Finding a Focus:
Repositioning Office REITs in the 21st Century

Working Paper # 364, April 14, 2000

Samuel Chasia
Akio Kishimoto
Bernard Kwan
Ronchang She

Executive Summary

Ever since the collapse in real estate share prices in 1998, the real estate community has been looking for a solution to the depressed share prices and capital constraints. There have been a number of quick fixes bandied about, with calls from some quarters to re-privatize some of the REITs. This had been due to the fact that the private companies had been seen to be doing rather well in the current environment, given the strength of the underlying market. However the overwhelming sentiment within the office sector has been that the advantages of size and access to public capital far outweigh the advantages of being a C-corporation[1].

A large number of suggestions have been made by a number of REITs in the field of balance sheet management and in trying to grow ancillary revenues to take advantage of the recent passage of the REIT Modernization Act ("RMA"). But in this paper we would like to argue that there are no quick fixes for the REIT industry. A framework will be provided to show that there are four value drivers that will help to enhance shareholder value, but at the end of the day there is no real substitute for the basics such as management expertise, a clean balance sheet and above all, a focused strategy.

In this paper we shall use also explode a number of myths about the REIT industry, such as the common assertion that greater size is naturally better, and that the provision of broadband technology and other ancillary revenues will make substantial impacts upon the bottom line of these REITs. The conclusions will become readily apparent when we analyze our two case studies in the office sector – Equity Office Properties and SL Green Realty.

[1] The Future of REITs, Part III

Although the collapse in real estate prices affected all the REITs equally in 1998, making no distinction in terms of individual companies, we have since seen a separation in 1999. This separation has been in very much in terms of the quality of the underlying REITs. Those REITs with a strong management team, low leverage and above all a focused growth strategy have seen share price out-performance. We labeled these REITs "Blue Chip REITs." The second class of REITs we labeled "Index REITs". Their size and diversification make them a core holding for any investors who want exposure to the sector, but whose size inhibit their ability to grow. Finally there have been what we have termed the "Laggards" – REITs who had overstretched themselves and had been struggling with over-leverage.

The challenge in this paper has been to try to reposition quality REITs into the "Blue Chip" category by highlighting a framework of value drivers. But we also wish to make the case that the most important of these value drivers is having a focused strategy, with which to differentiate oneself from ones peers. Companies that have shown a targeted growth strategy, that have leveraged core competencies have seen share price out-performance.