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Mind the REIT Gap: Considerations for REIT M&A in 2023

REIT M&A volumes in 2021 and 2022 were at record levels, but slowed down in the latter part of 2022 consistent with the broader market. The drivers for continued consolidation and take-privates remain as powerful as ever, but for the moment are being countered by large gaps between seller- and buyer-valuations and a challenging macro environment, particularly rising interest rates and difficult debt markets, volatility in REIT stock prices, and general economic and geo-political uncertainty.

As the new reality sinks in, we expect the gap to narrow between buyers' lowered target valuations and sellers' historically-based high expectations, which should help a number of pipeline-deals pencil out. REITs considering a major transaction would do well to look closely at their internal valuations, or NAV, and if appropriate revise them to reflect the current market. Historic, unrealistic NAVs can create unnecessary impediments to deals, and could potentially increase litigation risk.

While many transactions still make strategic sense in the current environment, boards are understandably slower to pull the trigger. Board confidence in the economy and the strength of their business is a key factor in making acquisitions. REITs continue to work on strategic transactions, but at a deliberate pace and with greater consideration to stock or part-stock structures given the state of the debt markets. Cash deals can still work, but can be tougher. The focus at the moment is often on balance sheet management and the impact of higher interest rates and inflation. In some cases, spinoffs or other restructurings are also being considered, sometimes for long-standing reasons and sometimes to address the post-Covid economy. One wild card is management fatigue with the continual stream of crises, particularly in the harder-hit sectors, which in some cases may make exit transactions more appealing.

There is still plenty of capital in the private equity and non-traded REIT sectors, but the cost of debt and the large valuation gaps can be difficult to overcome. All- or high-equity deals may start making sense for private equity, especially where there is a fuse on commitments or an IRR clock ticking away on funded capital. More broadly, there is some concern that, if rates continue their upward march for too long, some private-side business models, especially those premised on inexpensive debt, could be severely challenged.

Another challenge, and an opportunity, is the steady march of technology. Despite the hype, the metaverse isn't about to replace the built environment. Humans will need places to sleep, eat, work, learn, hang and play for the foreseeable future, and there are signs of a resurgence of brick-and mortar-based commerce in some sectors. But regardless of any resurgence, the built environment needs to adapt to keep up with our increasingly digital lives. Many functionally obsolete, well-located assets that are well-served by transportation and other infrastructure will likely be converted to other uses. And buildings will need to decarbonize and address climate risk. Fortunately, REITs, with their professional management and access to capital, are well positioned to capture the massive opportunities involved.

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Activism appears to be picking up in REITland and elsewhere (with a 20% year-over-year increase during the first half of 2022), with the decline in equity values creating some vulnerabilities, but, fortunately, well-prepared REIT boards have a number of tools to address short-termist and opportunistic attacks. REIT boards should "be their own activists" and follow best practices in order to shield their shareholders. REITs should also be mindful that, as explained in our recent memo, the SEC's new rule requiring universal proxy cards could result in an increase in proxy contests and could put a greater focus on individual directors because shareholders will now be able to pick and choose directors from different slates.

As highlighted in our memo on Key Issues in Corporate Governance for 2023, REIT boards should also keep in mind the importance of risk management (particularly involving interest rates, inflation, liquidity and technological challenges), ESG, cybersecurity, climate disclosure, executive compensation clawback rules, and board diversity. Given the complex and ever-changing environment, boards should remain nimble, engaged and open-minded.

We remain very optimistic about the publicly-traded REIT model, which has now been tested through financial crises, pandemics and other trials. Liquid real estate's advantages have resulted in a vibrant $1.5 trillion market for REIT stocks and a well-functioning market for corporate control of real estate. We expect to see more growth and consolidation, punctuated by take-privates, spins and debt-driven restructurings as the market continues to evolve.

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