

Anatomy of A Merger:
An Examination of Factors Influencing REIT Consolidation

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in Partial Fulfillment of the Requirements for the Degree of
Master of Science in Real Estate Development

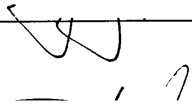
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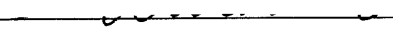
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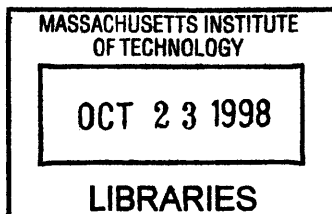
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ABSTRACT

An investigation was made into the factors influencing the recent merger and acquisition activity in the Real Estate Investment Trust ("REIT") industry. Several financial factors influencing consolidation activity were reviewed in theory including the desire to lower the cost of capital to the REIT, to take advantage of economies of scale, and to increase the liquidity of the REIT stock. Strategic factors including vertical and horizontal integration, the desire to influence market rents, and increasing management talent were also noted. The risks of integrating two organizations and the legal and tax implications of REIT mergers were also investigated as to their influence on current merger activity.

Observations of three office REIT mergers were made for purposes of comparison with the noted theoretical factors. Although financial factors were the underlying motivation of these mergers, strategic factors including horizontal integration played a visible role in each case.

The theoretical and practical observations were then used to create a framework for identifying the presence of acquirers and targets in the office/industrial sector of the REIT industry. Finally, strategic factors were used in combination with identified acquirers and targets in order to attempt to predict logical merger combinations in the future.

Thesis Supervisor: Blake Eagle

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Acknowledgements & Dedication:

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Chapter One: Introduction

As the Real Estate Investment Trust (REIT) industry moves into another phase of consolidation activity, the participants in the consolidations, the factors influencing consolidations and the expectations of consolidation benefits have changed substantially from previous periods.

Although growth remains the overriding general factor driving consolidation, the acquisition of real estate assets solely for the advantages brought with larger size has become increasingly difficult and less satisfying for the participants.

This thesis intends to explore the factors influencing this current phase of consolidation in the REIT industry, analyze selected merger activity according to these factors, and attempt to predict the participants of future merger activity in the office sector. After a brief introduction to the REIT industry and current consolidation trends, Chapter Two will provide the reader with an overview of the finance and strategic theory surrounding consolidation activity, including both general merger and acquisition (M&A) theory, and M&A theory unique to the REIT industry. In Chapter Three, the legal and tax issues relating to M&A activity will be briefly outlined in the context of the REIT industry. Chapter Four will analyze selected merger activity in the office REIT sector according to factors influencing consolidation. Chapter Five will establish a framework for identifying potential acquirers and targets, and demonstrate the framework within the context of the current office and industrial REIT sector.

Research Sources

Data sources for this thesis included existing literature for theory and background, interviews with industry professionals, and published databases from industry sources. Existing literature included textbooks, industry periodicals, trade journals, working papers, and class notes. The literature search was performed using traditional library research methods, plus databases and search engines available on the Internet. Interviews with industry professionals were performed in person or by conference call using identical questions for each participant. Participants were also given the opportunity to provide additional thoughts and information for the study.

Published industry databases used in the thesis included the Merrill Lynch Comparative Valuation REIT Weekly, Morgan Stanley Dean Witter Equity REIT Monthly Statistical Review, SNL Securities REIT data, and NAREIT Online data.

Brief Glossary of Terms

Throughout this thesis, terms are employed that have very specific meanings within the context of either finance theory or the REIT industry. To aid the reader in interpreting these terms, a brief glossary of terms is provide below.

Adjusted Funds From Operations (AFFO): Equal to FFO, as defined below, minus non-revenue-producing expenditures and adjusting for the REIT's use of floating rate debt..

Adjusted Funds From Operations Growth (AFFO Growth): Represents the expected growth in a REIT's AFFO in the next fiscal year. This figure is calculated by comparing the expected AFFO per share in one year with the expected AFFO in the following year.

Adjusted Funds From Operations Multiple (AFFO Multiple)¹: The ratio of stock price per share to AFFO per share.

Debt to Total Market Capitalization:² The ratio of total debt (excluding preferred stock) to total firm market value including debt.

Equity Capitalization: Equals the number of outstanding shares multiplied by the current share price.

Funds From Operations (FFO)³: GAAP Net Income, excluding gains/losses from non-recurring transactions *plus* depreciation *plus* amortization of capital expenditures.

Net Asset Value (NAV):⁴ This is an estimate of the current real estate/other asset value *non-inclusive* of franchise value. At the property level, NAV is the estimated price a property would trade for between a willing buyer and a willing seller in the private market. Net asset value is generally expressed in per share terms.

Price to Net Asset Value Ratio: This ratio compares the current share price to the net asset value (NAV) per share. This measurement gives a sense of the premium or discount at which the stock is trading relative to the underlying value of its real estate assets.

Total Market Capitalization: Equals the equity capitalization *plus* any outstanding debt of the firm.

¹ Adapted from definitions by Tim Riddiough, MIT/CRE Class Notes for Real Estate Capital Markets Spring 1998, pg. 43

² Adapted from definitions by Tim Riddiough, MIT/CRE Class Notes for Real Estate Capital Markets Spring 1998, pg. 43

³ Riddiough, Tim, MIT/CRE Class Notes for Real Estate Capital Markets Spring 1998, pg. 42

⁴ Riddiough, Tim, MIT/CRE Class Notes for Real Estate Capital Markets Spring 1998, pg. 43

REIT Industry Background

Although real estate had been commonly held in Massachusetts business trusts prior to the twentieth century, it was not until 1960 that Congress enacted specific REIT legislation in the form of the Real Estate Investment Trust Act of 1960. This legislation specifically identified the tax advantages of electing trust status for organizations holding real estate assets. The legislative goal was to create a vehicle whereby small investors could pool their capital to participate in the benefits of real estate ownership, without being double-taxed at the entity level and at the personal level. It also created a means to ensure a reliable flow of capital available for real estate investment. The Congressional Committee Report accompanying the legislation summarized the advantages as follows.

"These advantages include the spreading of risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly."⁵

Other benefits derived from the legislation included the lack of double taxation afforded by the exempt status, and the liquidity provided by a security tradable in the secondary market.

With the legislation came certain restrictions designed to insure the passive investment role of the REIT. Besides filing an election to select REIT status, REITs must maintain at least one hundred shareholders to insure a wide base of ownership. In addition, not more than fifty percent of outstanding shares can be owned by five or fewer stockholders. This rule has since been modified by the so called "look through" provisions that allow large, broadly held

⁵ Decker, Mark O., "The REIT Resurgence: A Resilient Industry Rebounds," *The Real Estate Finance Journal* (Summer 1997), p. 60.

institutions to own significant percentages of a REIT by "looking through" the institutional entity to its many investors. Other REIT requirements generally outlined below restrict asset type, source of income, and distribution of income.⁶

Asset Requirements

- At least seventy five percent of the REIT's assets must be real estate, cash, or government securities.
- Not more than five percent of the assets can be of any one issuer, if not included in the 75% test.
- The REIT cannot hold more than ten percent of the voting shares of any one issuer, if not included in the seventy five percent test.

Income Requirements

- At least ninety five percent of the gross income must come from dividends, interest, rents, or gains on sale.
- At least seventy five percent of gross income must come from rents, interest on mortgages, gains on sale, or income from other REITs.
- Not more than thirty percent of gross income can come from the sale of stock or securities held less than six months, or from real property held less than four years.⁷

Distribution Requirements

- At least ninety five percent of REIT taxable income must be distributed to shareholders.

⁶ Brueggemann, William B., and Jeffrey D. Fisher. Real Estate Finance and Investments. 10th ed. Irwin, 1997.

The first REITs established under the REIT Act of 1960 were equity REITs exhibiting slow growth in assets, earnings, and share price appreciation. By 1968, total REIT assets equaled only \$1 billion.⁸ However, from 1969 to 1972 the industry experienced unprecedented growth fueled by a lack of available construction funding from private sources. Since REITs had access to a variety of sources for capital, they were able to secure funds at relatively low rates, and invest these funds in higher yielding (albeit higher risk) construction loans. In addition to equity capital, REITs also issued commercial paper and borrowed from commercial banks. This strategy led to high industry debt ratios of close to eighty percent debt to total capitalization and set the stage for a major industry correction.

By 1974, the REIT industry had grown to over \$20 billion in total assets.⁹ At the same time however, the real estate development industry was starting to suffer from high interest rates, a national recession, and the overbuilt market created by the building boom of the early 1970's. Since many REITs had funded the overbuilt market, developer defaults started to negatively affect REIT earnings. This drop in earnings accompanied by decreases in dividend payouts drove REIT stock prices down significantly, especially those of mortgage REITs. It was not until later in the decade that the surviving REITs started to expand their operations again. The early 1980's showed relatively strong growth for the REIT industry, however the overwhelming tax advantages provided by private real estate partnerships continued to stifle broad investor interest in REITs. The Tax Reform Act of 1986 eliminated the tax advantages of private real

⁷ This restriction has since been repealed by the Real Estate Investment Trust Simplification Act of 1997 ("REITSA").

⁸ Decker, Mark O., "The REIT Resurgence: A Resilient Industry Rebounds," *The Real Estate Finance Journal* (Summer 1997), p. 60.

estate partnerships and focused interest on the economic based REITs. Unfortunately, the damage caused by the tax motivated development of the early 1980's had already become apparent in overbuilt markets and declining rent levels. The resulting distaste for real estate as an investment carried over to the REIT industry, again holding back growth.

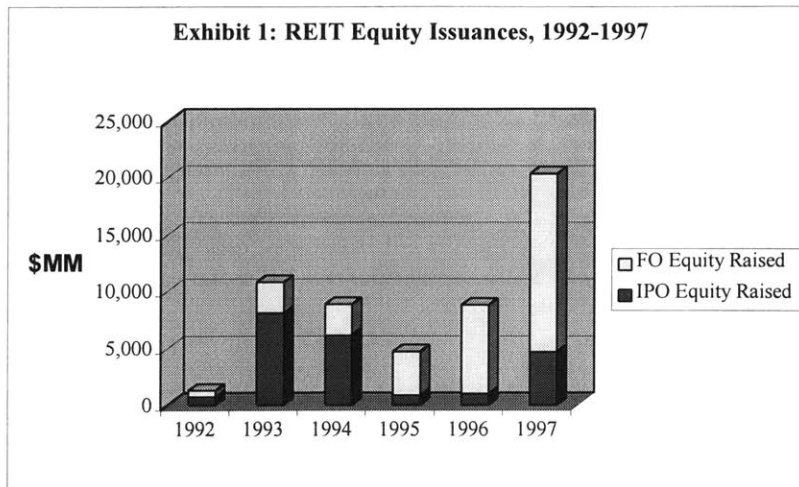
It was not until late 1991 that the industry started experiencing the meteoric growth that has characterized the industry during this decade. Kimco Realty Corporation's Initial Public Offering (IPO) of \$128 million led the way to several years of REIT expansion fueled by a need to recapitalize real estate projects in an environment devoid of private capital. By the mid-1990's the IPO boom had subsided with the return of private capital to real estate investment.

Secondary or Follow-On (FO) offerings soon overtook IPOs as existing REITs continued to grow through acquisitions.

With the emergence of well-known names in real estate adopting the REIT structure, this period also signaled the beginning of widespread investor confidence in REITs as a viable vehicle for real estate investment.

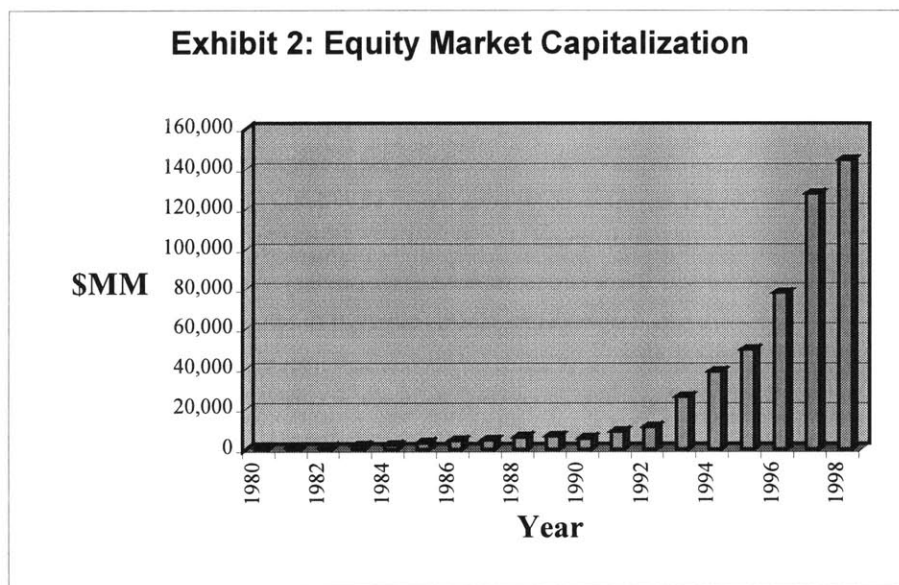
Exhibit 1 shows REIT equity issuances for public equity REITs only (not including mortgage or health care REITs) for the years 1992 through 1997. The trend shows substantial growth in IPO activity in the early 1990's, replaced subsequently by growth in follow-on offerings during the years 1995 through 1997.

⁹ Decker, p. 61.



Source: Salomon Smith Barney U.S. REIT Monthly Update, June 8, 1998

The public recapitalization of real estate can be demonstrated by the sharp rise in market capitalization of publicly traded equity REITs coinciding with the IPO boom in the early 1990's. Exhibit 2 below shows the market capitalization (outstanding shares multiplied by share price)



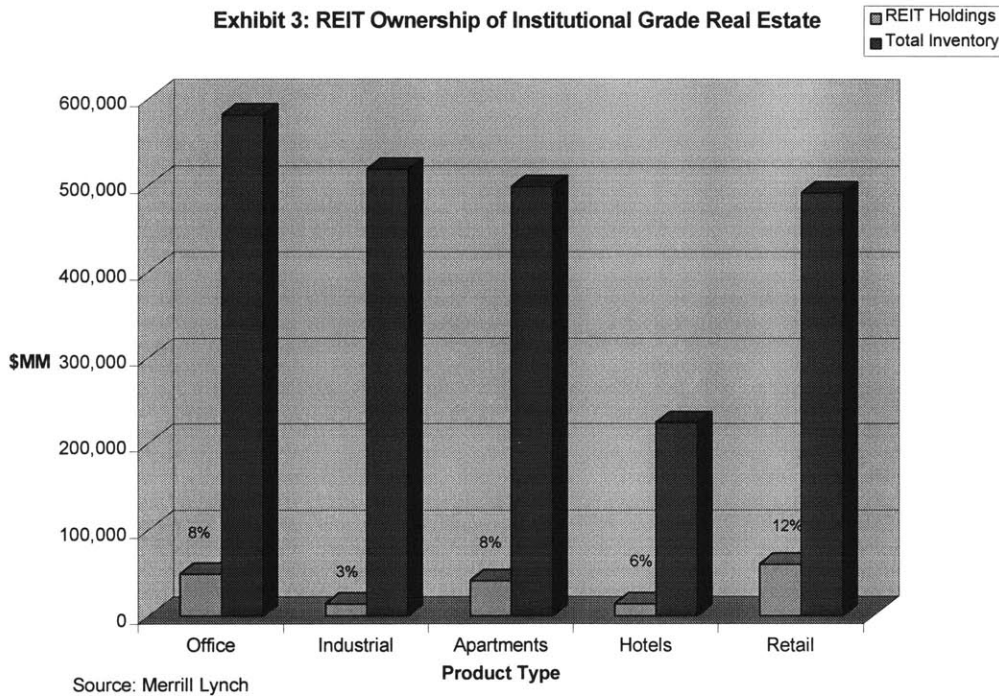
Source: NAREIT

of equity REITs each year from 1980 through the middle of 1998. The data does not include mortgage REITs nor does it include the value of any outstanding convertible partnership units from an UPREIT structure. As clearly shown, the market capitalization of equity REITs grew

slowly until the REIT IPO boom of the early 1990's, then increased substantially to its present value of approximately \$145 billion.

Current REIT Industry Status

As of June 30, 1998, there were a total of 215 individual REITs with a combined market capitalization of approximately \$160 billion.¹⁰ As of the same period, there were twenty office REITs with a combined market cap of approximately \$23 billion. It is estimated that equity REITs presently control approximately eight percent of the \$2.3 trillion in investment-grade commercial real estate located in the U.S.¹¹ As shown in Exhibit 3 below, the extent of REIT ownership tends to vary across product type.



¹⁰ Market capitalization does not account for the implied value of convertible partnership interests in Operating Partnerships. Source: NAREIT

¹¹ Merrill Lynch "In-depth Report: Are REITs Destined to Inherit the Earth", March 25, 1998

Given the higher percentage of public ownership found in other mature industries, it can be assumed that REITs or other forms of public ownership of real estate will continue to gain a larger percentage of ownership.

REIT Consolidation History

The roots of the current wave of consolidation in the REIT industry lie in the excesses of the 1980's, highlighted by a huge overbuilding of product in nearly all real estate sectors, and the subsequent credit crunch of the early 1990's. By the early 1990's, many large developers with sizable pools of highly leveraged real estate assets, faced a need to either refinance or sell these assets as short-term mortgages came due. At the same time, real estate prices had dropped by thirty to fifty percent in many sectors as a result of the oversupply, leaving developers in a "negative equity" position.¹² Exacerbating the situation even further was the fact that traditional real estate lenders such as banks, savings & loan associations, and insurance companies largely withdrew from making real estate loans during this period as many existing loans soured and new regulations increased these lenders' capital requirements.

Finally, these developers turned to Wall Street in an attempt to source capital to repay debt and to regain equity in their real estate assets through private to public "arbitrage". The "arbitrage" sought by developers involved leveraging the differences in capitalization rates used by public and private investors. Private investors buying a real estate asset may require a capitalization rate or current return of twelve percent, while public investors buying a "going concern" with growth potential may only use a capitalization rate of seven or eight percent. The difference

between these two capitalization rates can dramatically affect the value realized for these assets.¹³

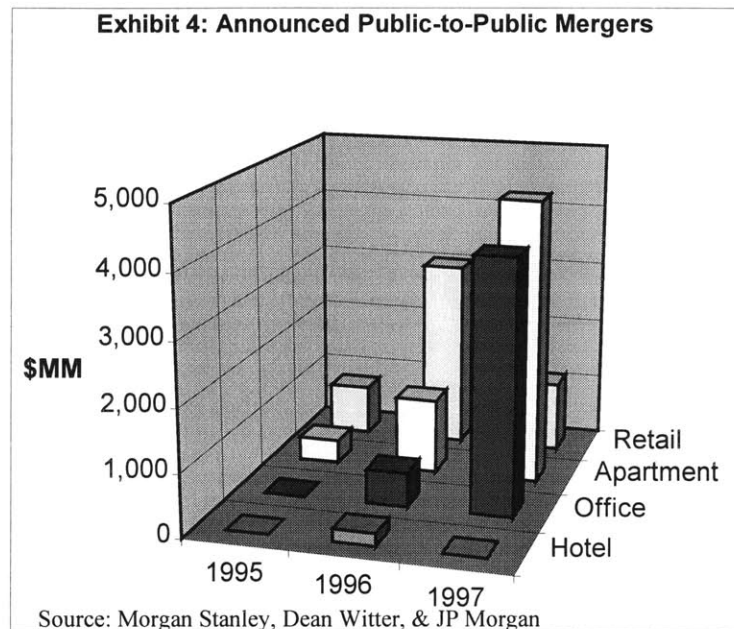
The final component leading to the dramatic securitization of real estate in the 1990's was the UPREIT structure, created in 1992. This structure allowed current owners of real estate to contribute their property on a tax-deferred basis to an operating partnership and avoid immediate taxation, as would likely be the case if the assets were simply exchanged for stock or cash. A more detailed discussion of the UPREIT structure is given in Chapter Three.

With this final link in place, the stage was set for the dramatic boom in REIT Initial Public Offerings (IPOs) that took place in 1993-94, where a small army of entrepreneurs and developers brought their assets public. The public markets responded positively to these new offerings because growth opportunities appeared strong for these newly recapitalized ventures. Growth opportunities for these ventures included buying troubled real estate assets well below their replacement values.

As real estate markets recovered in the middle to late 1990's, the opportunity for REITs to buy properties at bargain prices diminished. Furthermore, as more REITs were formed, competition among REITs for assets grew fiercer. With this noteworthy increase in competition, a natural separation between well-managed and poorly-managed REITs became more apparent. By the late 1990's, financially stronger REITs began to acquire weaker companies, and consolidation in the REIT industry rose into prominence.

¹² Negative equity refers to the condition where the existing debt on a property exceeds its fair market value.

Initially, REIT merger & acquisition activity focused on single properties, followed almost immediately by acquisition of large portfolios of properties. Acquirers found that the larger portfolios provided a faster route to increased earnings growth as the acquiring REITs grew ever larger. After substantial activity in the private asset-to-public REIT consolidation form,



consolidation between public real estate companies started to appear. Exhibit 4 shows the recent history of announced public-to-public REIT mergers by year, product type, and total announced transaction value.¹⁴

The poor performance of REIT prices in the first part of 1998 may reflect a change in investors' sentiment resulting from their lower expectations for REITs' external growth opportunities. These lower growth expectations raise investors' capitalization rates, making it increasingly

¹³ See Chapter Two for a more in-depth explanation of capitalization rates.

¹⁴ Source: JP Morgan

difficult for smaller REITs to go back to the equity markets for capital to fund growth (see the discussion about investor capitalization rates in Chapter Two.) At the same time, investor concern over increasing levels of debt of REITs has left smaller and poor performing REITs with few avenues to access capital. The larger REITs have a wider variety of instruments available to secure cost-effective capital including unsecured debt, convertibles, and shelf issues. _____

As the REIT industry continues to grow in size and stature, it will continue to enjoy the benefits of the public capital markets. Based on its relative youth as a publicly traded industry, combined with the current consolidation trends observed, it is clear the industry will become less fragmented. In the next chapter we review traditional mergers and acquisitions theory as it applies to public-to-public REIT merger activity.

Chapter Two: Merger & Acquisition Theory

In this section, financial and strategic factors that influence acquirer & target REITs in making M&A decisions are examined within the context of their effect on the consolidation within the REIT industry. Afterwards, a brief examination is made of the risks facing “acquirer REITs” in trying to integrate the “target REIT” into its organization.

Factors Influencing Acquirers in Making M & A Decisions

REITs identified within this thesis as “acquirers” are considered to be candidates for initiating a merger or acquisition of a “target” firm that has displayed signs of poor financial or managerial performance

Table 1 displays the factors that influence acquirer REITs in making M&A decisions. A discussion of how each of these factors affect REIT consolidation follows the table.

Table 1: Factors Influencing Acquirer REITs in Making M&A Decisions

Financial Factors	Strategic Factors
Lower the weighted average cost of capital (WACC)	Execute strategic vision
Reduce equity investors' capitalization rates	Respond to competitor's strategic initiative
Achieve economies of scale & scope	Vertically integrate
Enhance revenue opportunities	Horizontally integrate
Increase investor interest in company	Establish market power rents
	Differentiate product
	Seek “low cost producer” status

Financial Factors

Lower the Weighted Average Cost of Capital (WACC)

The weighted average cost of capital (WACC) among REITs plays an important role in the competition for assets and growth opportunities. The fact that a REIT's cost of capital (both equity and debt) represents its largest expenditure is a further indication of the importance of this factor. The WACC can be divided into three distinct parts: (1) cost of equity, (2) cost of debt, and (3) transaction cost of raising capital. The impact of each of these parts on REIT consolidation is discussed below.

Cost of Equity Capital

The cost of equity capital is the expected rate of return set forth by equity investors for making an investment and reflects investors' perceptions of the following:

- Relative risk of expected cash flows associated with the investment.
- Relative liquidity of its shares.

Relative Risk of Expected Cash Flows

The degree of risk associated with expected cash flows varies greatly among firms. To the extent that investors believe that there is increased certainty about a firm's expected cash flows, they will lower their required return on capital. A REIT can use a merger or acquisition to reduce one important aspect of this expected cash flow risk, that of concentration risk.

Concentration risk refers to the risk a firm bears by relying on a limited number of sources of revenue including: (1) maintaining a small customer base in term of their number or

concentration in a economic base, (2) relying on a small number income producing assets, (3) focusing assets in a single geographic area, and (4) offering a limited number of products or services.

A merger or acquisition, as described above, can diminish concentration risk, if the transaction reflects one or more of the following risk-reduction strategies:

- Horizontal Integration (e.g., merger or acquisition of a competing firm).
- Vertical Integration (e.g., merger or acquisition of a supplier to the acquirer or distributor of the acquirer's product).
- Economic Diversification (e.g., broaden tenant base across more industries).
- Geographic Diversification (e.g., expand the number of geographic markets served).

Liquidity Premium

To the extent that a firm can reduce risk associated with its share liquidity, it can conceivably reduce its cost of equity capital. To that end, larger REITs with higher trading volume have increased liquidity. Since investors attach a sizable liquidity premium to smaller REITs with low trading volume, consolidation allows a larger REIT to profit from this reduction in liquidity premium.

Better liquidity can also attract new classes of investors such as institutions or pension funds. Often, these entities shy away from sparsely traded stocks for two reasons: (1) illiquidity of shares caused by the small universe of buyers, and (2) the anticipated decline in share price if a large block of stock were to be put up for sale at one time.

Cost of Debt Capital

Large REITs can effect a lower cost of debt than smaller REITs primarily by achieving a higher credit rating on its debt. This higher credit rating can reduce the basis point spread a REIT pays for debt, which presents it with the opportunity to create shareholder wealth through acquisition of a REIT that is subjected to higher basis point spreads. Adding support to this argument, a recent study on scale economies of REITs provides empirical evidence that larger REITs do in fact have lower costs of debt.¹⁵

Transaction Costs

Even among publicly held entities such as these, significant economies of scale exist in the effort to raise either equity or debt capital. The transaction cost savings available to large REITs with large issuances of debt or equity can be quite substantial. For example, when comparing the transaction costs for several small REITs to raise a total of one billion dollars and one large REIT to raise a similar amount, the large REIT's savings on these transaction costs can be as much as fifty percent due to fixed costs inherent in the smaller issues.

Other Theoretical Implications of a Lower Cost of Capital

While not directly supported by any current empirical evidence, industry observers have nonetheless postulated that firms achieving a lower cost of capital may also have the opportunity to leverage this lower cost of capital advantage in the following ways:

- Outbid competitors for property.

- Offer lower rents to recruit and retain tenants.
- Increase capital expenditures.
- Recruit and retain better management with higher compensation.
- Expand marketing efforts.

Reduce Equity Investors' Capitalization Rate

The equity investors' capitalization rate is the rate at which a firm's current dividend is discounted to arrive at the value of a share to the investors. There are three separate components of the capitalization rate:¹⁶

- Cost of Equity Capital (r)

As discussed in an earlier section, the cost of equity capital is the expected rate of return demanded by investors for making an investment.

- Expected Internal Growth (g_i)

Expected internal growth reflects the investors' growth expectations for assets currently held by the firm. Factors influencing these expectations include management ability, property characteristics, and market conditions.

- Expected External Growth (Δg_e)

The expected external growth component represents investors' expectations about the ability of management to recognize and capture external growth opportunities

¹⁵ Bers, Martina and Thomas M. Springer. Sources of Scale Economies for REITs, Real Estate Finance, Winter 1998, pg. 47-57.

¹⁶ Riddiough, Tim, MIT/CRE Real Estate Capital Markets – Lecture Notes, Spring 1998 pg. 44

including new development, acquisitions, and mergers. These expectations are also influenced by external factors such as market conditions.

The relationship of these three components to the capitalization rate can be expressed in the following manner:

$$\begin{aligned} \text{Capitalization Rate} &= \text{Cost of Equity Capital} - (\text{Internal Growth} + \text{External Growth}) \\ &= r - (g_i + \Delta g_e) \end{aligned} \quad (1)$$

To calculate an appropriate share price for a firm, an investor simply divides the firm's current dividend by the capitalization rate estimated above:

$$\begin{aligned} \text{Share Price} &= \frac{\text{Current Dividend}}{\text{Capitalization Rate}} \\ (P_0) &= \frac{(DIV_1)}{r - (g_i + \Delta g_e)} \end{aligned} \quad (2)$$

To illustrate the impact and importance of these components on the capitalization rate and share price, two simple examples are presented below:

Example: ABC REIT (no growth)

Dividend:	\$2.00 per share
Cost of Equity Capital (r)	15%
Expected Internal Growth (g _i)	0%
Expected External Growth (Δg _e)	0%

$$\text{Capitalization Rate} = 15\% - (0\% + 0\%) = 15\%$$

$$\text{Share Price} = \$2.00 / .15 = \$13.33 \text{ per share}$$

Example: ABC REIT (with growth)

Dividend:	\$2.00 per share
Cost of Equity Capital (r)	15%
Expected Internal Growth (g_i)	2%
Expected External Growth (Δg_e)	3%

$$\text{Capitalization Rate} = 15\% - (2\% + 3\%) = 10\%$$

$$\text{Share Price} = \$2.00 / .10 = \$20.00 \text{ per share}$$

These two examples demonstrate how significant a role that investors' expectations of growth plays in valuing a firm. Despite the fact that the dividend (DIV_1) and cost of equity capital (r) were identical for both examples, the value of the "growth" firm was fifty percent (50%) greater than the "no growth" firm. The "growth" firm share was valued at \$20.00, while the "no growth" firm's share was worth only \$13.33.

Clearly, a firm's management has an extraordinary opportunity to create shareholder value with only a small increase in growth expectations. While internal growth rates are often limited to low or modest single digit increases, a firm can easily achieve much higher external growth through new development, mergers, and acquisition. These facts explain how mergers and acquisitions are driven by management's desire to increase investors' external growth expectations.

Achieve Economies of Scale and Scope

Large REITs often cite lower overhead resulting from economies of scale as a significant advantage over their smaller REIT brethren. Furthermore, market results indicate that within a

commodity-like industry such as real estate, efficient operators with such savings are rewarded by investors with higher share values. As with savings in other areas, the savings in overhead attained by larger REIT operators can be capitalized to substantially increase the value of the firm.

In a recent study on the sources of scale economies for REITs, the study ranked the areas in which the scale economies were the largest.¹⁷ General & administrative and management fees, and certain operating expenses such as insurance seem to offer notable scale opportunities. Other opportunities to leverage economies of scale include reducing electricity cost, marketing costs and eliminating redundant personnel.

Enhance Revenue Opportunities

To the extent a larger REIT can derive additional revenue from suppliers or customers relative to its smaller REIT competitors, consolidation will be encouraged. However, care must be given when considering these many of these opportunities because many of them are classified as “non-qualified” income, which could be taxable.¹⁸ Within the REIT industry, these revenue enhancing opportunities for larger REITs could take the following forms.

- Referral Fees From Telecommunications, Cable, and other Service Providers.
- Referral Between Company Properties.
- Broadcast and Tower Fees.
- Parking and other Service Fees.

¹⁷ Bers, Martina and T. M. Springer. “Sources of Scale Economies for REITs”, Real Estate Finance, Winter 1998

- Franchise Value.

Referral Fees from Telecommunications, Cable, and other Service Providers

Among the larger apartment and office REITs, some have begun leveraging information they routinely collect from their tenant base into an income source by selling it to telecommunication, cable, Internet, and other service providers. Many of these companies will pay referral fees to the REIT for the name and contact information for tenants that are expanding, moving in, or vacating.

Referral between Company Properties

Another way larger REITs are leveraging this information is to refer current tenants who are moving or expanding to other REIT-owned properties in the tenant's new location. For instance, if a client in Boston were planning to move or expand part of its operations to San Francisco, a larger REIT could refer the client to a property it owns in that area. Similarly, apartment tenants could be allowed to transfer a lease among properties held by the REIT. This could be a huge strategic and financial advantage for a large apartment REIT dealing with large firms that require employees to move frequently.

Broadcast and Tower Fees

Yet another revenue source that larger REITs seem to be leveraging more than smaller ones is the opportunity to erect broadcasting towers atop their buildings or elsewhere on-site. Large

¹⁸ See the discussion on the REIT income test in Chapter One.

communication companies enjoy the convenience of being able to secure a large number of sites with a single negotiation rather than having to deal with a string of smaller property owners. These broadcasting revenues are quite significant in some of the larger metropolitan areas. With annual broadcast revenues in the millions for some large office buildings, the capitalized value of this source of revenue for a larger REIT with dozens of office buildings can be quite significant. In a speech to MBA candidates at Harvard Business School in April 1998, Equity Office Group's Chairman Sam Zell illustrated the value of broadcasting fees by citing the fact that one major metropolitan office building, owned by his firm, collected annual broadcast fees in excess of \$3 million.¹⁹

Parking and Other Service Fees

Well-managed large REITs also frequently identify and capture additional revenue by charging for parking and offering day care, valet, and other services for a fee. In the case of larger REITs, the fixed cost of setting up a common program for offering these services are spread over a greater number of properties. However, by offering these additional services a REIT exposes itself to several potential problems:

- New sources of income could be classified as “non-qualified”, resulting in a tax liability.²⁰
- New services could create new liability risks for the REIT, particularly in such areas as childcare.

¹⁹ Source: Speech given by Sam Zell at Harvard Business School in Spring 1998.

²⁰ See the discussion on the REIT income test in Chapter 1.

Franchise Value

Classic examples of franchise value seldom revolve around real estate companies, with the notable exception of such names as Trump or DeBartolo. However, this has not stopped larger well-managed REITs from attempting to establish it. These REITs are adopting common signage and other elements of franchising and are working diligently to make themselves commonly known between markets.

Increase Investor Interest in Company

Increasing investor interest in your company is yet another financial factor for potential acquirers to consider. For with increased investor interest, garnered through an merger or acquisition, the management of the firm can:

- Increase liquidity of company shares.
- Expand Wall Street research following.
- Attract a larger institutional following.

These achievements will, in most circumstances, lead to a reduction in the cost of both equity and debt capital as a broader universe of investors become aware of the company. Furthermore, this lower cost of capital places the firm at an advantage over its smaller brethren in the contest for assets.

Strategic Factors

Strategic factors that influence M & A decisions are often less quantifiable and are geared toward achieving some longer-term effect, in comparison to the financial considerations discussed above, which are often more focused on short term results. The intent of any strategic move is to better position the firm to compete at some point in the future. The strategic factors to be considered by an acquiring REIT are examined below.

Execute Strategic Vision

A firm's strategic vision describes the method and manner in which a firm intends to carry on its business and reflects the degree of visionary leadership possessed by its management. The key dimensions of this visionary leadership are: (1) the ability to identify and capture new opportunities that offer superior returns, (2) the ability to communicate a clear and convincing investment strategy to employees, clients, suppliers, and others, and (3) the ability to manage existing assets in a disciplined, yet entrepreneurial manner.

A frequent non-real estate example of the effect of visionary leadership is the influence of Warren Buffet's leadership on the stock price of his company, Berkshire Hathaway.²¹ The stock trades at a substantial premium to the underlying value of its holdings (the equivalent of real estate's net asset value-NAV) because shareholders believe in Mr. Buffet's ability to identify new investments that will yield above-market returns and in the disciplined approach to

²¹ Linneman, Peter. "Forces Changing the Real Estate Industry Forever." *Wharton Real Estate Review*, Spring 1997, pp. 1-12.

management he institutes to achieve low-cost producer status. Furthermore, the stock price premium achieved by Berkshire Hathaway results in a higher price/earnings ratio that infers a lower weighted average cost of capital (WACC). A lower cost of capital is crucial for capital hungry industries like real estate and is particularly important to REITs because of their frequent trips to the equity capital market. Since REITs have stringent income distribution regulations, they must issue equity or debt in lieu of retained earnings if they need capital to fund growth.

On the other hand, entities that do not display visionary leadership and simply hold a collection of assets (such as closed end mutual funds) often trade at a substantial discount to NAV. In this case, the investors' required return is notably higher and the fund's ability to compete for assets or raise additional equity is poor.

Respond to Competitor's Strategic Initiative

A potential acquirer may also choose to undertake a merger or acquisition in response to a competitor's strategic initiative. This M&A activity could be either defensive or offensive in nature. In the case of a defensive merger or acquisition, the acquirer may move to protect its current customer base or market area from an invading competitor. Conversely, in a offensive response, the acquirer may move to take advantage of a competitor's withdraw from a market, product line, or customer base.

Vertically Integrate

Vertical integration refers to an action by an entity to undertake additional tasks along its industry value chain.²² A firm that chooses to vertically integrate can either backward or forward integrate. Backward integration involves a firm undertaking an activity that had previously been provided to it by a supplier. An example of backward integration within the REIT industry could include the acquisition of a development company by a REIT that had not previously undertaken development. The strategic implications for an acquiring REIT of such a merger or acquisition include:

- Gaining a source of new investment opportunities other than strictly acquisitions.
- Acquiring the ability to redevelop existing properties held by the REIT.
- Eliminating of the time and uncertainty involved in trying to start its own development team from scratch.

Forward integration entails a firm undertaking an activity that had previously been assumed by a buyer or distributor of the firm's existing products or services. Forward integration for a REIT may include the acquisition of a property management company, if the REIT had been using third party property management. Here again, such an acquisition can have strategic consequences by providing the REIT with new avenues for competitive advantage and growth. For example, a REIT could implement a new information system throughout its new in-house property management division that would generate information useful in planning future development, capturing untapped markets, and reducing operating expenses.

²² Porter, Michael E., Competitive Advantage, 1985 pg. 55

Horizontally Integrate

Horizontal integration takes place when two competing firms combine.²³ This contrasts with a conglomerate merger or acquisition, which is done for the sake of diversification, and where the target is involved in an unrelated business.²⁴ The distinction is important since classic finance theory supports horizontal integration, while generally disfavoring the merger of unrelated firms.²⁵

A recent example of horizontal integration in the REIT industry is the acquisition of Beacon Properties by Sam Zell's Equity Office REIT. These two REITs held competing office building portfolios in a number of major central business districts (CBDs). The combining of these two portfolios will allow Equity Office to not only increase market share and expand geographically, but possibly move to establish market power rents in areas where conditions are favorable. A discussion of the market power rents follows below.

Establish Market Power Rents

Market power is defined as “the ability to set and maintain price above competitive levels.”²⁶

The ability of any firm to achieve “market power” is dependent on three elements of the competitive environment:

- Product Differentiation.
- Barriers to Entry.

²³ Porter, Michael E., Competitive Advantage, 1985 pg. 55

²⁴ Gaughan, Patrick A, Mergers, Acquisitions, and Corporate Restructurings, 1996 pg. 7-8, 125-132

²⁵ Brealey, Richard A., Stewart C. Myers, Principles of Corporate Finance, 5th Edition, 1996, pg. 920-4

- Market Share.

Without the presence of all three of these elements, it is unlikely that a firm can achieve market power. For example, assuming a firm held a large market share in a market with few barriers to entry, an increase in rent may only serve to attract new competitors and drive prices down below the original market level. Similarly, if a firm with a large market share were unable to differentiate its product, its ability to sustain market power rents is unlikely.

An important consideration with respect to establishing market power through M&A activity revolves around the application of anti-trust legislation to real estate transactions. The Hart-Scott-Rodino Antitrust Improvement Act of 1976 (Hart-Scott-Rodino Act) requires that the FTC and Justice Department be given the opportunity to examine proposed mergers and acquisitions in advance.²⁷ However, a provision in the Hart-Scott-Rodino Act exempting real estate transactions has been interpreted through a series of FTC letters as an exemption for REIT to REIT mergers.²⁸

The yet unanswered question though is whether or not any government agency would take action if a single entity were able to accumulate a large enough share of a market to effect oppressively high leasing rates. No one knows the answer to this question and given the fragmentation of ownership in the overall real estate market, this question may not be answered for some time.

²⁶ Gaughan, Patrick, *Mergers, Acquisitions and Corporate Restructuring*, 1996, pg. 126

²⁷ Gaughan, Patrick A, "Mergers, Acquisitions, and Corporate Restructurings", 1996 pg. 83

²⁸ Schalop, Lee, "JP Morgan Industry Update, Real Estate M&A, Part IV", May 29, 1998

Differentiate Product

Product differentiation is one of the two types of competitive strategies a firm can pursue, the other being low cost.²⁹ A firm can achieve product differentiation if it can deliver something unique that is valuable to a buyer. An acquirer can realize product differentiation with a merger or acquisition transaction if the target makes new, valued product features or attributes available to the acquirer.

Seek “Low Cost Producer” Status

An alternative strategy to differentiation is to seek “low cost producer” status within an industry. A firm can achieve this status in one of two ways: (1) controlling cost drivers, and (2) reconfiguring the value chain.³⁰ An acquirer can pursue either of these “low cost” paths with a strategic merger or acquisition that accomplishes one or more of the following:

- Achieves greater economies of scale or scope.
- Provides access to proprietary technology (e.g., facility design, construction techniques, marketing expertise, proprietary software, etc.)
- Facilitates preferential access to raw materials; (e.g. In the case of a REIT, “raw materials” could include vacant land for development, an in-house development team, or a strategic alliance with outside developer leading to a lower delivered cost of newly constructed projects.)

²⁹ Porter, Michael E., Competitive Advantage, 1985 pg. 119

³⁰ Ibid., pg. 99

Factors Influencing Targets in Making M & A Decisions

Firms identified within this thesis as target REITs are considered to be candidates for takeover by way of a merger or acquisition by an acquirer REIT that has displayed signs of superior financial or managerial performance. Table 2 displays the financial and strategic factors that influence target REITs in making M&A decisions. A discussion of how each of these factors affect REIT consolidation follows the table.

Table 2: Factors Influencing Target REITs in Making M&A Decisions

Financial Factors	Strategic Factors
Enhance access to public capital	Reorient business strategy
Improve ability to compete for assets	Alleviate demands of running a public company
Increase financial flexibility	Acquire improved management

Financial Factors

Enhance Access to Public Capital

An important consideration for a REIT in deciding whether to accept a merger or acquisition offer is whether or not the merger will enhance access to public equity or debt capital. In view of the financial characteristics listed in Table 2 above, a REIT that has fallen into the “target” category could have limited ability to access public capital for two reasons: (1) its higher than average debt levels make raising more public debt difficult, and (2) its below average expected FFO growth makes the REIT unattractive to equity investors who can realize greater gains from higher growth REITs. Under these circumstances, a decision by the target REIT’s management to seek or accept an offer from an acquirer REIT may be best for its shareholders.

Improve Ability to Compete for Assets

REITs with the lowest cost of capital and best access to the public markets are better positioned to compete for assets than their weaker brethren. As a result, REITs bearing the financial characteristics of a target may improve their ability to compete for assets by seeking a financially strong merger partner who will give better access to public capital, while also lowering the cost of capital in all likelihood.

Increase Financial Flexibility

Larger acquirer REITs possess a considerable advantage over smaller REITs in terms of the timing and choice of financial instruments it uses. These acquirer REITs can float secondary offerings easier than smaller REITs because their larger size commands better analyst coverage. Furthermore, larger REITs have greater access to unsecured debt so that when the timing is poor to access capital markets, they can still move forward with profitable opportunities. With increased financial flexibility resulting from a merger or acquisition transaction, smaller target REITs will find themselves better able to compete.

Strategic Factors

Reorient Business Strategy

As the REIT industry continues to mature and grow, the necessity for some REITs to reorient their business strategy is inevitable. For instance, a REIT founded on the premise of building multifamily apartments in a particular region of the country may find that the region has become overbuilt and that it is no longer a profitable region in which to build or acquire properties.

Under these types of circumstances, the REIT's management may chose to reorient its business strategy to a more national scale by merging with a larger national apartment REIT.

Alleviate Demands of Running a Public Company

The IPO boom of the early 1990's saw many new REITs formed by former private entrepreneurs taking their assets public. Some of these executives have had difficulty adjusting to the demands of running a public company including close scrutiny by analysts, regulators, and active shareholders. By allowing their REIT to be acquired or merged with a larger target REIT, these entrepreneurs could be alleviated of these demands and could redirect their energy to more palatable endeavors.

Acquire Improved Management

Employees in any firm are motivated by the opportunity to achieve promotions and advancements. If a company stagnates, ambitious employees will seek out other companies that offer growth opportunities. If a REIT fails to grow or is unable to grow because of some financial constraints, it will inevitably face the prospect of not only losing its best employees, but that of having difficulty in recruiting quality replacements. For these reasons, a no-growth target REIT may be better off accepting a merger or acquisition offer rather than permitting the value of the REIT to erode as key personnel leave. Alternatively, the public REIT may chose to "go private" and entice key employees with equity in the new private company.

Integration Risks of Mergers and Acquisitions

An acquirer REIT faces some important challenges in integrating a target REIT into its existing organization. The two most frequently cited challenges are: (1) redefining corporate culture, and (2) integrating employees, systems, and assets.

Redefining Corporate Culture

Distinct corporate cultures develop in nearly every organization. After a merger or acquisition, the surviving firm must carefully examine the corporate culture of both entities and make a conscientious decision about the values that it will hold dear. Furthermore, after these values are identified and ratified, they must be clearly articulated throughout the organization. Failure to carefully redefine the corporate culture and effectively communicate a firm's values and corporate culture can easily thwart any synergies that may have been accessible. No corner of the firm's operations goes unaffected by these values, and customers as well as employee relationships can hang in the balance.

Integrating Employees, Systems and Assets.

The physical integration of two merged entities is yet another substantial challenge to the surviving firm and its management. Important decisions involving employees, systems, and assets must be made and can be the deciding factor as to the ultimate success or fail of the merger or acquisition.

As previously described, there are financial and strategic factors that influence both acquirer and target REITs in their respective decisions to merge. However, the priority of these factors varies between individual REITs. In addition to the financial and strategic factors outlined above, there are other issues REITs must consider in a potential merger situation. Chapter Three presents the general legal and tax issues inherent in a REIT merger decision.

Chapter Three: Legal and Tax Issues of REIT Takeovers

Despite regulations and bylaws that discourage potential acquirers from accumulating large amounts of a REIT's outstanding shares, REITs are not immune from unsolicited takeover attempts. This chapter provides a brief overview of legal and tax issues surrounding REIT takeovers.

Hostile Takeovers

A hostile takeover is typically initiated by the potential acquirer sending the target's board of directors a "bear hug" letter in which a friendly merger is proposed. If the parties are unable to reach agreement, the acquirer then generally proceeds with a tender offer directly to the shareholders which includes a consent solicitation to remove any provisions in the corporation's bylaws that obstruct a takeover.

Fiduciary Responsibility of Board Members

The fiduciary responsibility to shareholders, born by each member of a target's board of director, is the primary principle on which board member's decisions about a takeover offer should be made. Fiduciary responsibility encompasses both the duty of "loyalty" and duty of "care". The duty of "loyalty" mandates that directors act in the best interest of shareholders rather than themselves. The duty of "care" requires directors to act in good faith and to use the same level of care that a "prudent person" would use in similar circumstances.

Generally, directors' actions are judged using the "business judgement rule", which presumes directors have conformed with their fiduciary responsibility. However, in circumstances such as hostile takeovers, courts subject directors' behavior to enhanced scrutiny, particularly when actions are taken to entrench the existing board or management.

Unique Elements of REIT Takeovers

The REIT industry adds two unique elements to be considered with respect to a takeover:

- Excess share provision.
- UPREIT structure.

Excess Share Provision

The excess share provision is the most common anti-takeover device utilized by REITs.

Typically, this provision is included in the REIT's articles of incorporation and restricts any shareholder from accumulating more than approximately 9.8% of the REIT's outstanding shares.

It further provides that if this limit is exceeded, the shares held in excess of the limit would have their voting rights and dividend suspended until they are transferred to another owner.

While this provision is normally justified on the basis of protecting the REIT's tax status by avoiding a violation of the "5/50 Rule", most versions of this provision act more as anti-takeover devices by ignoring the "look through" mechanism of that rule.³¹ As a result, a hostile acquirer would have two options:

³¹ The "5/50 rule" is one of the requirements for REIT tax status set forth in the IRS Tax Code, Section 856(a). The rule prohibits five or fewer individuals from owning more than 50 percent of the shares of a REIT during the last half of the REIT's tax year. The "look through" mechanism provided in Section 544(a)(1) of the Code states that

- Seek to nullify this provision as a condition of its tender offer.
- Pursue legal channels to test the defensibility of the provision to block a transaction that does not threaten a REIT's tax status.

UPREIT Structure

The advent of the UPREIT structure has helped propel much of the growth in the REIT industry during the 1990's. The success of the UPREIT structure is primarily attributable to its enabling property owners to contribute their assets to the entity on a tax-deferred basis through the use of operating partnership (OP) units.³² While often subject to some restrictions, these OP units provide liquidity to the contributing property owners in so far as they are redeemable for stock in the REIT or cash at the REIT's discretion.

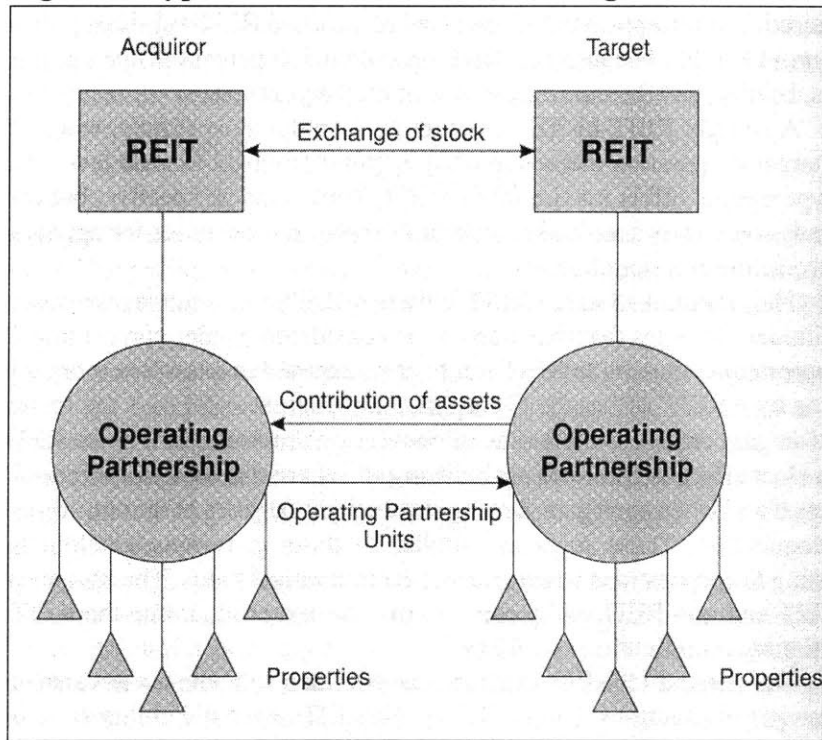
Figure 1 presents a diagram of a typical UPREIT to UPREIT merger. When considering a merger or takeover of an UPREIT, special attention must be paid to the rights and treatment of OP unitholders. Under the circumstances listed below, OP unitholders could face a significant tax burden as a result of an improperly structured takeover deal:

- Dissolution of the operating partnership.
- Repayment of operating partnership debt.
- Sale of operating partnership assets.

“Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionally by its shareholders, partners or beneficiaries.”

³² Garrigan, Richard T., & John F.C. Parsons, Real Estate Investment Trusts: Structure, Analysis, and Strategy, 1998 pg. 53-59

Figure 1: Typical UPREIT to UPREIT Merger



Source: Real Estate Investment Trusts: Structure, Analysis, and Strategy, 1998

Because of this risk of triggering a taxable event, the original partnership agreement may grant OP unitholders additional rights such as the right to approve merger transactions. There is also notable potential for conflicts of interest to emerge between REIT shareholders and OP unitholders in these merger transactions. An example of a potential conflict could include a proposed stock swap. While a stock swap may be attractive to the REIT shareholder because it could be used to defer a taxable gain, an exchange of stock for OP units would almost certainly result in an immediate taxable event for the OP unitholders.

Standard Preventative Anti-Takeover Measures

Many of the nation's large corporations have adopted preventative anti-takeover measures to ward off unfriendly takeover attempts. Below is a brief discussion of the three most commonly used anti-takeover provisions and their essential elements.

Share Rights Plan (a.k.a. The Poison Pill)

A share rights plan, popularly known as the "poison pill", is the anti-takeover defense of choice for hundreds of American companies. Like the "excess shares provision", a share rights plan seeks to deter an unfriendly takeover, but it is likely to be more effective for two important reasons:

- It holds out the threat of permanent dilution of the acquirer's shares.
- It is less vulnerable to legal challenges since they have already been upheld as a means to deter non-coercive bids.

Share rights plans can be generally classified into two types: flip-over plans and flip-in plans.

Each of these categories of share rights plans is discussed below.

Flip-Over Provisions

Under a flip-over provision, a target REIT issues call options to its shareholders, in the form of "rights", which allow these "rights" owners to purchase a certain amount of stock in the surviving entity at a substantial discount once a one hundred percent takeover of the target is completed. These "rights" are distributed to target shareholders once a "triggering event" has occurred. Typically, a "triggering event" would include:

- Acquisition of twenty percent of the target’s outstanding stock.
- Issuance of a tender offer seeking thirty percent or more of the target’s outstanding shares.

Like other financial obligations of the target, an acquirer assumes responsibility for these “rights” once it owns one hundred percent of the target’s outstanding shares. The major drawback of a flip-out rights plan is that the “rights” are only redeemable once the acquirer owns one hundred percent of the outstanding shares. This limitation prevents this provision from effectively blocking a takeover that seeks only a controlling interest and not outright full ownership.

Flip-In Provisions

In contrast to “flip-out” provisions discussed above, a “flip-in” provision is used against an acquirer seeking to gain control of the REIT with less than one hundred percent ownership. Because the acquirer only seeks control and not total ownership, “flip-in” provisions are designed to dilute the target’s shares, once a “triggering event” has occurred, irrespective of whether the acquirer ever actually merges with the target. “Triggering events” for a “flip-in” rights plan are typically the same as those discussed above for a “flip-out” provision. The “rights” issued under a “flip in” provision, however, are distinct in two important ways: (1) they grant the right to purchase a certain number of target shares rather than acquirer shares, and (2) they can be redeemed immediately rather than being conditioned on the completion of a one hundred percent takeover.

Corporate Charter Amendments

Another avenue to institute preventative takeover provisions is by making changes to a corporation's charter. The most common anti-takeover changes are identified and explained below.

Staggered Terms for Board Members

A staggered term amendment generally provides for one-third of the board to be elected in a given year and for each member to serve a three-year term. By adopting a staggered term amendment for its board members, a firm can delay an unwanted acquirer from gaining control of the board over the short run. While this delay may not deter a potential acquirer, it should at least improve the bargaining position of the incumbent board or management.

Supermajority Amendment

A supermajority amendment dictates that a higher than majority approval of shareholders, often ranging from sixty-six percent to ninety-five percent, must be achieved in order to undertake certain prescribed activities. These activities can include a merger, liquidation, and other transactions that can have significant effect on shareholder value. This amendment is often used in conjunction with other anti-takeover provisions and can effectively preclude a hostile acquirer from erasing the other anti-takeover measures with a simple majority of shareholder votes.

Fair Price Provision

A “fair price” provision in the charter of a corporation requires an acquirer to pay minority shareholders at least a fair price for the company’s stock. Typically, a formula to calculate the “fair price” is set forth in the provision and often is tied to a historical price/earnings ratio. Alternately, the provision may simply call for an acquirer to pay all of the target’s shareholders at least the maximum price paid for any target shares the acquirer purchased.

Fair price provisions are most effective in combating two-tiered tender offers, which try to prompt a quick response from shareholders by offering a higher price for the first fifty-one percent of shares.

Dual Capitalization

Under dual capitalization, a corporation’s equity is restructured into two separate share classes with different voting rights. Shares with superior voting rights often have ten to one hundred times more votes than regular shares and are generally held by management or other insiders. By concentrating voting rights into the hand of management, yet another obstacle is created to discourage an unfriendly suitor and improve management’s bargaining power.

Golden Parachutes

A final anti-takeover measure used to thwart an unfriendly change of control is the adoption of special compensation agreements, known as golden parachutes, for key management personnel. Under such agreements, lucrative cash payments are promised to these key employees if they

voluntarily leave the company or are fired within one year of a change of control. The aim of this strategy is to create a potentially large cash liability for a hostile acquirer. Like other anti-takeover provisions discussed above, golden parachutes are designed to be an additional obstacle to an unfriendly takeover and provide management with additional leverage in its negotiations with a potential acquirer.

The foregoing is presented merely as a general discussion of some of the legal and tax issues inherent in REIT mergers. It is not intended to be a complete list of such issues and should not be considered as such. Having addressed the theoretical factors and issues behind merger activity, Chapter Four will examine selected mergers to test the validity of the theory presented.

Chapter Four: Analysis of Recent Office REIT Merger Activity

Reviewing data for the years 1995-1997 shows limited REIT-to-REIT merger activity in the office sector. While publicly traded apartment and retail REITs were merging with regular frequency during this period, public office REIT merger activity was limited primarily to two major acquirers, Highwoods Properties, and Equity Office Properties. This chapter will summarize three selected public-to-public REIT mergers in the office sector. These examples were selected based on their size, the arms-length nature of the merger or acquisition, and the publicly-traded nature of the stock. Included with the summary and description of the merger will be a brief analysis using the financial and strategic factors outlined Chapter Two.

Highwoods Properties Acquisition of Crocker Realty Trust

Company Background

Just prior to the merger announcement in April 1996, Highwoods Properties, Inc. (Highwoods) had a total market capitalization of \$881 million. At its April 8 share price of \$29.13, Highwoods was trading at an AFFO multiple of approximately 13.5 times expected 1996 AFFO. Analysts expectations at the time for the growth in AFFO per share between 1996 and 1997 was 11.5%. Prior to the merger, Highwoods owned ninety six suburban office buildings and 103 industrial and service center buildings totaling approximately 10.2 million square feet, primarily located in North Carolina, Virginia, and Tennessee.³³

³³ PR Newswire, Financial News. Source: LEXIS®-NEXIS® Academic Universe

Crocker Realty Trust, Inc. (Crocker) was formed in July 1995 with the merger of Crocker Realty Investors and Southeast Realty Corp., an affiliate of Apollo Real Estate Investment Fund, L.P. In December 1995, Crocker sold 8.8 million shares to AEW Partners, L.P. The Crocker portfolio consisted of seventy suburban office properties totaling approximately 5.7 million square feet located in sixteen southeastern markets.³⁴ At the time of the transaction announcement, Crocker was controlled by Apollo, AEW, and Crocker management, and was not broadly covered by analysts. Based on Crocker's share price of \$10 just prior to the announcement, the company had an equity capitalization of approximately \$270 million and a total capitalization of approximately \$510 million. Values for AFFO and growth in AFFO per share were unavailable.

The Merger

In September 1996, Highwoods Properties acquired the office portfolio of Crocker Realty Trust for approximately \$300 million in cash and assumption of approximately \$240 million in debt. At the time, the Crocker portfolio was the largest office portfolio in the Southeast owned by a public company. The merger added seventy suburban office buildings totaling 5.7 million square feet in sixteen Southeast markets to the Highwoods portfolio. This addition increased Highwoods' portfolio by fifty-six percent to 15.9 million square feet, making Highwoods a dominant suburban office owner in the Southeast.³⁵ Although financed initially using a \$250 million unsecured credit line from NationsBank and a \$100 million bridge loan led by NationsBank and co-agented by First Union, Highwoods ultimately issued equity to pay down its

³⁴ Ibid.

³⁵ JP Morgan Industry Update, Real Estate M&A, Part I, May 26, 1998

unsecured credit sources used to finance this and other acquisitions.³⁶ This financial flexibility allowed Highwoods to initiate and proceed with advantageous acquisitions, even when the equity markets were not favorable.

Factors Influencing the Merger

According to the Highwoods press release detailing the transaction, the factors influencing the transaction included growth in market capitalization and FFO, economies of scale, increased growth in new markets, and market dominance in the Southeast. The acquisition made Highwoods one of the largest public equity REITs at that time with a total market capitalization of \$1.5 billion. Management also expected the acquisition to provide economies of scale from operating synergies of over \$6 million per year, helping to increase expected FFO per share by twelve percent in 1996 and fifteen percent in 1997 over analysts' original estimates.³⁷ Although the annual cost savings from operating synergies were expected to boost the AFFO multiple, this should have been a one-time effect occurring in the year of closing, reflecting the net present value (NPV) of these savings. Finally, the acquisition increased Highwoods' presence in its existing markets and provided a platform for growth opportunities in several new markets.

According to Ronald P. Gibson, President and CEO of Highwoods,

"The acquisition of Crocker will create long-term benefits for our shareholders and represents an extension of our growth strategy in the Southeast. The transaction expands Highwoods' presence in 11 growing southeastern cities. The integration of these new markets along with the existing local market expertise will place our company in a unique position to take advantage of excellent growth opportunities throughout the Southeast. We expect the transaction to generate operating synergies in excess of \$6 million and that it will be accretive to 1996 and 1997 FFO and cash available for distribution ("CAD")."

³⁶ Real Estate Finance & Investment, Vol. II, No. 19, Pg. 5. Source: LEXIS®-NEXIS® Academic Universe

³⁷ PR Newswire, Financial News. Source: LEXIS®-NEXIS® Academic Universe

Although the acquisition did appear to provide Highwoods substantial market diversification and portfolio growth, its actual FFO growth was less than expected for the entire year due to the costs of closing and integrating the Crocker portfolio, and severe weather in some of its markets.

According to a Highwoods press release concerning 1996 financial performance, FFO per share for the year ended December, 1996 grew nine percent over the previous year. For the last quarter of 1996, however, FFO per share grew eighteen percent over FFO per share reported for the last quarter of 1995. Since the Crocker acquisition closed just prior to the last quarter of 1996, the favorable fourth quarter 1996 performance figures for Highwoods included the income generated by the Crocker portfolio, and gave a better indication of the accretive nature of the acquisition. According to financial data supplied by Bloomberg, Highwoods' actual growth in annual FFO per share grew 18.7% between the end of 1996 and 1997, continuing the trend seen in the last quarter of 1996, and exceeding the 14.95% annual growth in FFO per share reported between 1995 and 1996.

Given the previous ownership position in Crocker of opportunistic investors Apollo and AEW, it appears the transaction was friendly and not opposed by Crocker's Board of Directors or management. Unlike some of Highwoods' later acquisitions, the senior management of Crocker did not take new positions with Highwoods. According to published reports, a residual Crocker entity retained ownership of 243 acres of developable land with a book value of approximately \$0.60 per share. Combined with the ten percent premium over market value paid for the outstanding Crocker shares, Crocker shareholders should have realized substantial gain from their relatively short-term investment from the July 1995 IPO to the September 1996 merger.

This information leads us to believe that the Crocker portfolio was sold willingly and in simple anticipation of a substantial short-term profit.

Equity Office Properties Acquisition of Beacon Properties

In one of the largest and most spectacular mergers to date in the REIT industry, Equity Office Properties Trust (“EOP”) acquired Beacon Properties Corporation (“Beacon”) in December 1997 in a deal valued at approximately \$4.3 billion. At EOP's share price on the closing date of the merger, the deal represented a twenty percent premium over Beacon's market price prior to the announcement.³⁸

Company Background

EOP was created in July 1997 when Samuel Zell took four Zell Merrill Lynch Opportunities portfolios public in an IPO. Almost immediately, the REIT used its access to public capital to grow through the acquisition of several large portfolios. By the end of 1997, EOP had made a total of eleven acquisition transactions totaling over \$6.4 billion in assets, 33 million square feet, in 167 properties. This acquisition activity made EOP the largest equity office REIT at the end of 1997 with 258 office properties containing approximately 65.3 million leasable square feet of office space.³⁹ As of May 29, 1998, the portfolio had increased to 272 buildings encompassing 71.6 million square feet in 24 states, the District of Columbia, 39 Metropolitan Statistical Areas, and 80 sub-markets.⁴⁰ At approximately the same period, Merrill Lynch estimated EOP's NAV at

³⁸ Equity Office Properties 1997 Form 10-K.

³⁹ Ibid.

⁴⁰ Equity Office Properties web page, URL: www.equityoffice.com

approximately \$7.45 billion, its equity capitalization at approximately \$7.9 billion, and its total market capitalization at approximately \$12.1 billion.⁴¹

Just prior to the merger announcement on September 15, 1997, EOP had a total market capitalization of \$7.1 billion and an equity capitalization of \$5.5 billion. At its September 12 share price of \$33.44, EOP was trading at an AFFO multiple of approximately 22.8 times expected 1997 AFFO. Analysts expectations at the time for the growth in AFFO per share between 1997 and 1998 was 11.6%.⁴²

CEO Alan Leventhal took Beacon Properties public in May 1994 at an initial offering price of \$17 per share. Previously a successful private developer and investor, Beacon owned some of Boston's premier office buildings in addition to holdings in Atlanta, Washington, Chicago, Los Angeles, and San Francisco. Prior to the merger announcement, Beacon was one of EOP's primary competitors for tenants as well as acquisitions.

As of September 12, 1997, Beacon had a total market capitalization of \$3.3 billion and an equity capitalization of \$2.3 billion. At its share price of \$36.63, Beacon was trading at an AFFO multiple of approximately 16 times expected 1997 AFFO. Analysts expectations at the time for the growth in AFFO per share between 1997 and 1998 was 13.5%.⁴³

⁴¹ Merrill Lynch Comparative Valuation REIT Weekly, June 5, 1998.

⁴² Merrill Lynch Comparative Valuation REIT Weekly, 12 September, 1997.

⁴³ Merrill Lynch Comparative Valuation REIT Weekly, 12 September, 1997.

Factors Influencing the Merger

The Beacon acquisition followed EOP's stated strategy of pursuing both internal and external growth in cash flow and growth in portfolio value through acquisitions and resulting economies of scale in major office markets.⁴⁴ This merger of two strong REITs also signaled a move toward more M&A activity at the public-to-public level. As EOP became increasingly large through its previous acquisitions of single properties and private portfolios, it was forced to target public real estate companies like Beacon in order to continue its strategy of seeking economies of scale through acquisitions. Other less-publicized factors driving this particular merger were the desire by EOP to eliminate a major competitor for acquisitions, and the attempt to gain market power by increasing its ownership in markets with high barriers to entry such as Boston. EOP expected the acquisition to provide cost savings of \$15 million to \$20 million in the first year of operations from closing overlapping administrative offices, as well as increased leverage in negotiating rental rates and service contracts.⁴⁵

Crescent/Reckson Joint Venture Acquisition of Tower Realty

Company Background

Crescent Real Estate Equities Co. (Crescent) was taken public in May 1994 at an initial offering price of \$25 per share. Controlled by investor Richard Rainwater, the diversified REIT has office, retail, hotel, and residential properties primarily in Texas and Colorado. As of the first week of July 1998, the time of the merger announcement, Crescent had a total market

⁴⁴ Equity Office Properties web page, URL: www.equityoffice.com

⁴⁵ Equity Office Properties press release

capitalization of \$6.6 billion and an equity capitalization of \$4.7 billion. At its share price of \$34.19, Crescent was trading at an AFFO multiple of approximately 14.6 times expected 1998 AFFO. Furthermore, analysts' expectations at the time for the growth in AFFO per share between 1998 and 1999 were twenty two percent.⁴⁶

Reckson Associates Realty Corp. (Reckson) came public in June 1995 at a share price of \$24.25. The REIT is highly focused geographically, concentrating primarily on suburban office and industrial properties within a 50-mile radius of New York City. As of July 1998, Reckson had a total market capitalization of \$1.9 billion and an equity capitalization of \$1.4 billion. At its share price of \$24.75, Reckson was trading at an AFFO multiple of approximately 14.9 times expected 1998 AFFO. At the same time, analysts' expectations for the growth in AFFO per share between 1998 and 1999 were thirteen percent for Reckson.

Tower Realty Trust, Inc. (Tower) is a fully integrated REIT that concentrates on acquiring and adding value to distressed office buildings in Manhattan, Phoenix, and Orlando. The trust owns interests in more than twenty-five properties totaling over four million square feet. The company also controls fifty acres of land capable of supporting up to 2.2 million square feet of additional development. As of July 2, 1998, Tower had a total market capitalization of \$722 million and an equity capitalization of \$415 million. At its share price of \$22.38, Tower was trading at an AFFO multiple of approximately 11.8 times expected 1998 AFFO. Analysts' expectations for the growth in AFFO per share between 1998 and 1999 were nine percent.

⁴⁶ Merrill Lynch Comparative Valuation REIT Weekly, 2 July, 1998.

The Merger

On July 9, 1998, a joint venture between Crescent and Reckson agreed to acquire Tower for \$445 million in cash and stock and the assumption of \$289 million in debt. The new joint venture, Metropolitan Partners (“Metropolitan”), was created to invest in Manhattan real estate, and plans to retain the Manhattan properties while selling off the remaining properties. Crescent has the right to buy the discarded properties for a fixed price for a certain period of time, enabling Crescent to add to its own portfolio as well as that of Metropolitan's. The joint venture, totally controlled by Crescent and Reckson, represents a different form of acquisition by REITs. Using this method, Tower shareholders can be paid all in cash, or partially with an equity interest in both Crescent and Reckson.

The closing of the merger is expected in late 1998, and is subject to Tower shareholder approval. Although the \$24.00 per share offer price is below the \$26.00 per share paid by shareholders in Tower's October 1997 IPO, the rather unique deal allows Tower shareholders to trade up to forty percent of their shares for interests in the more proven and successful Crescent and Reckson. Tower shareholders will have the option to receive .4615 share of Reckson stock and .3523 share of Crescent stock for each Tower share instead of the \$24 cash price. Tower shareholders can elect this form of payment for up to forty percent of the total consideration paid by the joint venture. The deal also offers a slight premium over the current share price and stems a constant decline in share price since Tower's initial public offering. Tower's total return for 1997 was a negative ten percent (primarily due to its drop in share price from \$26 to \$24.63 over the last three months of 1997), while the office REIT sector average total return was twenty-nine percent

for the same period.⁴⁷ It is possible that other suitors may at least attempt to make a tender offer at a more favorable price for shareholders. The probability of this occurrence lies in the terms of the merger agreement and the presence of a rights plan or an excess share provision in the REIT's bylaws. These issues are further discussed in Chapter Three.

Factors Influencing the Merger

Factors that may have influenced Tower in the decision to merge were enhanced access to public capital, improved ability to compete for assets, increased financial flexibility, and improved management. All these benefits will accrue to existing shareholders that retain an equity interest in the new ownership. Reorientation of the business strategy and alleviation of public disclosure demands were probably of less significance in this merger. Lester S. Garfinkel, CFO for Tower, summarized the benefits to the Tower shareholders as follows.

"We believe this transaction provides an excellent value to Tower Realty Trust shareholders and the opportunity to participate in the growth of two prominent REITs. The priority of the Board of Directors and management has been to position Tower Realty to build the long term value of its portfolio and, in turn, its return to shareholders. The merger is consistent with this priority. Tower's real estate properties will now become part of an enterprise which will have far greater resources. This transaction provides Tower shareholders with the opportunity to receive a cash payment which is higher than Tower's 1998 stock price range or, if they choose, the ability to receive an ongoing equity interest in Crescent and Reckson."

For Crescent and Reckson, the factors included an ability to diversify geographically by acquiring strategic assets in Manhattan at an attractive price relative to the underlying value of the assets. The pair also plan to use the acquisition as a platform for growth through other

⁴⁷ NAREIT

acquisitions in the Manhattan market. Since analysts see the acquisition as favorable to both acquirers, the merger should also reduce their cost of equity through increased earnings per share. Crescent's decision to joint venture the acquisition with Reckson instead of acquiring Tower outright was not publicly revealed, however Reckson's proximity to and familiarity with the Manhattan market compared with Crescent's Texas home base, probably influenced the decision to joint venture with a "local".

As discussed in Chapter Two, concerns over integration of the assets are not eliminated by the unique joint venture ownership structure. In fact, since the entity will be controlled by two potentially competing REIT parents, integration of the operating assets must be well planned and executed. Since neither parent has a dominant presence in the Manhattan market, the choice of a management team for the new entity presents not only opportunities for strategic alliances, but also a potential for conflict with future acquisition targets of the new entity.

Observations and Comments

These three merger examples illustrate both financial and strategic factors influencing M&A activity in the office REIT sector. Although all appear to be driven by the financial benefits that continued growth brings, the mergers also seem to satisfy some longer term desires of the participants, including continued execution of the REIT's strategic vision, geographic diversification, and establishing a platform for further growth. The desire to achieve significant value from economies of scale was a large factor in both the Highwoods-Crocker, and Equity-Beacon mergers, but almost nonexistent in the Crescent/Reckson-Tower merger. Unique factors

to the Equity-Beacon merger included the elimination of an acquisitive competitor and an attempt to establish market power rents.

Chapter Five: A Framework for Identifying Acquirers & Targets

In this chapter, we seek to accomplish two goals. First, we will establish a framework for identifying potential acquirers and targets. Second, we will demonstrate the framework within the context of the current Office/Industrial sector of the REIT industry. To accomplish these goals we will undertake the following three-step integrated analysis: (1) determine financial characteristics that are common among the “acquirer” and “target” REITs, (2) examine the current field of office/industrial REITs for M&A candidates with these financial characteristics, and (3) consider the strategic factors influencing acquirers and targets, identified in earlier chapters, to pose hypothetical mergers between the M&A candidates identified above.

Financial Characteristics

Potential acquirers and targets in the REIT industry bear a number of distinct financial characteristics. Many of these REIT characteristics derive from traditional merger and acquisition theory, while others are unique to the REIT industry. Throughout this section, we will refer to both finance theory and to actual financial data from the three office REIT mergers, examined in the previous chapter, to test the financial characteristics being discussed.

Adjusted Funds From Operations (AFFO) Multiple

A REIT’s adjusted FFO multiple (AFFO) is similar to the price/earnings ratio used to measure financial performance in other industries and is a strong indicator of whether the REIT may be an acquirer or target. Finance theory holds that a firm with a price/earnings ratio that is below the

average of its competitors is likely to be considered a target.⁴⁸ A relatively low AFFO multiple infers that investors are using a higher capitalization rate to price the stock because the REIT's prospects for growth ($g_i + \Delta g_e$) are lower than its competitors or that the expected rate of return (r) is higher because it is inherently riskier (see the discussion of capitalization rate in the Chapter Two). Conversely, a firm with a higher than average price/earnings multiple may be a possible acquirer for just the opposite reasons presented above.⁴⁹

Table 3 presents a summary of the AFFO multiples for the three recent mergers studied and the average for the sector just prior to the time of the merger announcement. In each case, the acquiring REIT's AFFO multiple was higher than the sector average. However, the results are mixed for the target REITs with one target having a higher than average AFFO multiple and the other target having a lower than average AFFO multiple.

Table: 3
AFFO Multiples for Recent Office REIT Mergers as of Announcement Date

REIT	AFFO Multiple	Sector Average AFFO Multiple at Announcement
As of September 1997		
Equity Office Properties	22.75	14.7
Beacon Properties	16.07	
As of April 1996		
Highwoods Properties	13.50	10.7
Crocker Realty	N/A	
As of July 1998		
Crescent Real Estate	14.61	13.4
Reckson Associates	14.91	
Tower Realty	11.78	

⁴⁸ Gaughan, Patrick A, Mergers, Acquisitions, and Corporate Restructurings, 1996 pg. 501

⁴⁹ Schalop, Lee, "JP Morgan Industry Update: Real Estate M & A Part II", May 27,1998, pg.1

In Table 4 below, a partial list of REITs in the office/industrial sector and their respective AFFO multiples as of June 1998 is given. An examination of this data begins to expose firms that deviate from the sector average multiple of 13.40 and that could emerge, after additional analysis, as potential acquirers or targets.

Table 4: AFFO Multiples: Office Industrial Sector		
As of June 5, 1998		
OFFICE/INDUSTRIAL SECTOR	TICKER	AFFO Multiple
SECURITY CAPITAL INDUSTRIAL	SCN	15.80
SPIEKER PROPERTIES	SPK	15.40
BOSTON PROPERTIES	BXP	14.90
RECKSON ASSOC.	RA	14.80
EQUITY OFFICE PROPERTIES	EOP	14.30
CRESCENT REAL ESTATE	CEI	14.10
MACK-CALI REALTY	CLI	13.80
CENTERPOINT PROPERTIES	CNT	13.50
ARDEN REALTY	ARI	13.40
DUKE REALTY	DRE	13.20
WEEKS CORP.	WKS	13.20
KILROY REALTY CORP.	KRC	12.80
CARR/AMERICA REALTY	CRE	12.50
CORNERSTONE PROPERTIES	CPP	12.40
BRANDYWINE REALTY	BDN	12.00
HIGHWOODS PROPERTIES	HIW	11.90
TOWER REALTY	TOW	11.80
FIRST INDUSTRIAL	FR	11.50
LIBERTY PROPERTY TRUST	LRV	10.70
PRENTISS PROPERTIES	PP	10.40
SECTOR WEIGHTED AVERAGE		13.40
Source: Merrill Lynch Comparative Valuation REIT Weekly, June 5, 1998		

AFFO Growth

Within the context of our analysis, the AFFO growth measurement is the estimated growth in the REIT's AFFO in the next fiscal year. AFFO growth is useful in identifying potential acquirers or targets based on the following reasoning:

- Finance theory postulates that firms with high growth rates may be desirable targets for slower growing firms looking for growth opportunities.⁵⁰
- Firms with higher than average growth expectations may also become acquirers to satisfy investors, if internal growth opportunities are insufficient to meet expectations and capital is available.
- Firms that are “dead in the water” with low growth prospects and limited access to new capital may also become targets as a result of under-valued share prices.

To identify which of these arguments has the strongest impact on the REIT industry, we again turn to an examination of the three recent office sector mergers. Exhibit 1 displays three graphs on which the AFFO multiple and AFFO growth of the acquiring and target REITs are contrasted. The horizontal and vertical lines through these graphs (as well as forthcoming graphs) represent the sector's weighted average of the factor being considered.

These graphs show solid support for the argument that acquirers have both relatively high AFFO growth and high AFFO multiples. They reveal that three out of four acquiring REITs had high expected AFFO growth and high AFFO multiples relative to the sector's weighted averages. Only one acquiring REIT had low expected AFFO growth and a high AFFO multiple. On the

other hand, of the two targets for which we have data, both had low AFFO multiples, but the expectations about their AFFO growth was mixed. One target REIT had lower than average expected AFFO growth while the other had higher than average expected AFFO growth.

⁵⁰ Gaughan, Patrick A, Mergers, Acquisitions, and Corporate Restructurings, 1996 pg. 501

Exhibit 1: AFFO Multiple vs. AFFO Growth for Recent Office REIT Mergers

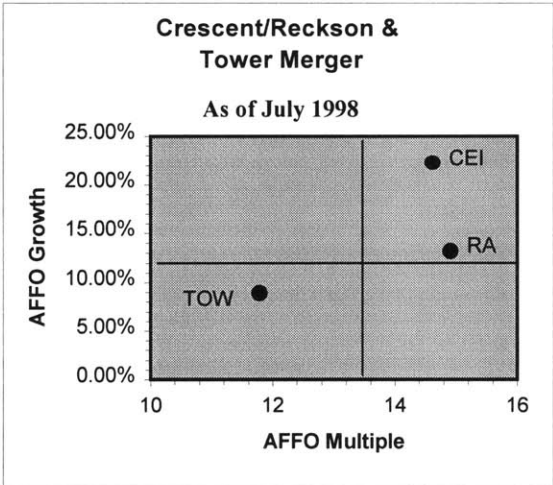
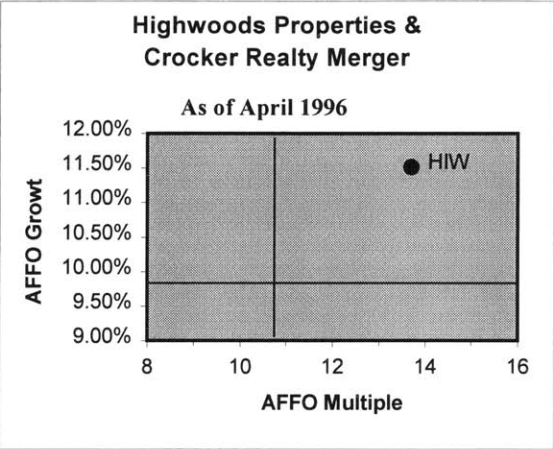
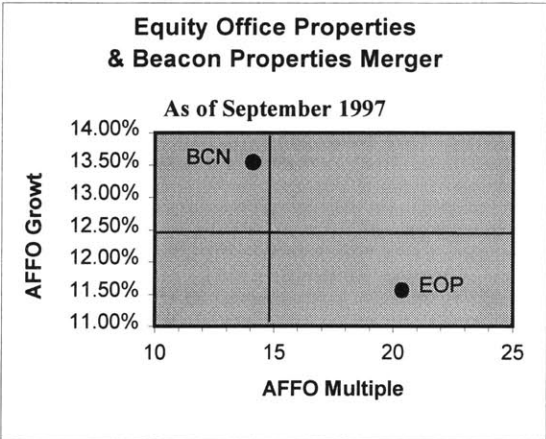
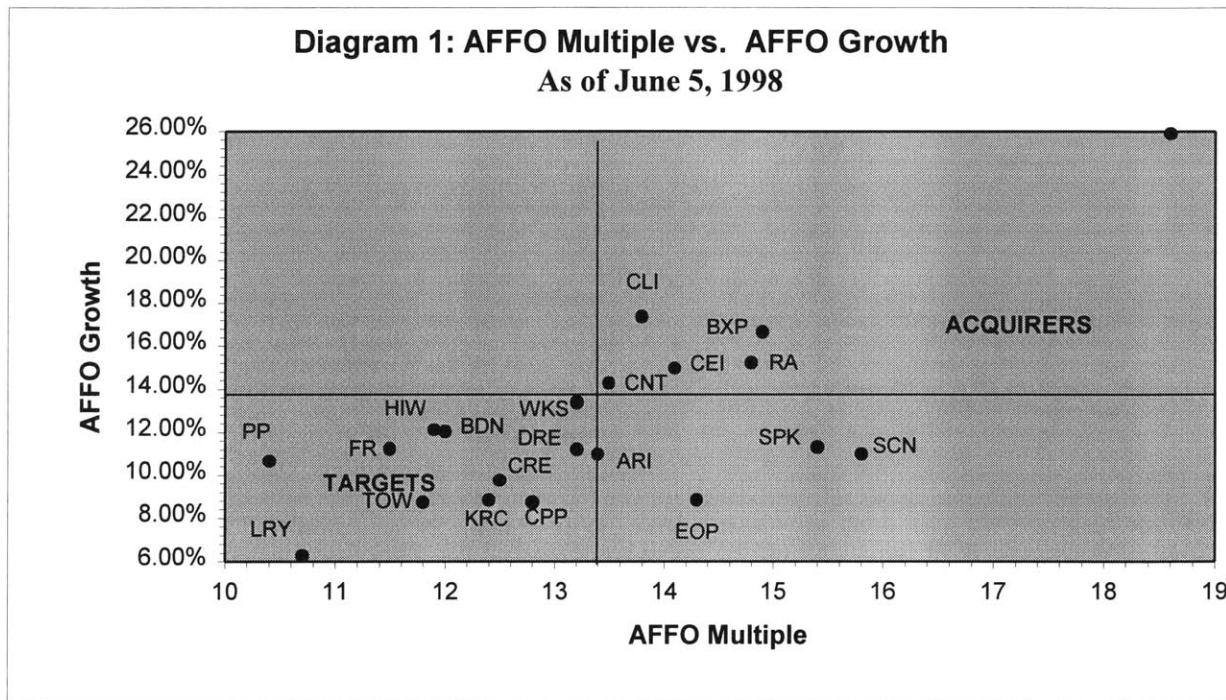


Diagram 1 graphs the estimated AFFO growth of the office/industrial REITs against their AFFO multiple. Drawing on the reasoning presented above, REITs with low AFFO multiples and low growth are considered potential targets. Conversely, REITs with high AFFO multiples and higher than average growth could be good candidates for being acquirers.



Total Market Capitalization

Empirical evidence also points to a REIT’s relative total market capitalization as yet another indicator of potential for being acquirers and targets. In a recent study by JP Morgan of REIT-to-REIT mergers between 1994 and 1997, eighty-two percent of acquirers had above average market capitalization and eighty-six percent of targets had below-average market capitalization.⁵¹

Examining the three REIT mergers we study in this report, three graphs are presented in Exhibit 2 , which compare the total market capitalization and AFFO multiple of the acquiring and target REITs. Our findings support those of the JP Morgan study in that we found three out of four of the acquiring REITs had both high AFFO multiples and higher than average total market capitalization. The remaining acquirer also had a high AFFO multiple, but its total market capitalization was slightly lower than sector's weighted average.

Once again, our findings about the targets we studied were inconclusive, with one target having higher than average total market capitalization and the other target having below average total market capitalization. However, despite this inconclusive evidence, we support the premise set forth in the JP Morgan study that it is more likely for a target to have below average total market capitalization.

⁵¹ Schalop, Lee, "JP Morgan Industry Update: Real Estate M & A Part II", May 27,1998, pg.1

Exhibit 2: AFFO Multiple vs. Total Mkt. Capitalization for Recent Office REIT Mergers

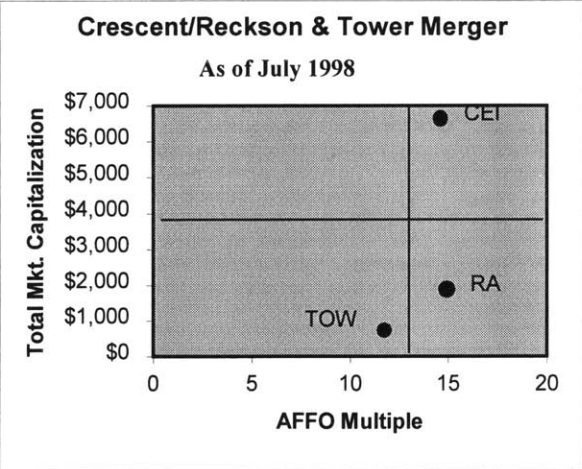
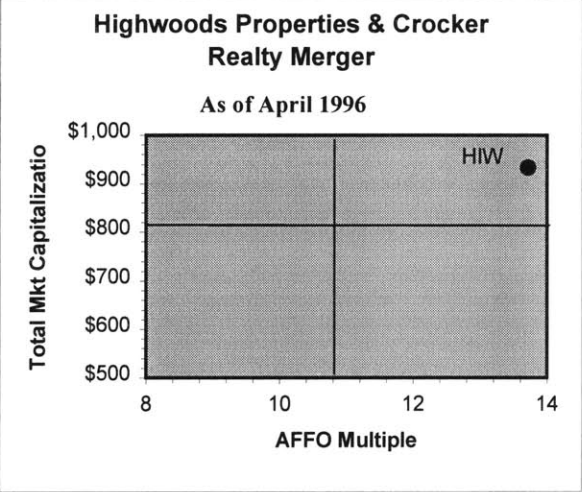
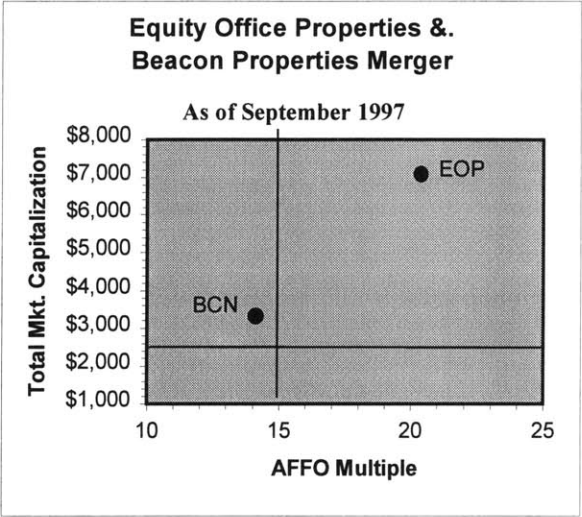
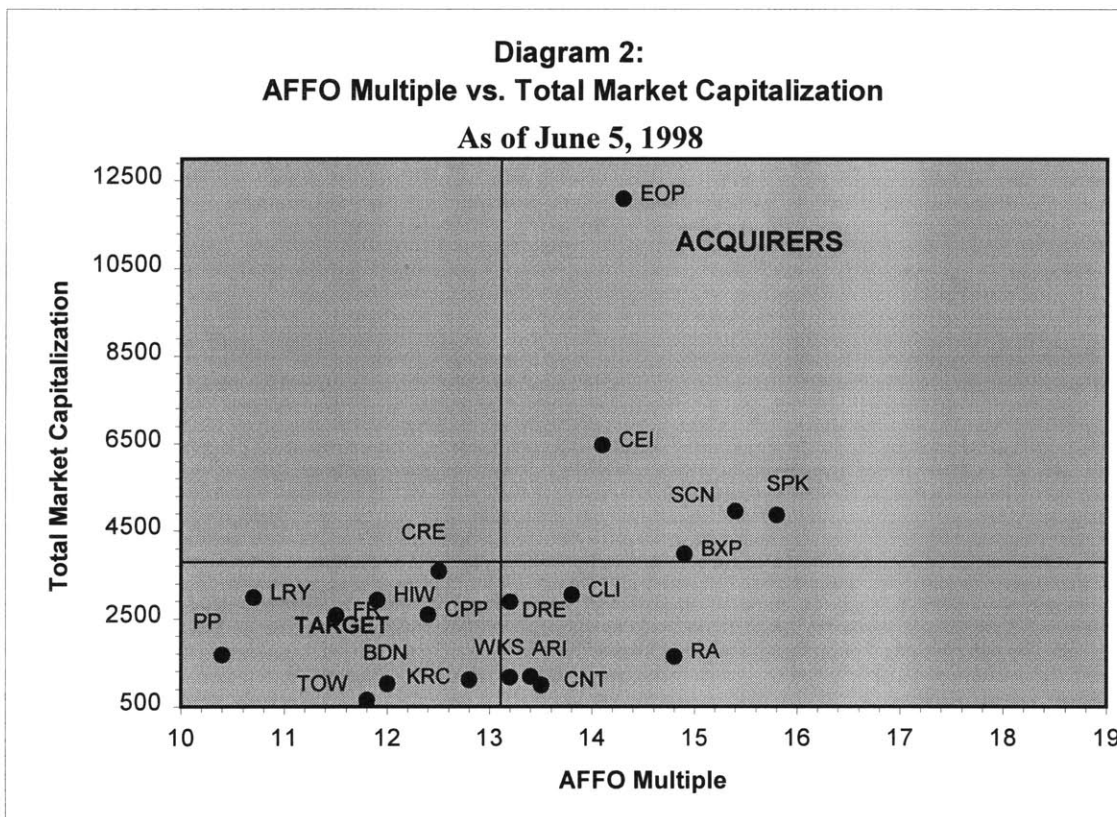


Diagram 2 displays a scatter-gram of the total market capitalization versus AFFO multiple for each of the office/industrial REITs we considered. Applying the theory presented above, in conjunction with earlier evidence on AFFO multiples, potential acquirers and targets can be identified. Acquirers are identified as having high AFFO multiples and high total market capitalization. Targets feature relatively low AFFO multiples and below-average total market capitalization.



Debt/Total Market Capitalization Ratio

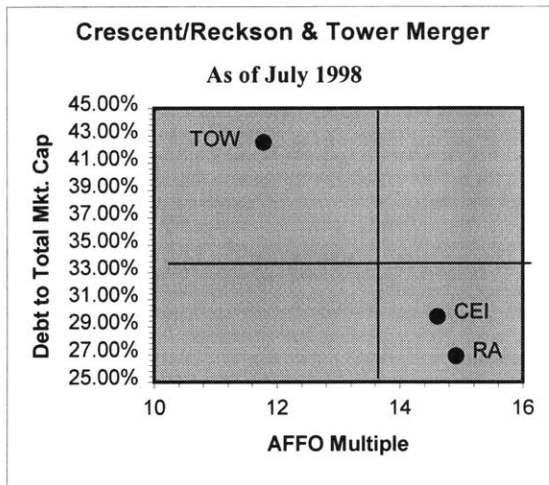
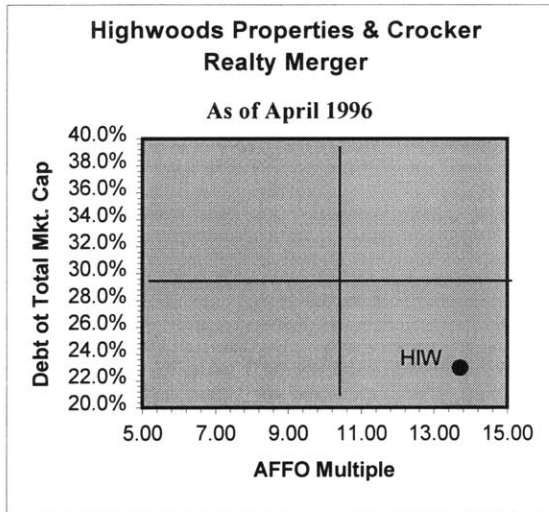
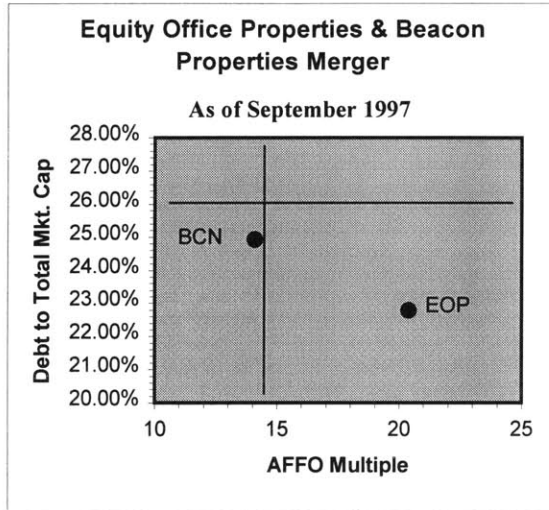
A REIT's debt to total market capitalization ratio gives an indication of not only its ability to grow but its relative risk as well.⁵² Along with other acquirer attributes such as a high AFFO multiple, acquirers generally have relatively low to moderate levels of debt since they require debt capacity or equity to undertake an acquisition or merger. Meanwhile, REITs possessing target characteristics, such as a low AFFO multiple, may attract unwanted suitors if they have either abnormally low or high debt levels. In the case of a REIT with low debt, it can become a target because it is seen as having a lower level of risk and its debt capacity can be used to finance the takeover.⁵³ On the other hand, abnormally high levels of debt may reflect a reduced ability to grow (at least temporarily) and could drive down a REIT's share price, leaving the REIT vulnerable to a takeover.

Exhibit 3 compares the debt to total market capitalization to the AFFO multiples for the three REIT mergers we examined. All four of the acquirers had below average debt to total market capitalization ratios as well as high AFFO multiples, confirming theory presented above about acquirers. With respect to targets, one had a below average debt ratio and the other had an above average debt ratio. These findings also fit the theory proposed above about targets' debt ratios.

⁵² Ross Steven A. et al, "Corporate Finance", 4th Edition, 1996, pg. 314-322

⁵³ Gaughan, Patrick A, "Mergers, Acquisitions, and Corporate Restructurings", 1996 pg. 501

**Exhibit 3:
AFFO Multiple vs. Debt to Total Mkt. Capitalization for Recent Office REIT Mergers**



Premium (Discount) to Net Asset Value (NAV)

The final financial characteristic to be considered for identifying potential acquirers and targets is the premium or discount to net asset value reflected in the REIT's current share price. If a share is priced at a premium to net asset value, investors are signaling that they place value on the REIT's management and its ability to recognize and capture growth opportunities ($g_i + \Delta g_e$). Alternately, if a REIT's share price trades at a discount to net asset value, it is signifying that investors only value the investment as a collection of assets without a defined growth strategy.

Again looking to the selected office REIT mergers we studied, Exhibit 4 shows two graphs depicting the premium (discount) to NAV and the AFFO multiples for the participants. All three of the acquirers for whom there was available data had share prices that reflected above average premiums to NAV and high AFFO multiples. As with the prior financial characteristics, these findings support the theory presented about acquirers.

Targets in the recent mergers studied also match the theory presented. Both of the targets' shares traded at premiums or discounts below the sector average and both had below average AFFO multiples.

**Exhibit 4:
AFFO Multiple vs. Premium (Discount) to NAV for Recent Office REIT Mergers**

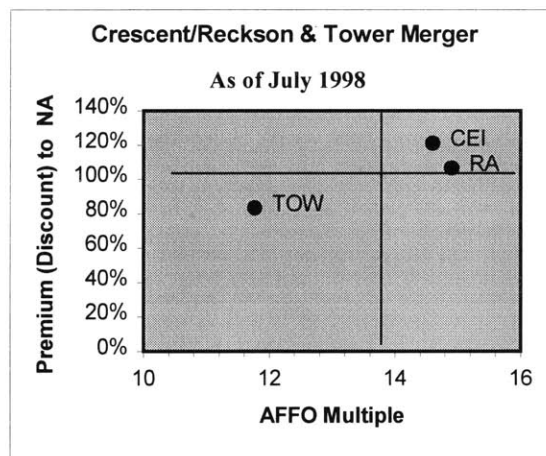
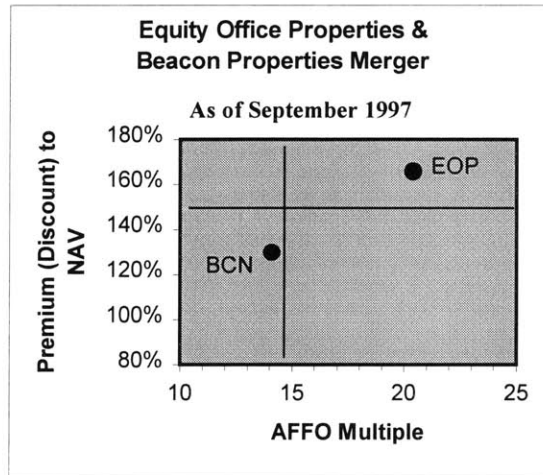
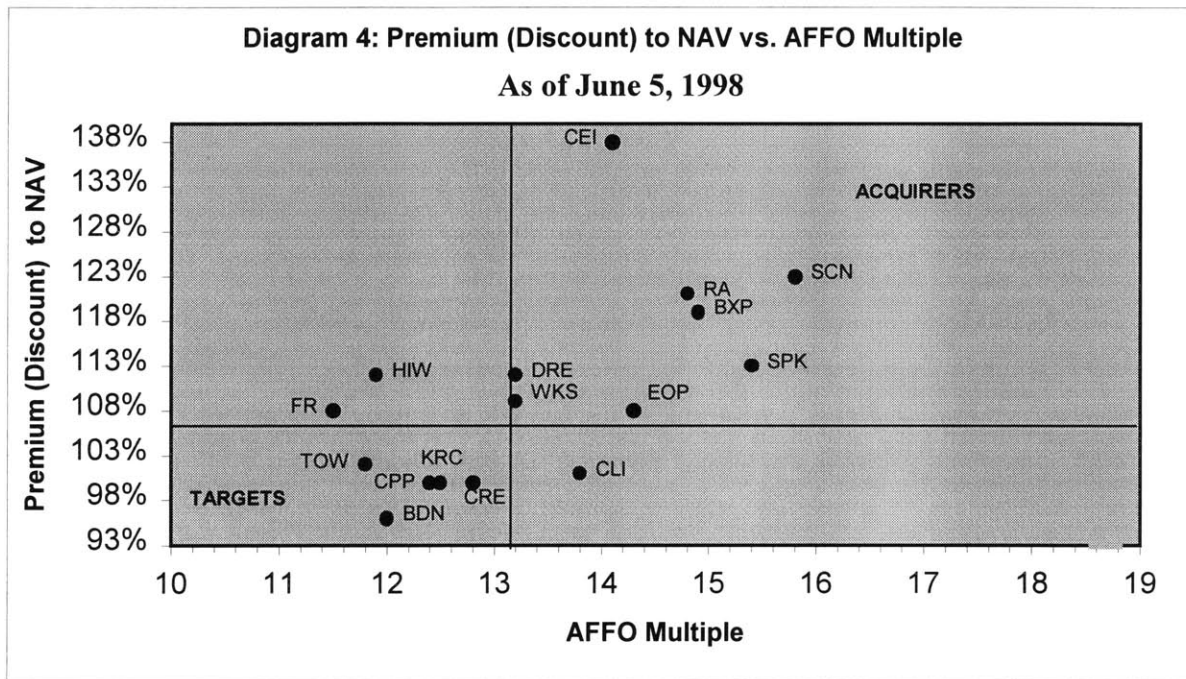


Diagram 3 displays a scatter-gram of the premium (discount) to net asset value versus AFFO multiple for each of the office/industrial REITs being examined. Acquirers are identified as having share price premiums to net asset value in excess of the sector's weighted average and high AFFO multiples. Targets are defined as having a share price discount to net asset value (or a premium below the sector's weighted average) and relatively low AFFO multiples.



Summary of Financial Characteristics of Acquirers and Target REITs

In Table 4 below, a summary of the financial characteristics of “acquirer” and “target” REITs are presented.

Table 4: Summary of Financial Characteristics of Acquirers REITs and Target REITs⁵⁴

Acquirers	Targets
Adjusted Funds from Operations (AFFO) Multiple above sector’s weighted average ⁵⁵	Adjusted Funds from Operations (AFFO) Multiple below sector’s weighted average
Expected AFFO Growth above sector’s weighted average	Expected AFFO Growth below sector’s weighted average
Total Market Capitalization above sector’s weighted average	Total Market Capitalization below sector’s weighted average
Debt/Total Market Capitalization Ratio below sector’s weighted average	Debt/Total Market Capitalization Ratio above sector’s weighted average
Share price reflects a premium to net asset value (NAV)	Share price reflects a discount to net asset value (NAV)

Using the information from Table 4 and the diagrams above, a list of potential acquirers and targets can be compiled for the REIT office/industrial sector. Table 6 presents a matrix containing a list of all the office/industrial REITs being studied and the acquirer or target characteristics they currently display. The table goes on to summarize the number of acquirer or target characteristics for each REIT, with the strongest candidates having a count of three or more in a particular category. Based purely on the financial analysis, Table 5 displays a list of potential acquirers and targets that can be identified.

⁵⁴ Goodman, Steven E., Peter H. Madden, “An Analysis of Mergers & Acquisitions Within the Apartment REIT Sector”, September 1995, MIT Center of Real Estate Thesis used as a partial source for financial characteristics.

⁵⁵ Mullaney, John A., REITs, 1998, pg. 241-2, $AFFO\ Yield = \frac{AFFO\ per\ share}{Share\ Price}$, $AFFO = Net\ Income + Depreciation - or + Gains\ or\ Losses\ from\ the\ sale\ of\ Property\ or\ Debt\ Restructuring + or- Adjustments\ to\ standardize.$

Table 5: Scores for Potential Acquirer & Target REITs From Table 6

Potential Acquirers		Potential Targets	
Boston Properties (BXP)	4	Brandywine (BDN)	4
Crescent (CEI)	4	Carr/America (CRE)	4
Equity Office Properties (EOP)	3	Cornerstone (CPP)	4
Reckson Associates (RA)	3	First Industrial Realty (FR)	3
Security Capital Industrial (SCN)	3	Highwoods Properties (HIW)	3
		Kilroy (KRC)	3
		Liberty Property Trust (LRY)	3

TABLE 6:							
Potential Acquirers & Targets		T = Target					
		A = Acquirer					
	TICKER	AFFO Growth vs.	Total Mkt. Cap. vs.	Debt/Total Mkt. Cap. vs.	Premium to NAV vs.	Target	Acquirer
OFFICE/INDUSTRIAL SECTOR		AFFO Multiple	AFFO Multiple	AFFO Multiple	AFFO Multiple	Characteristics	Characteristics
ARDEN REALTY	ARI			A			1
BOSTON PROPERTIES	BXP	A	A	A	A		4
BRANDYWINE REALTY	BDN	T	T	T	T	4	
CARR/AMERICA REALTY	CRE	T	T	T	T	4	
CENTERPOINT PROPERTIES	CNT			A			1
CORNERSTONE PROPERTIES	CPP	T	T	T	T	4	
CRESCENT REAL ESTATE	CEI	A	A	A	A		4
DUKE REALTY	DRE	T			A	1	1
EQUITY OFFICE PROPERTIES	EOP		A	A	A		3
FIRST INDUSTRIAL	FR	T	T	T		3	
HIGHWOODS PROPERTIES	HIW	T	T	T		3	
KILROY REALTY CORP.	KRC	T	T		T	3	
LIBERTY PROPERTY TRUST	LRY	T	T	T		3	
MACK-CALI REALTY	CLI	A					1
PRENTISS PROPERTIES	PP	T	T			2	
RECKSON ASSOC.	RA	A		A	A		3
SECURITY CAPITAL INDUSTRIAL	SCN		A	A	A		3
SPIEKER PROPERTIES	SPK		A		A		2
WEEKS CORP.	WKS						

Potential Future Merger Activity

Based on our identification of probable acquirers and targets from a financial perspective, the next logical step is to use the more subjective strategic factors driving each firm as a basis to pair potential merger candidates.

Horizontal Integration

The recent trend in horizontal integration through geographic diversification leads us to explore candidates with existing asset bases in different regions. Specifically, targets with a large concentration of product in a limited region will be particularly attractive to acquirers with a national scope who may not have a platform for growth in that region. These targets would include Brandywine Realty (“Brandywine”) with approximately eighty percent of its portfolio in Philadelphia, Highwoods Properties (“Highwoods”) with a broad-based portfolio in the Southeast, and Kilroy Realty (“Kilroy”) with the majority of its portfolio in Southern California. By looking at the portfolios of the potential acquirers outlined previously, the deficient geographic regions in their portfolios can be determined and matched with the existing portfolios of potential targets.

Other Strategic Considerations

Other strategic considerations would include the acquisition of development expertise to increase future growth, improved management from the acquiring firm, and the attempt to establish market power rents. Although often cited as driving forces and potential benefits of REIT mergers, these strategic factors will be considered as secondary to the goal of horizontal

integration. It is important to note that although a potential merger may look perfectly logical on paper, there are often unknown and less rational forces such as ego and family ties to the company that will act to preclude the possibility of any merger between two otherwise compatible REITs.

Crescent Real Estate Equities - Highwoods Properties

Based solely on the financial characteristics outlined in the previous section, Highwoods Properties appears to be a potential target candidate. Its adjusted FFO multiple and total market capitalization are both below peer averages and its debt to total cap ratio is above peer averages. The only financial factor that makes Highwoods an unattractive target is its higher-than-average premium to net asset value. However, as shown in the Equity Office-Beacon Properties merger, a high price to net asset value of a target is not of itself a sufficient barrier to acquisition.

Strategically, Highwoods' portfolio would make a welcome addition to a REIT portfolio in need of a Southeast U.S. presence. Possible acquirers might include Crescent or EOP. Both REITs are of sufficient size to be able to digest a relatively large REIT like Highwoods, and both have significant gaps in their portfolios in the Southeast. Given Crescent's previous experience in the Sunbelt, a Crescent-Highwoods merger might make more strategic sense. Crescent also targets portfolios that can provide significant internal growth from existing assets (a commonly stated REIT objective). Highwoods' acquisition of existing properties, in high growth areas, with significant potential for rent increases should be attractive to Crescent. Just as important to a potential acquirer is the development expertise provided by Highwoods. With forty-five projects

totaling 4.8 million square feet under development and over 2,300 acres of land for future development, Highwoods brings sufficient capacity for external growth to a potential merger.⁵⁶

However, the barriers to this potential merger could be substantial. First and foremost is Highwoods' critical mass of properties and current momentum in acquisitions. With a well-diversified asset base in the Southeast, considerable market power in select markets (Raleigh/Durham and Tampa), and significant growth coming from its development pipeline, Highwoods may not consider a merger at current share price levels advantageous to shareholders. Second, management at Highwoods is primarily real estate focused, while the Crescent management is more opportunistic, leading to a potential clash in corporate culture. Although a combined company may look attractive on a national basis, the barriers to such a merger are significant.

Reckson Associates - Brandywine Realty

A merger between Reckson and Brandywine Realty (Brandywine) would allow Reckson to expand its holdings in the Northeast and provide a platform for Reckson to grow outside the New York metro area. Although Brandywine's portfolio might also be attractive to Equity Office because of its ability to add to its Philadelphia portfolio, Equity's recent concentration on downtown properties may make this portfolio less attractive as an acquisition. Reckson, on the other hand, has significant experience in suburban markets, and its Long Island base may make a suburban Philadelphia portfolio more attractive based on proximity and economies of scale.

⁵⁶ Highwoods Properties web page

Since Reckson's stated growth objectives are largely opportunistic, Brandywine's current financial characteristics may also provide a logical basis for merger discussions. With Brandywine's current share price at a discount to net asset value, Reckson may find the portfolio attractive purely based on the value of the underlying assets. In addition, Brandywine's low market cap and relatively low debt level would make a potential acquisition more digestible for Reckson. However, its conservative capital structure may give Brandywine the longevity to avoid a forced merger.

Boston Properties - Kilroy Realty

Kilroy's concentration of assets in the Southern California area would be attractive to REITs with a national focus, but with a gap in their west coast portfolio. Of the potential acquirers mentioned in the last section, Boston Properties might benefit most from the acquisition of Kilroy's portfolio. With the recent purchase of the 3.5 million square foot Embarcadero Center in San Francisco, Boston Properties has signaled its intent to have a West Coast presence. The acquisition of Kilroy's holdings in San Diego, Los Angeles, and Seattle would boost Boston Properties' West Coast holdings significantly.

Other considerations include Kilroy's price discount to net asset value and its development based management team. Buying Kilroy's 3.6 million square foot office portfolio at a discount to net asset value would be attractive to Boston Properties on a purely from a financial basis. The shareholders of Kilroy might also consider the opportunity to trade their shares for a REIT with significant operational talent. Kilroy's roots as a developer may reveal a management team that is less focused on operations than on opportunities for future development.

Summary and Conclusions

This thesis examined a broad spectrum of financial and strategic factors that could influence potential acquirers and targets in their M&A decisions. Following a brief introduction to the REIT industry and overview of consolidation trends, a primer on M&A theory was presented, with particular note to factors unique to REITs. After presenting a summary of legal and tax issues governing REIT mergers, a framework for identifying potential M&A candidates was considered. The thesis concludes by applying this framework in conjunction with the strategic factors discussed earlier to propose several potential mergers among existing office REITs.

Based on the preceding analysis, it is clear that REITs use consolidation to pursue stated or unstated goals including: (1) lower the weighted average cost of capital, (2) achieve economies of scale and scope, and (3) and increase investor interest in the REIT. Financial markers of consolidation activity were observed to be AFFO multiple, total market capitalization, and price-to-net asset value. Using these financial characteristics as a screen to determine likely acquisition acquirers and targets, strategic motivations such as a desire for vertical and horizontal integration were then used to propose likely merger scenarios. Although three specific merger pairs were predicted, this is not intended to preclude the possibility of any number of other combinations among the list of potential acquirers and targets.

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