Is There a 'New Normal' for REIT M&A?

We participated in and attended NYU's annual REIT M&A symposium, co-chaired by Wachtell Lipton. The conference, now in its 18th year, always features a stellar line-up of REIT CEOs, bankers, lawyers, investors and industry icons. This year's event focused on M&A, the capital markets, the non traded REIT sector, foreign expansion, REIT conversions, the single family rental business and investment landscape.

Citi's Take on Wachtell's 7 Future Surprises for the Next 12-18 Months

Robin Panovka, Partner at Watchell, Lipton, Rosen & Katz, opened the event with 7 surprise predictions for the next 12-18 months for the REIT industry. We've added our thoughts to the predictions which are as follows:

1) ***REIT equity market cap will grow by $100bn, exceeding $600bn.*** Wachtell sees this driven by the continued acquisition of private portfolios by REITs, REIT conversions and more listing of non-traded REITs. This assumption seems quite reasonable given REIT's current advantageous cost of capital and recent acquisition activity. In addition, with many large portfolios and companies across the various property sectors still in private hands, we will likely see a continuation of private owners sell to REITs, and also look to the public markets for IPOs.
2) ***Leverage use will increase as aversion to debt fades with the pendulum swinging back from the financial crisis.*** We believe REITs will be hesitant to increase leverage substantially given their experience in '08-09. However there is some "dry powder" for debt funded acquisitions given current ratios are low - net debt to EBITDA of ~7.1x and Debt/GAV of ~38%. Sound use of increased leverage – staggered term and rate – makes a lot of sense in our opinion. "Cheap" long term debt could become an important "asset" in a few years.
3) ***Fast pace migration of non-traded REITs into publically traded markets, with associated M&A, in order to take advantage of strong public REIT valuations***. With the amount of assets under management in the NTR sector, and deals already occurred (ARCT/O, RPAI, Cole/Sprit, Cole pending listing etc) – there is likely much more to come. However, it remains unclear whether non-traded REITs will be embraced by the dedicated REIT community. Key issues in our mind are alignment of interests and a clear value creation (vs. asset gathering) strategy. Internal management is critical and essential.
4) ***Slowdown in the pace of REITs conversion as the spreads seem to be decreasing.*** The increase in market multiples has certainly lowered the valuation spread – however, the spread remains large especially for those that own hard assets. It doesn't help that many REIT conversions have seen a rapid rise in share prices, even though the long term value is unclear.

5) ***Increased REIT M&A, including possibly a return of privatization, in sectors trading below NAV or showing differentiation.*** Panel speakers at the conference tended to talk down prospects for REIT public to public M&A (see following section). With the recent rally in REIT securities and the majority of sectors trading at premiums to NAV, it is difficult to see an increase in privatizations, particularly when the overall REIT sector is trading at a premium to private market valuations. Never say never, which is why we include our views on potential M&A on pages 10-15 herein.

6) ***Activists losing credibility as flaws in 'short term-ism' become apparent as the pendulum swings back to focus on long term shareholder value****.* REIT sector activism has increased recently and has acted to highlight problems with the structure of certain REITs and self dealing. With the current rally in REIT shares, the probability of activism increasing has reduced significantly.

   We addressed the issue of activism in our March 22, 2013 Weekly REIT and Lodging Strategy - The Four Questions, where we asked *"Why has activism increased in REIT space recently, but historically it hasn't worked? Even so, who may be the next targets and why?* REITs, like the broad market, are trading near all-time highs, leaving investors searching for value amid a sector where many stocks trade at premiums. Given the underlying value of the real estate owned by the public REITs and the resulting valuation backstop in the private market, combined with a robust lending market, it makes sense for hedge funds to pursue companies that are clearly trading at substantial discounts. With the uptick in REIT conversions and the increased potential for M&A, the hedge fund community will likely continue to pay more attention to REITs. We have mentioned **BRE, DFT, ELS** and **PPS** as most ripe for activism. While **BRE** and **DFT** have had a variety of issues that have weighed on their stocks, **ELS** and **PPS** are both well run companies that simply trade at very large NAV discounts - that could be unlocked through activists or sales.

7) ***Trouble for Single Family REITs on the operational side.*** Wachtell had concerns that there may be problems for single family REITs on the operating side of the business. In our opinion, the jury is still out on the long term viability of single family REITs as a new institutional business. It remains to be seen if this was simply a trade on discounted housing prices, or if a long term business with attractive economics can be created with economies of scale. It does remain difficult to manage a substantial pool of assets across geographies.