100	25.750	25.375	25.375	-0.375	0.375	15.34%
	Day 6	244,800	25.375	25.000	25.125	-0.250	0.375	14.20%
	Day 7	322,500	25.375	25.000	25.250	0.125	0.375	14.77%
	Day 8	161,400	25.250	25.125	25.125	-0.125	0.125	14.20%
	Day 9	225,200	25.500	25.000	25.500	0.375	0.500	15.91%
	Day 10	152,800	25.500	25.125	25.375	-0.125	0.375	15.34%
AVERAGES		839,140	25.475	25.038	25.288	0.083	0.438	14.94%

COMPANY:	Marks Centers	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	5/26/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$19.50							
	Day 1	2,838,900	20.250	19.625	19.625	---	0.625	0.64%
	Day 2	603,100	19.875	19.500	19.750	0.125	0.375	1.28%
	Day 3	455,200	19.625	19.500	19.500	-0.250	0.125	0.00%
	Day 4	616,400	20.375	19.500	20.375	0.875	0.875	4.49%
	Day 5	216,900	20.250	19.750	19.750	-0.625	0.500	1.28%
	Day 6	58,600	19.875	19.625	19.750	0.000	0.250	1.28%
	Day 7	148,400	19.750	19.500	19.500	-0.250	0.250	0.00%
	Day 8	169,800	19.625	19.500	19.500	0.000	0.125	0.00%
	Day 9	225,800	19.750	19.500	19.625	0.125	0.250	0.64%
	Day 10	78,000	19.750	19.500	19.625	0.000	0.250	0.64%
AVERAGES		541,110	19.913	19.550	19.700	0.000	0.363	1.03%

Appendix A (cont.)

Daily Stock Price Information - Equity REIT IPOs, 1991-1993

COMPANY:	TriNet Corp.	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	5/26/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$24.25							
	Day 1	2,101,600	24.250	23.625	23.750	---	0.625	-2.06%
	Day 2	357,600	23.875	23.250	23.875	0.125	0.625	-1.55%
	Day 3	165,800	24.125	23.500	24.000	0.125	0.625	-1.03%
	Day 4	176,300	24.625	24.000	24.250	0.250	0.625	0.00%
	Day 5	101,700	24.500	23.750	23.875	-0.375	0.750	-1.55%
	Day 6	77,100	23.750	23.500	23.625	-0.250	0.250	-2.58%
	Day 7	81,500	23.625	22.750	23.125	-0.500	0.875	-4.64%
	Day 8	60,100	22.875	22.500	22.625	-0.500	0.375	-6.70%
	Day 9	30,200	23.000	22.625	22.875	0.250	0.375	-5.67%
	Day 10	22,700	23.500	22.875	23.375	0.500	0.625	-3.61%
AVERAGES		317,460	23.813	23.238	23.538	-0.042	0.575	-2.94%

COMPANY:	Tanger	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	5/27/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$22.50							
	Day 1	2,331,200	23.000	22.375	23.000	---	0.625	2.22%
	Day 2	149,700	23.000	22.500	22.500	-0.500	0.500	0.00%
	Day 3	69,200	22.500	22.250	22.250	-0.250	0.250	-1.11%
	Day 4	44,800	22.750	22.250	22.375	0.125	0.500	-0.56%
	Day 5	35,500	22.375	22.125	22.250	-0.125	0.250	-1.11%
	Day 6	43,800	22.375	22.250	22.250	0.000	0.125	-1.11%
	Day 7	51,100	22.375	22.250	22.250	0.000	0.125	-1.11%
	Day 8	22,300	22.375	22.125	22.125	-0.125	0.250	-1.67%
	Day 9	46,500	22.375	22.125	22.250	0.125	0.250	-1.11%
	Day 10	13,500	22.250	22.125	22.250	0.000	0.125	-1.11%
AVERAGES		280,760	22.538	22.238	22.350	-0.083	0.300	-0.67%

COMPANY:	Factory Stores	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	6/3/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$23.00							
	Day 1	2,670,800	25.125	24.000	24.500	---	1.125	6.52%
	Day 2	431,500	24.750	23.750	24.000	-0.500	1.000	4.35%
	Day 3	197,300	24.000	23.000	23.500	-0.500	1.000	2.17%
	Day 4	202,800	23.625	23.000	23.125	-0.375	0.625	0.54%
	Day 5	165,600	23.500	23.250	23.375	0.250	0.250	1.63%
	Day 6	88,600	23.625	23.375	23.500	0.125	0.250	2.17%
	Day 7	66,100	23.750	23.500	23.625	0.125	0.250	2.72%
	Day 8	98,900	23.750	23.625	23.750	0.125	0.125	3.26%
	Day 9	64,800	23.875	23.500	23.875	0.125	0.375	3.80%
	Day 10	54,300	23.875	23.625	23.750	-0.125	0.250	3.26%
AVERAGES		404,070	23.988	23.463	23.700	-0.083	0.525	3.04%

Appendix A (cont.)

Daily Stock Price Information - Equity REIT IPOs, 1991-1993

COMPANY:	Holly Residential	Trading	Hi	Lo	Close	Net	Trading	Return
IPO Date:	6/11/93	Volume	Price	Price	Price	Change	Range	To IPO
IPO Price:	\$23.00							
	Day 1	2,331,200	23.000	22.375	23.000	---	0.625	0.00%
	Day 2	149,700	23.000	22.500	22.500	-0.500	0.500	-2.17%
	Day 3	69,200	22.500	22.250	22.250	-0.250	0.250	-3.26%
	Day 4	44,800	22.750	22.250	22.375	0.125	0.500	-2.72%
	Day 5	35,500	22.375	22.125	22.250	-0.125	0.250	-3.26%
	Day 6	43,800	22.375	22.250	22.250	0.000	0.125	-3.26%
	Day 7	51,100	22.375	22.250	22.250	0.000	0.125	-3.26%
	Day 8	22,300	22.375	22.125	22.125	-0.125	0.250	-3.80%
	Day 9	46,500	22.375	22.125	22.250	0.125	0.250	-3.26%
	Day 10	13,500	22.250	22.125	22.250	0.000	0.125	-3.26%
AVERAGES		280,760	22.538	22.238	22.350	-0.083	0.300	-2.83%

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