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Firms see REITs as right move

Managers look to launches as way to raise investment capital

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Dedicating: Ron Sturzenegger said companies seeking IPOs are putting their entire business in REITs.

Everybody wants to be a REIT.

Some real estate investment managers, finding that raising new investment capital is a tough and unrewarding slog, are considering launching a real estate investment trust to raise money.

Investment bankers say they are working furiously to prepare a number of REIT initial public offerings for real estate money managers.

REITs have been able to raise piles of cash in the public markets. According to the National Association of Real Estate Investment Trusts, REITs concluded \$23.6 billion in additional stock offerings — called secondary offerings — in 2010, the most since NAREIT began tracking them in 1992.

These days, most investor real estate capital is invested in commingled funds. According to the Pension Real Estate Association's 2010 investor survey, slightly more than 42% of U.S. institutional real estate portfolios were invested in commingled funds in 2009, up from 40% in 2008. During the same time period, direct real estate investment dropped three percentage points to 40%.

REITs have an easier time raising money than investment managers of private real estate because investors again are seeking liquidity, said Jahn Brodwin, senior managing director at New York-based real estate consultant FTI Schonbraun McCann Group.

"Investors may not always be happy with the price, but they can always get out of their investments," he said.

And it's taking longer than ever to raise money. Firms that closed funds in 2010 spent an average of 17.6 months in the market vs. 10 months in 2007, according to Preqin, a London-based alternative investment research firm.

Lower return

Since REITs are more liquid, investors expect a lower return than they do from less liquid funds and other types of private real estate investments, Mr. Brodwin said. “It all boils down that at this moment REITs have a lower cost of capital.”

Some managers are launching REITs in order to “continue to play in the game,” said Brad Case, NAREIT's chief economist.

“The cost of capital is even cheaper than it was in the mid-1990s,” when REITs went on their last buying spree, Mr. Brodwin said. This will lead to more REIT IPOs.

Investment managers that have good track records and solid core properties with good cash flow have a better shot at successfully launching REITs than they do raising a real estate fund, Mr. Brodwin said.

“There are roughly 12 IPOs on file right now or waiting to launch this week,” said Ron D. Sturzenegger, managing director and global head of real estate, gaming and lodging investment banking, in the San Francisco office of Bank of America Merrill Lynch.

“Most of the companies (such as real estate investment managers) that are pursuing IPOs are putting their whole businesses, including management, in the REIT,” he said.

And most are already big players in private real estate investment businesses, looking now for an easier route to raise investment capital than the fundraising trail, he said. A few that are not big enough — because they don't own enough properties to form a sizable REIT — are entering into options to buy properties with the transactions closing after the REIT launches, Mr. Sturzenegger explained.

Hudson Pacific Properties Inc., a Los Angeles-based REIT, entered into option agreements with Morgan Stanley Real Estate and Farallon Capital Management LLC before taking the REIT public in November, Mr. Sturzenegger said. The real estate transactions that were optioned closed after the REIT went public, he said.

Real estate managers with closed-end funds they want to convert to REITs must get approval from their limited partnerships. “We're currently working on several ... to get the consent from investors to contribute their limited partnership interests for a share in a publicly traded REIT,” Mr. Sturzenegger said.

Many of the real estate managers converting to REITs have been down this road before. Hudson Pacific was formed by Victor Coleman, who was president of office REIT Arden Realty Inc., which was sold in 2005 to GE Real Estate for \$4.8 billion, including debt.

“We are seeing a number of sponsors looking to take companies public again after taking them private in 2007,” Mr. Sturzenegger said.

“Sponsors generally like the public markets as they tend to be faster. Raising a private fund can take a year or more, whereas doing a road show for a REIT can be completed in as little as two weeks. In addition, once you are public, raising additional capital can be done in a follow on offering which is typically very fast, vs. raising a second private fund which still can take a lot of time,” he said.

In 2009 and the early part of 2010, a few REITs without an existing portfolio — so-called blind pools — were launched. Colony Capital LLC raised a blind pool REIT in September 2009, for example. Those REITs relied on the strength of the investment team and enticing themes such as distressed debt.

But, generally speaking, the days when a blind pool REIT could be raised are over, Mr. Sturzenegger said. These days, REIT investors want to know what will be in the portfolio.

Bankruptcy savior

Not only successful managers will turn to the public markets, but those on the verge of bankruptcy are also expected to try a REIT conversion as a way of saving the company, NAREIT's Mr. Case said. In those cases, managers will have to convince REIT investors that the portfolio contains good properties with too much debt and that the firm's investment executives have what it takes to turn the properties around, he said.

"You have to convince investors that you have a good portfolio and you are a good manager of real estate," Mr. Case said.

Some real estate managers are looking to the public markets as a way to sell off properties. In November, Chicago-based real estate investment firm Harrison Street Real Estate Capital LLC spun off three student housing communities into a new REIT, Campus Crest Communities Inc., Charlotte, N.C.

"We and our partners are looking at the public market as a way to exit," said Christopher Merrill, co-founder, president and chief executive officer of Harrison Street Real Estate.

Expecting the REIT market to be growing, Harrison Street expanded into the business. Last week, Harrison Street bought the \$700 million REIT business of Transwestern Investment Co., and hired the Chicago-based real estate investment firm's six-member team.

"We concluded that the public market will be growing," Mr. Merrill said.