The Halting Consolidation Revolution

Despite changes in the real estate industry, there are many stumbling blocks to major consolidation.

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THE INTENSE DEBATE about consolidation that captured the real estate industry in the mid-1990s was fueled by a highly plausible and persuasive economic argument: real estate, like other capital-intensive industries, was in the first stage of a long-run industry transformation that would prove inevitable (if not unstoppable) because long-term comparative advantages would accrue to those players operating with the lowest cost of capital, best access to capital, and most efficient operations based on cost economies of scale relative to competitors. This argument, put forth by Peter Linneman and others, predicted a major shift to public ownership and a corresponding focus on

the evolution of true corporate-style operating businesses that could command premium valuations based on their value-added management capacity. The consolidation argument forecast that small, less efficient REITs would disappear through mergers and acquisitions (M&A), an organic market-driven process by which the surviving real estate companies would be defined by size dominance. The intense REIT bull market of 1994–1997 appeared to support the hypothesis, as did a wave of M&A activity during 1997–1998. Implicitly, if not explicitly, the message was bigger is better—until the complications of execution added shading and nuance to the prevailing logic.

The logic of consolidation applied to real estate begged the question of whether real estate is sufficiently different from other capital-intensive industries to foil the inevitability of an industrial transformation. Bernard Winograd argued in this journal ("You Say You Want Revolution," *WRER* Fall 2000) that the revolution stalled precisely because real estate remained tied to a historical dependence on debt capital, whereas the logic of consolidation presumes a ruling role for equity capital. Other kinks that were likely to interfere with a smooth transformation included: a noisy debate about the right measure of depreciation in real estate; continued questions about real estate's true volatility and the changing nature of risk in real estate investing; and real estate's contribution to portfolio diversification. All these issues were of critical concern to institutional investors whose acceptance of REITs as a complement to (if not a substitute for) direct investment in their real estate portfolios has always been viewed as critical to the development of a public real estate equities market.

The past decade of experience added other questions to the consolidation argument. The benefits of economies of scale, for example, might be a function of achieving critical mass, after which larger REIT size triggers diseconomies of scale. There may well be value in being large, but the question is how large? Similarly, from a diversification perspective, there may be value in establishing a presence in several geographic markets, but as those local property markets increase in number, so do the risks of managing widely dispersed operations. In short, size becomes a factor that must be managed with increasing people-based systems, managerial skill, and strategic sophistication.

So, with the hindsight of a decade, let's assess the record. To begin, consolidation is an empirical issue. What does the empirical evidence on economies of scale and public ownership penetration suggest? What can we learn from the analyses to date, and how do these insights modify the logic or add to our understanding of the transforming forces that have already

reshaped the industry? The late-1990s REIT bear market evidenced the type of capital-raising vulnerability that should have made conditions ripe for M&A activity, friendly or otherwise. That was the expectation expressed in the popular press as well as in trade journals. As measured by the number of publicly-traded equity REITs, the industry shrank by about 15 percent from a high of 178 in 1995 to 151 by 2001; during the same period, the average size of an equity REIT grew significantly from $280 million to $974 million (Figure 1). Yet the real estate industry did not consolidate in terms of pricing power or market share. What factors confounded the logic of opportunity? One answer seems rooted in the institutional dynamics surrounding changes in corporate control. While compelling economic and business logic provided fertile and necessary conditions for consolidation, M&A experience during the 1990s suggests that the forces of consolidation in the public arena faced well-known institutional hurdles that raised the bar on execution.

To date the evidence on consolidation is preliminary and ambiguous. Nevertheless, it suggests that at this stage of the process the metrics for assessing the potency of consolidation forces may have less to do with absolute measures of dominance and more to do with how the public markets have forever changed the rules of real estate. There is as well a strong message about the institutional complexities of transition from one state of industry structure to another.

Figure I Equity REIT Market Capitalization Outstanding: 1991–2001

Year End	Number	Market Capitalization (millions)	Average Size (millions)
1991	86	$ 8,786	$102
1992	89	11,171	126
1993	135	26,082	193
1994	175	38,812	222
1995	178	49,913	280
1996	166	78,302	472
1997	176	127,825	726
1998	173	126,905	734
1999	167	118,233	708
2000	158	134,431	851
2001	151	147,092	974

Source: National Association of Real Estate Investment Trusts

SCHOLARLY SKEPTICISM

Prior to 1990, the research literature on REITs was both short on quantity and narrow in focus. The small size of the REIT market, the limited scope of property representation, and a near-total absence of institutional investors made this research arena too small, too specialized, and too atypical to attract many academic researchers. REITs were of particular interest to a few researchers only because those provisions of the IRS code that made for their tax-advantaged status—mandated payouts, for example—also made the investment vehicle a natural experimental control for exploring certain questions of importance to corporate finance.

The development of a larger, more deeply capitalized REIT market representative of a broader slice of the universe of the income-producing property sector changed that condition. Data on commercial real estate, hitherto proprietary and the bane of much real estate investment research effort was now readily available. With the inclusion of institutional-grade property assets, the scope of generalization on a significant range of research issues—capital structure, dividend policy, taxes and share prices, investment performance, management focus, alignment and conflicts of interest, industry structure—expanded significantly. In short, by going public, real estate broadened the long-term prospects of probing academic research.

Several studies of concentration, merger activity, and scale economies appeared in scholarly and practitioner journals. Stimulated by the controversy, these studies sought an immediate empirical read on the arguments of the consolidation debate, as some of the more skeptical titles suggested: "The Great REIT Consolidation: Fact or Fancy?" and "REIT Economies of Scale: Fact or Fiction?" Taken as a set, the research sought to determine whether observable rapid growth of the REIT sector over the decade actually resulted in greater concentration within the real estate industry; whether economies of scale related to size (expense cost savings, higher quality or professional management), branding, or geographic concentration (informational efficiencies, monopoly pricing power) actually exist for REITs; whether larger REITs actually benefited from such cost efficiencies; and whether meaningful differences in managerial ability actually make consolidation economically valuable. The empirical findings are mixed:

Concentration: Despite dramatic growth in the size of the average equity REIT and increasing merger and acquisition activity during the 1990s, there is no strong and unambiguous evidence of a sweeping trend toward consolidation. Measured in terms of penetration by public-market ownership, by year-end 2000, the share of

the investable commercial real estate universe owned by public companies had actually declined from its peak; this data point represented the first contraction in public ownership for five of the six major property types (the exception being the apartment sector, which experienced a decline the year earlier), marking a reversal of an earlier upward trajectory for public ownership.

Wealth-enhancing merger gains: Nearly two out of three of the equity REIT mergers between 1994 and 1997 produced negative returns for REIT acquirers (unless they were paired-share tax-structure acquisitions) in the immediate days following the announcement, indicating that these managers generally failed to capture value-enhancements for their shareholders. While the acquired equity REITs registered positive returns, they significantly underperformed compared to their non-REIT counterparts.

Cost economies: Evidence of cost economies exists, primarily in the area of general and administrative expenses and management fees, but these are the smallest components of total REIT costs, making for a small potential impact on performance. Moreover, the research found that for G&A expenses little variation exists across REIT size, while for management fees, diseconomies appear with larger asset size.

NOI growth and scale economies: Enhanced ability to grow rental income by strategic asset acquisitions and higher-quality and professional management does not appear to be related to size. Contrary to the large-REIT hypothesis, an analysis of twenty-one apartment-focused REITs (between 1994 and 1997) failed to reveal evidence that large REITs have higher NOI growth rates, but rather the just opposite: in the apartment sector, small REITs appear to generate higher NOI growth rates relative to large REITs.

Branding and scale economies: While establishing a brand image affords marketing advantages and offers significant returns in other capital-intensive, service-oriented industries, this does not appear to be the case for multifamily REITs. In particular, there is no evidence that REITs with a branding strategy generate higher income growth rates relative to the market.

Geographic concentration and scale economies: There is no support for pricing power (evidenced in higher income growth rates) arising from geographic concentration, at least within the REIT apartment sector. While geographic concentration might allow larger REITs to dominate smaller REITs by achieving informational efficiencies with respect to pricing (or by attracting top management talent able to choose strong markets), this potential is undercut by REITs' controlling relatively low market shares in any one market.

These academic studies suggest that size alone does not confer advantage. This conclusion offers ambiguous evidence. To the contrarians, it indicates that the central tenet of the consolidation argument was faulty. To those who contend that the transformation will take several decades, these preliminary findings, based on only a very modest level of research, cannot possibly settle the issue: the revolution is still young. I believe that the jury is still out. Much more time needs to pass and more information is needed to assess the question of whether or not economies of scale and meaningful differences in managerial ability actually make consolidation economically valuable. In the meantime, a number of factors have complicated the path toward consolidation.

MANAGING SIZE

One of the early lessons from consolidation activity is that the cost-of-capital advantage, while logically necessary for any capital-intensive industry, is not sufficient to establish a sustainable competitive advantage in the real estate industry (at least not in a REIT format, where turning properties under a capital-allocation strategy is comparatively difficult to execute). Size is important for a number of reasons, but size alone cannot bring on efficiencies. Capital needs to command not just efficiencies, but operational excellence at both the property and corporate level in order to deliver what the public market demands: predictable, sustainable earnings along with growth. Size may allow larger REITs to attract higher quality and professional management, which by implication may make them better positioned to acquire properties and position them for superior income growth, but that too is not sufficient. Assuring revenue productivity from existing operations while managing the transitions inherent in asset growth through substantial mergers and acquisitions of companies and portfolios depends on the development of a strong corporate infrastructure of sophisticated business systems. It demands an operational efficiency that goes beyond, for example, the elimination of redundant general and administrative costs. When major multibillion-dollar REITs merge, as in the case of Equity Office Properties and Boston Properties, or Archstone and Charles E. Smith Residential, overheads are not so large relative to these companies' assets. Moreover, the personnel issues and ongoing costs of blending companies can swamp even these one-time cost savings.

The platform for the type of competitive advantage that underlies the logic of consolidation, as applicable to the real estate industry, implies a management model capable of forging a company culture that can be responsive to the demands

of two distinct sets of business dynamics: entrepreneurial sales and corporate discipline. It must be capable of blending both behavior sets, which mirror the dual character of real estate as both a physical product transacted in local property markets and an investment asset transacted in national (global) capital markets. It must cultivate the type of entrepreneurial management necessary to succeed at the product level in local markets, which are small and where tenants needs are often unique to that market. It must also build business systems of corporate focus and discipline necessary to aggressively manage the asset portfolio, maintain a strong balance sheet, and extract marginal efficiencies at the operating level. Creating shareholder value in this manner requires that vision marry discipline in a new format distinctively tailored to the real estate business, which cannot elude its highly localized character.

Not unexpectedly perhaps, consolidation as measured by the level of public-market ownership penetration (in data published by Prudential Real Estate Investors) is greatest in those product sectors where the character of the tenant market is least localized and the contracts for space less likely to be single, one-off transactions: regional malls (34.1 percent) and hotels (17.1 percent). The tenant markets for regional malls, dominated by department stores and chain-store tenants and those for investment-grade hotels catering to business and recreational travelers, are large and national in scope. Multiple transactions with the same tenants are the norm, as are package negotiations. These markets seem to be the ones most suited to the type of economies of scale, branding, pricing power, and informational networks that have characterized consolidation of other consumer-oriented capital-intensive sectors. In the absence of new management models that are focused on the development of people, business systems, and company culture, executing the strategy of scale to apartment, office, and warehouse sectors where tenant markets are more localized is likely to remain a significant challenge to the logic of consolidation.

The real estate industry's embedded entrepreneurial culture is both an asset and a constraint in this task. In a deal-oriented industry of hard-driving entrepreneurs, the corporate style has been a rare exception, until recently. "Style makeovers," Winograd wrote, "were reasonably common among those who aspired to change from a mobilizer of debt to a mobilizer of public equity capital, and industry leaders emerged to prominence who would have been much less conspicuous in the old environment." It may take the next generation of entrepreneurial-minded yet corporate-trained leadership, CEOs who did not privately operate the asset portfolios they built from scratch, to forge the new

management model that possesses all the tools needed to push forward the next stage of consolidation.

THE MARKET FOR CORPORATE CONTROL

During a sector slowdown, the forces driving the logic of consolidation intensify. Flat performance, weak stock prices, and minimal prospects for growth make access to equity capital nearly impossible for REITs, which have minimal discretion to retain earnings and must pay out 90 percent of net income. The capital divide between strong and weak companies becomes most acute, and prospects for growth stall. Stable performance at the property level at best affords few resources for a public company to do much more than manage operations. Facing low multiples and an inability to raise equity because of a depressed stock price, while simultaneously being at or close to the market's tolerance ceiling on debt, makes for limited horizons in terms of the creation of shareholder value. If management frustration with just operating the asset base becomes sufficiently high, it might provide the catalyst for a sale. But, it might not. Weak REITs can survive, management can continue to draw financially rewarding compensation and maintain other benefits of control, and shareholders can continue to receive dividends (assuming adequate funds from operations). Modest acquisitions can be funded through selective property dispositions and, under the appropriate market conditions, development commenced and off-balance sheet joint ventures pursued. Though alive, these weakened companies are not viewed as survivors, and when selling at substantial discounts to perceived net asset values, they become obvious candidates for consolidation. The dynamic of stalled growth drives the potential opportunity: for both private and public players, it may be cheaper to buy a REIT than it would be to buy real estate direct.

Figure II Number of Completed Public Real Estate Company Mergers: 1992–2001

Year	Merger Announcements
1992	0
1993	0
1994	2
1995	5
1996	7
1997	14
1998	18
1999	8
2000	6
2001	8
Total	68

Includes all announced, completed mergers in which the acquiring firm and the target were public real estate property companies; 54 are equity REIT-to-equity REIT combinations.

Source: Lehman Brothers.

Consolidation within the public real estate company sector did in fact accelerate during a four-year period between 1997 and 2000, when 46 public companies were absorbed in mergers (Figure 2). The overlay with the REIT bear market is not exact, however. Merger announcements tapered off notably in 1999 and 2000, years in which the number of secondary equity offerings, unsecured debt offerings, and initial equity offerings among REITs were a fraction of the strong activity recorded in 1997 and 1998 for each of these forms of capital raising. Public companies continued to consolidate through acquisitions of private real estate firms in 1997 and 1998, but this M&A activity nearly disappeared in 1999 and 2000; activity picked up only slightly in 2001 and 2002. Toward the end of 1998, the pendulum swung toward privatization, with the announcements of investor groups taking two public real estate companies private. In the next three years, eight other equity REITs would disappear from the public sector through privatization (see Figure 3 for aggregate data on public company real estate mergers).

Judging from the pronouncements in trade journals and the media at the time, the stage was set for great consolidation. Wall Street analysts and investor groups prepared lists of takeover candidates. Other industry observers anticipated an increase in hostile takeover attempts. There was a lot of talk about potential combinations, but little activity. Mergers occurred, but they often failed to generate big premiums for investors. No unfriendly merger activity succeeded during the late-1990s REIT bear market, though two hostile attempts failed.

Does the lack of hostile deals suggest a failure of the takeover market, as might be suggested by the analogy with corporate finance, which regards hostile takeovers as a necessary tool to discipline managers? Or is this missing element another manifestation of how real estate might differ from other capital-intensive industries?

Figure III Public Company Real Estate Mergers by Type of Merger: 1997–2002 (June)

Type of Merger	Number	Total Rank Value (millions)
Public acquiring Public	53	$81,085
Public acquiring Private	36	$29,828
Private acquiring Public	15	$20,064
Total	104	$130,978

Includes all announced, completed mergers over $250 million in which the acquiring firm or the target was a public real estate property company, equity REIT or C-corp.

Source: Lehman Brothers.

For a number of financial and institutional reasons, hostile takeovers of public real estate companies are difficult and complex, if not impossible.

On the institutional side, the REIT excess-share-ownership provision is often cited as special legal protection and a key inhibitor of hostile actions, a built-in anti-takeover safeguard, because a would-be acquirer cannot build a meaningful ownership position. Typically adopted as a part of a REIT's articles of incorporation, the excess-share-ownership provision usually restricts the number of shares that any shareholder can own to 9.8 percent or some lesser provision (to empower management to enforce the 5/50 rule of the IRS Code, which prohibits five or fewer individuals from owning in the aggregate more than 50 percent of the REIT), and thereby ostensibly serves to protect the company's tax-advantaged status. The conventional wisdom on this point is not firm, however. While the excess-share-ownership provision puts in place a hurdle, M&A attorneys David M. Einhorn, Adam O. Emmerich, and Robin Panovka have argued that, in practice, REITs appear no less vulnerable to unsolicited takeovers than other public companies. The excess-share limitation does not make a REIT "bulletproof." At best it serves as no more protection than a "poison pill" and, in many instances, it is more vulnerable to attack than a "pill" because the excess-share-ownership provision has not been tested in the courts (unlike poison pills, for which there are legal precedents). The hostile attempt by Manufactured Home Communities (MHC) for Chateau Properties, which had announced a friendly merger with ROC Communities in mid-1996, came close to testing this provision in court, but after a series of moves among the contending parties that ultimately resulted in the merger of Chateau and ROC (though not before ROC sweetened its offer by more than 3 percent to avert a shareholder revolt), MHC withdrew its hostile bid later that year.

The lesson was not lost on REIT managers and boards when the downturn hit in 1998. To protect themselves against unwanted takeovers and inadequate bids, some forty-seven REITs adopted poison pills between January 1998 and May 1999. Since the board of directors has the right to waive the excess-share-ownership provision, or a pill for that matter, in practical terms, both function to almost eliminate the ability to buy a target without negotiating with its management or board. "Bear hugs" such as Public Storage, Inc.'s bid for Storage Trust Realty in 1998, which finally resulted in a definitive transaction, are more likely, according to M&A specialists.

The tax-related impediment associated with change of control actions brought to the fore in MHC's bid for Chateau

highlighted the ways in which a takeover target with an UPREIT structure has an additional means to thwart or deter a takeover. To protect the tax position of contributing partners, UPREIT operating-partnership agreements sometimes give OP unit-holders the right to veto certain transactions. The existence of veto rights, as well as put rights that OP unit-holders generally have, strongly suggests that the tax issues generated in a potential merger transaction may be a bigger constraint on a hostile bid than the excess-share ownership provision. Thus, hostile offers for REITs involve layers of additional complexity not associated with other public companies.

The major impediment to unsolicited takeovers in the REIT arena has been a perceived inability to justify the type of premium that would be required in a hostile takeover. The premium paid by Equity Office Properties for Beacon Properties Corporation (40 percent over asset value and 22 percent over stock price) did not become the turning point in REIT merger pricing that some expected, but rather an exception to prevailing practice. As a collection of properties, real estate is reasonably straightforward to price. It has relatively fixed income streams and operating expenses, especially if the assets are fully or near fully leased and years away from substantial rollovers. Unlike a manufacturing company where there may be unpriced capacity or a financial-services firm where there may be many synergies from a merger, for a REIT target it is hard to justify paying a price much above the estimated value of the underlying properties. If economies of scale existed, it would be possible to justify a large premium. But typically the present value of the anticipated economies is not large. If the bid premium were large enough, many boards would ultimately agree to a sale, as their fiduciary responsibility would demand that they do so. But if in offering a large premium the market perceives the buyer has overpaid, the buyer will be quickly disciplined. Companies need to be selling at very sizable discounts to net asset value for the hostile equation to work in practice.

Other items add dead weight to the financial calculus. Unfriendly takeovers are expensive to mount as well as uncertain. To the extent that the weakest target companies are also small, several million dollars of expenses for an acquisition whose outcome isn't clear (especially if a proxy battle gets under way) becomes an expensive way of acquiring assets that initially were considered cheap. In other words, it is prohibitively costly in the REIT world to do anything that is unfriendly. A final important takeover impediment distinguishes the real estate industry. Unlike other capital-intensive industries, there is a large private market, which, as past cycles have shown, can and will arbitrage significant pricing

differentials between the public and private sides of real estate.

"One of the reasons industry evolutions take so long," Linneman asserted in his 1997 *Wharton Real Estate Review* article, "is that it takes several periods of industry distress to fully shake out the weakest operators." Based on the merger evidence to date, this caveat on expectations seems exceptionally appropriate. Evidence of continual merger activity, friendly or otherwise, is an essential thread of the consolidation argument. Yet in an industry as splintered and diverse as real estate, even in mergers of multibillion-dollar companies, no one company emerges with dominance and pricing power. While M&A activity on both the public and private sides of the market is clear evidence that consolidation continues to take place, relative to the size of the investment-grade commercial real estate universe, the overall impact on the structure of the industry, especially at the level of the local property market, remains small.

There is widespread consensus about the manner in which the public market has changed the rules of the real estate business. Greater transparency, fuller disclosure, and ongoing monitoring of public real estate companies have increased the informational efficiency in both local space and national asset markets. Ironically, the heightened scrutiny of public companies in the post-Enron era is likely to be more of an immediate drag on private-to-public activity. With the public debt market as a price setter, greater discipline in lending exists through fast and visible spread adjustments pegged to global capital markets. And the continued existence of a large private market for real estate capital continues to provide opportunities for capital-market arbitrage. A different world from ten years ago, for sure: more complex, more challenging, and also more interesting.

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