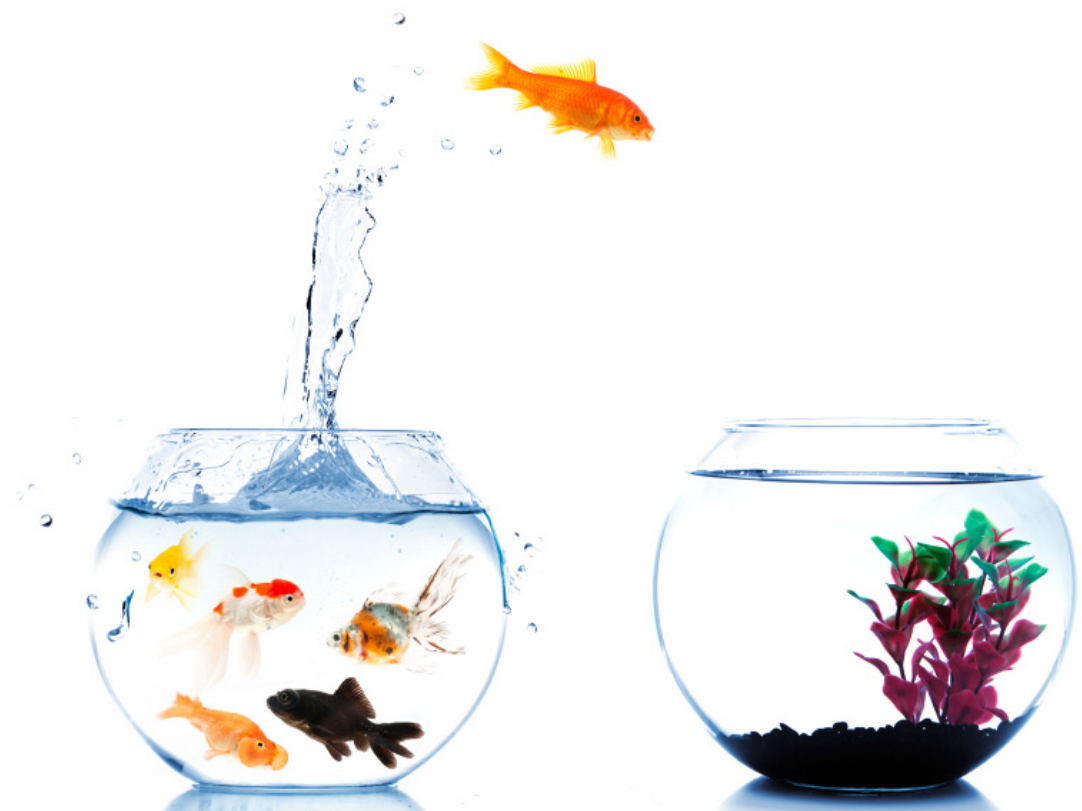


Non-traditional commercial Real Estate: Capitalizing on the REIT opportunity



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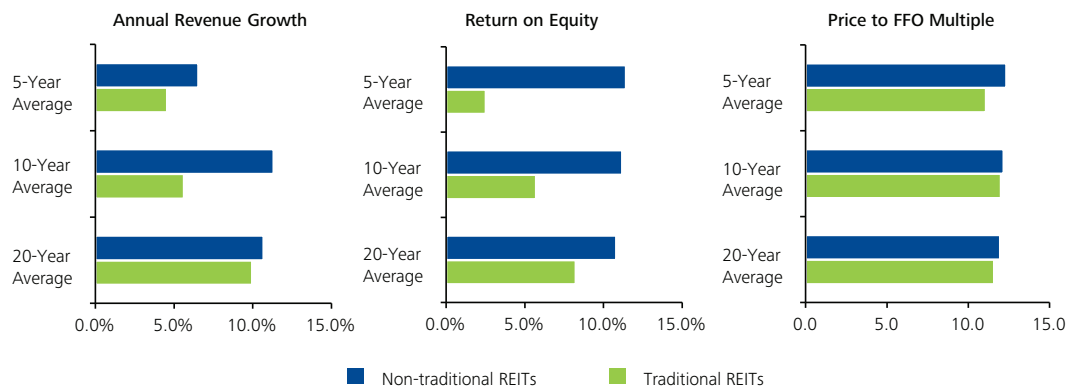
Introduction

Traditionally, owners of commercial properties, such as retail, office, industrial, multifamily, hotels and healthcare, have adopted a real estate investment trust (REIT) structure due to its inherent benefits. These benefits include a single-level of taxation, easier access to low-cost capital, and higher valuation attributed by capital markets. In addition, investors consider REITs an alternate asset class from a portfolio diversification perspective, given that their returns have a moderate correlation with the S&P 500.

Over the past few years, an alternate REIT segment has emerged, comprised of owners of income-producing real estate such as timber, data centers, document storage facilities, cell towers, prisons, and billboards. These companies have opted to convert to a REIT to capitalize on the benefits of the structure, and are classified as “non-traditional”ⁱ as the underlying assets have different and unique characteristics compared to the owners of traditional properties. In fact, the returns of the non-traditional REITs have low to moderate correlation with the S&P 500 and the traditional REITs, which provides diversification option to investors within the real estate sector.

Non-traditional REITs have performed better financiallyⁱⁱ relative to the traditional ones during the past five-year (2007-2011), 10-year (2002-2011) and 20-year period (1992-2011), likely due to the distinctive features of the varied non-traditional REIT subsectors. For instance, data center REITs have posted strong topline growth as they are in a high-growth phase, propelled by the increase in adoption of cloud computing and demand for analytics and data storage. Timber REITs have demonstrated better return on equity (ROE) due to timber sales from qualified REIT properties, and production and manufacturing businesses under their taxable REIT subsidiaries (TRS), which have driven the asset turnover higher. From a valuation perspective too, average price/funds from operations (FFO) of non-traditional REITs exceeded the traditional ones in all three periods.

Financial Comparison of Non-traditional and Traditional REITs



ⁱNon-traditional REITs include 13 firms across subsectors such as timber, data center, manufactured home, entertainment and infrastructure. Traditional REITs include 123 firms across subsectors such as office, retail, industrial, multifamily, lodging, healthcare, and self-storage.

ⁱⁱBased on average performance comparison on the basis of revenue growth, ROE and valuation multiples

An analysis of the post-conversion performance of one of the non-traditional REIT sub-sectors (timberland)ⁱⁱⁱ reveals that the subsector grew, and shareholder return and market valuation were higher. For instance, Rayonier Inc., which converted to a REIT in 2004, improved its performance post-conversion compared to the pre-conversion period^{iv} — compounded annual growth rate for revenue was 3.0 percent (0.3 percent in the pre-conversion period), price to FFO multiple increased to 10.6x (from 5.6x) and ROE to 19.9 percent (from 10 percent)^v. In addition, timber REITs^{vi} outperformed their C-Corp peers on all the performance parameters that we have enumerated, during the 10-year (2002–2011) period. For instance, from 2002-2011, average^{vii} annual revenue growth of timber REITs was 3.5 percent (industry: 1.9 percent), average price to FFO multiple was 11.9x (industry: 2.8x), and average ROE was 18.1 percent (industry: 7.3 percent).¹

That said, a REIT conversion is a complex process and requires strategic, financial, and operational restructuring to comply with regulations.



ⁱⁱⁱIncludes Rayonier Inc. and Potlatch Corporation

^{iv}Pre-conversion period — 1994-2003; post-conversion period — 2004-2011

^vRepresents median numbers during each period

^{vi}Includes Rayonier Inc., Potlatch Corporation, Plum Creek Timber Company, Inc., and Weyerhaeuser Company

^{vii}Represents median numbers for the timber REITs

Key conversion priorities

What factors does a company need to consider prior to converting to a REIT? At the very outset, should a company merge with an existing REIT or convert on a standalone basis? A potential merger with an existing REIT may require evaluation of the asset classification, shareholder base and relative valuation of potential targets. However, this route may result in loss of identity, control, and independence. A company can also spin-off or contribute non-traditional real estate assets into a REIT as part of a larger corporate restructuring, with the shares of new REIT distributed to existing shareholders in a dividend and/or offered to the public in an initial public offering. On the other hand, a company that plans to convert and operate as a REIT on a standalone basis needs to consider several strategic and tactical aspects before making a decision to convert. In the sections below, we look at some of the key considerations that a company should evaluate as part of the due diligence process.

Strategic priorities

Priority 1: A REIT conversion will support future growth

- Does the existing business model and structure conform to the REIT qualification guidelines?
- What are the potential changes that a company will be required to make to its organizational structure?
- Does the conversion align to the long-term strategy of the company?

A company needs to understand the implications of the REIT regulations on its existing business. This is important as REITs must comply with asset^{viii} and income tests^{ix} on an ongoing basis: a minimum percentage of assets have to be invested in qualifying assets, and a minimum percentage of income has to be generated from qualifying assets. Further, non-qualifying assets and business activities may need to be held in a TRS. However, there is a limit on proportion of assets that can be held as part of the TRS.^x

^{viii}Quarterly, at least 75 percent of a REIT's assets must consist of real property, loans secured by real property, government securities or cash.

^{ix}Annually, at least 75 percent of the REIT's gross income must be derived from real property rentals and interest on mortgages secured by real property. In addition, 95 percent of the REIT's gross income must be from the above-listed and passive sources such as dividends and interest.

^xThe value of a TRS' equity should be limited to 25 percent of the total value of a REIT's assets

Hence, a company needs to assess the strategic importance of such assets and determine the ones that will reside in a TRS. For assets that do not form a part of the REIT and the TRS, it will likely have to evaluate other options, including a potential divestiture. For instance, an information management company divested its digital document storage business to meet the operational and technical requirements of a REIT structure. Further, the company considered the process of restructuring some of its domestic and international operations into TRS/ REIT as one of the major drivers of the time required for conversion.

While evaluating a potential conversion, a company should also assess the impact of REIT requirements on its future growth. For instance, the growth of new or existing business lines may be limited by either the asset or income requirements within the REIT, even if the growth occurs in a TRS, as there are limits as to the relative value of the TRS within the REIT.

Priority 2: Potential converts may need to consider financial restructuring in order to both meet dividend distribution requirements to maintain REIT status and to derive the tax benefits^{xi}

- Does the company have sufficient liquidity to pay out the accumulated earnings and profits (E&P) and minimum dividend required to qualify and maintain a REIT status, respectively?
- What are the various forms in which a REIT can pay dividends?
- What are the alternative finance mechanisms available to a REIT to enhance liquidity to sustain its status?

A company considering a conversion needs to evaluate the impact of the REIT distribution requirements on its financial structure. The existing capital structure, expected

^{xi}A REIT is required to distribute at least 90 percent of its taxable income (without regard to capital gains) each year. The remaining 10 percent of taxable income is taxed, if not distributed.

cash flows, future access to capital, and the proportion and form of dividend distribution should be assessed to determine the funding gap.

All these parameters determine the company's valuation as a REIT. A company should also compare itself to future REIT peers on varied financial parameters to assess its competitiveness as a REIT. Such an analysis can provide insights about investor perception once the company converts to a REIT.

A company converting to a REIT is required to pay out its undistributed Earnings & Profits (E&P) for all years prior to conversion. This is a one-time payout separate from the annual dividend requirement. Typically, the E&P distribution (sometimes referred to as a "special dividend" in converting company's public filings), results in a significant outflow for a company. A company can satisfy the distribution requirement with cash, or a combination of stock and cash. For example, Weyerhaeuser Company paid out a special dividend of \$5.6 billion in September 2010 (including regular quarterly dividend of \$11 million), at the time it converted to a REIT. The company restricted the cash distribution to 10 percent of the special dividend and paid the remaining through issuance of approximately 324 million new common shares to its shareholders.²

A REIT can plan to pay out the annual required regular minimum dividend in many forms:

- Cash
- Cash/stock dividend mix
- Dividend reinvestment program (DRIP)

If a company expects excess cash flows over the medium-to-long term, it should opt for a complete cash payout. A 100 percent cash dividend payout is attractive to shareholders and investors. In contrast, if a company would like more flexibility and minimal transaction cost, it may opt for either a cash/stock dividend mix^{xiii} (a portion paid out as stock) or a DRIP (reinvest dividends in additional common stock). The decision to include a

^{xiii} IRS guidelines bind a cash/stock dividend payout

stock component is also driven by the cash conservation requirements of a company.

The proportion of dividend payout may be limited by covenant restrictions for existing debt. A company can negotiate with its lenders to modify its covenants; however, this can be challenging to accomplish and sometimes results in higher interest rates or fees.

Along with the regular dividend distribution requirements, a company should factor in debt service costs, capital expenditure, and working capital needs to determine the potential size of the liquidity gap created by the distribution. A company has several options to finance the gap and the amount of capital, financing costs, existing leverage, and time availability can help determine the appropriate funding alternative.

One of the easier routes for REITs to raise capital is accessing the unsecured debt market. With most REITs rated in the Baa/BBB (Moody's/S&P) category, the cost of unsecured debt tends to be favorable. The non-traditional REIT converts that we have tracked for this report have tapped the debt market (including unsecured high-grade and revolving credit) for approximately two-thirds of their capital requirements since conversion.³

There are several options to raise equity. A company looking at a cost-effective alternative to raise equity can induce early conversion on existing convertible debt. This can help conserve cash and eliminate coupon. A company that requires a fixed amount of proceeds on a particular date and has time commitment from its senior management can opt for a registered follow-on equity offering.^{xiii} The follow-on equity offering has been the favored route for non-traditional REITs to raise additional equity.⁴ In contrast, a company that requires cash over an extended period of time and on a need basis can take advantage of the equity drawdown program (EDP).^{xiv}

^{xiii} In a registered follow-on equity offering, new registered shares are offered to new and existing shareholders up to 20 percent of market cap.

^{xiv} In an equity drawdown program (EDP), banks act as placement agents and perform continual sale of shares in the secondary market up to 5-10 percent of market capitalization or 10-20 percent of average daily traded volume (ADTV) sold daily without market interruption.

Tactical priorities

Priority 3: REIT regulatory and compliance requirements entail operational re-engineering

- Has the company done sufficient tax due diligence?
- Does the company have appropriate infrastructure in place to monitor the ongoing reporting and compliance requirements?
- Does the company have a change management plan?

There are several tax considerations for a company considering a REIT conversion. Stakeholders may want to understand the implications of any built-in gains at the date of conversion; realizations of such gains are subject to corporate level tax for a 10-year period post conversion. For example, during the 10-year period following the REIT conversion, Weyerhaeuser Company is expected to pay corporate level tax on the built-in gain (excess of fair market value over tax basis as of January 1, 2010) on disposed properties (except standing timber).⁵ Also, given that the income-producing assets must be treated as real estate for a REIT status, a company may have to modify their current depreciation method for certain assets. For example, if a company has historically treated assets as equipment, it may need to modify its treatment to real estate. The modification generally results in a correction of the historic depreciation, which may lead to a large adjustment to income and subsequently a substantially high tax charge prior to conversion. For instance, an information management company estimates that the total recapture of its depreciation and amortization expenses will likely result in tax liabilities of approximately \$225 million to \$275 million, which is to be paid within five years, beginning 2012.

Further, a company will have to develop and document appropriate processes and controls and establish an enabling technology platform that can support a timely and efficient closure, consolidation and process for financial and tax reporting. This may involve evaluation of appropriate technology infrastructure alternatives and identifying improvements in internal controls and accounting.

In addition, a company should have adequate financial controls to ensure that transactions between the REIT and its TRS are conducted at arm's length, as a failure may result in 100 percent tax on the shortfall amount. It is customary for companies to perform transfer pricing studies to document the appropriate charges and fees between the REIT and its TRS. Also, certain prohibited transactions, such as sales of dealer property, may trigger a 100 percent tax on the income generated by such transactions.

In summary, it is imperative for a company considering conversion to a REIT to have appropriate internal and external resources that will monitor its compliance with the myriad REIT tax requirements and qualification tests on an ongoing basis, unlike a C-corp. A company also needs to design an effective "soft" change management plan for a successful execution, which will accompany the "hard" change in structure and/or technology.⁶ This is because a conversion may include aspects such as management changes, to include professionals well-versed with the nuances of running a REIT business. Proactive management of the transition and communication should help to retain top performers.⁷

Conclusion

A conversion can be a time consuming affair. Recent cases of conversion show that companies may take at least 18-24 months following a board approval to restructure and convert to a REIT. A company will generally obtain a private letter ruling from the Internal Revenue Service to validate certain aspects of their ability to qualify as a REIT, which requires time as the assets are unique compared to the traditional ones. In addition, shareholder approval for a conversion can take some time.

That said, a company will convert if the due diligence implies that the potential post-conversion benefits outweigh the costs associated with the strategic and tactical priorities outlined here. Given the intricacies involved with conversion and maintenance of a REIT status, it is important for a potential convert to understand the actions that can help in a successful conversion and lead to short- and long-term value creation.



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Endnotes

¹ FactSet, Deloitte Analysis

² Weyerhaeuser Company 10K, FY2010

³ Thomson SDC, Deloitte Analysis

⁴ *ibid.*

⁵ Weyerhaeuser Company 10K, FY2010

⁶ Aaron Eisenberg, Robyn Wagner Skarbek, and Dan Mchugh, Strategic Change: Living in interesting times — and taking charge. Deloitte, 2010, http://www.deloitte.com/view/en_US/us/Services/consulting/all-offerings/9bd113049370c210VgnVCM2000001b56f00aRCRD.htm, accessed January 15, 2013

⁷ *ibid.*

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