2019

REIT IPO Market Update

By Brian Hirshberg, Anna Pinedo, Yelena Dunaevsky and Tom Shen

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Interest Rate Hikes Subdue REIT IPO Market in 2018

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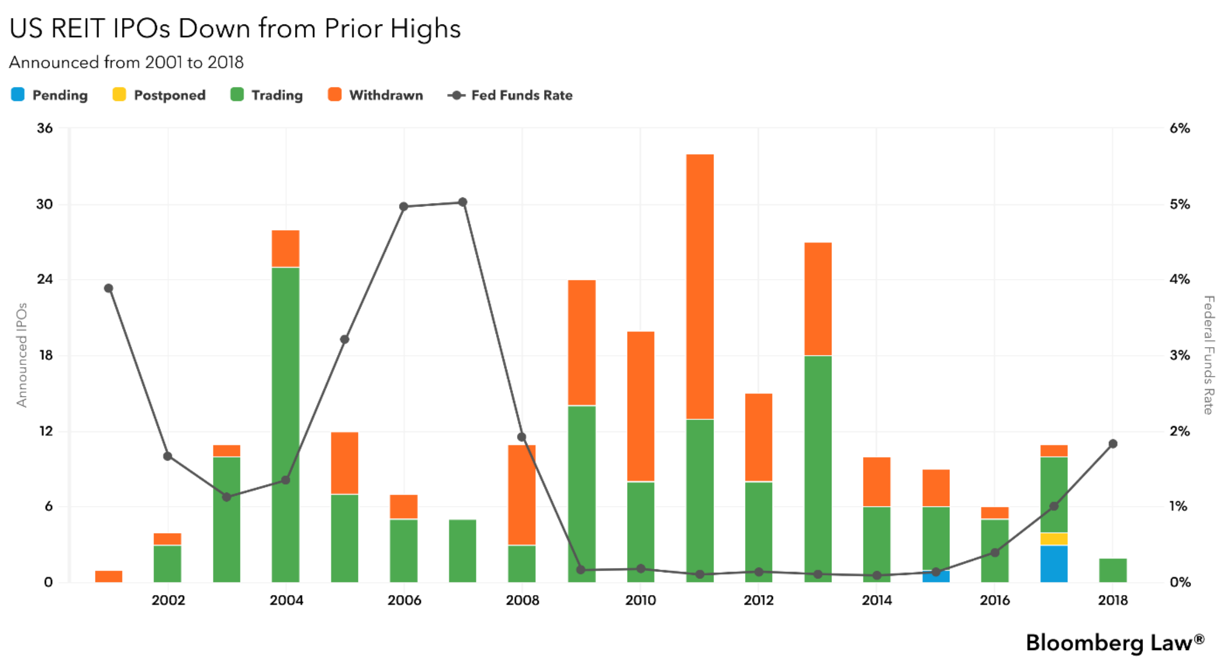
Real estate investment trusts ("REITs") faced a difficult capital-raising market in 2018 due to rising interest rates, a softening real estate market, economic uncertainty and resulting market volatility. In 2018, the FTSE NAREIT All REITs Index fell approximately 4.1%. During 2018, many publicly-traded REITs traded at a significant discount to their reported book values compared to private real estate vehicles, the broader equity market and fixed income market. This resulted in a significant impediment to initial public offering ("IPO") and follow-on offering activity for REITs and an acceleration of the consolidation that the REIT sector experienced in 2017.

Public Markets are Underperforming

Ultra-low long-term interest rates, a limited supply of real estate and elevated property valuations have been chief contributors to strong and sustained performance in the equity REIT sector since the last recession in 2008. However, given the recent Federal Reserve interest rate hikes and the resulting higher interest rate environment, announced U.S. REIT IPOs declined from 11 in 2017 to two in 2018.

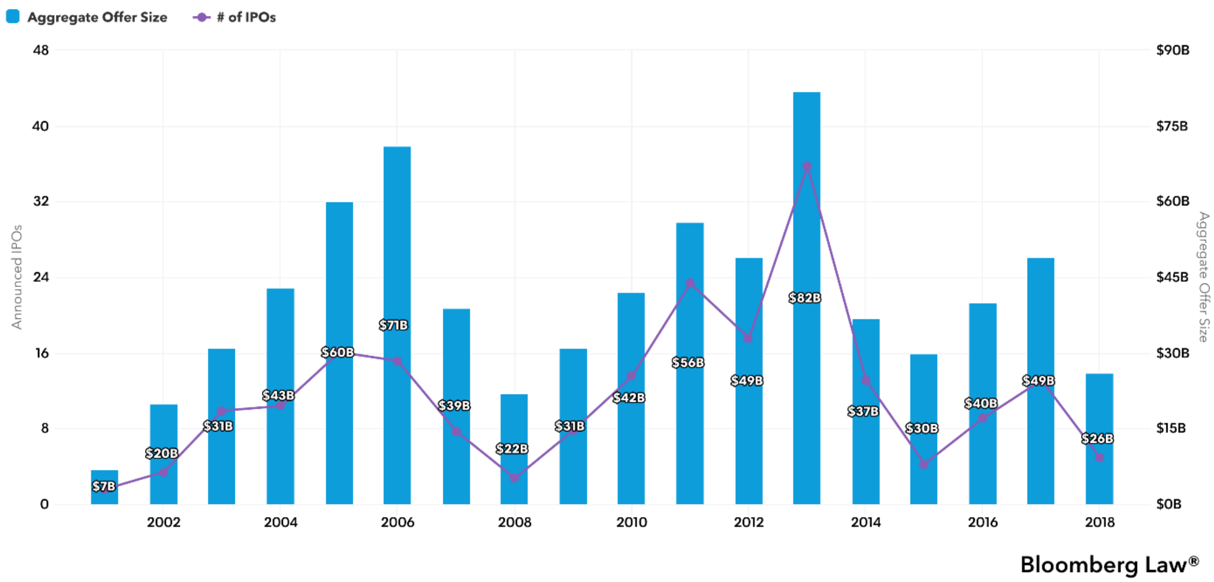


It is interesting to note a smaller percentage of REIT IPO withdrawals in the last three years compared with the withdrawal activity between 2008 and 2015. This indicates a more measured approach by issuers and underwriters, perhaps opting not to go ahead with an IPO at all, instead of filing for an IPO and then withdrawing. As discussed below, many REITs may be opting to raise capital privately, grow in scale and defer accessing the public markets for IPOs.

Worldwide, the number of REIT IPOs decreased by 47% from 49 REIT IPOs in 2017 to 26 REIT IPOs in 2018. This past year, 2018, was the worst year in a decade when measured by amount of funds raised, and one of the worst measured by number of IPOs. Notwithstanding these recent worldwide REIT IPO market challenges and the decline in the number of offerings, the median REIT IPO offering size increased approximately 42% from $108 million during 2015 and 2016 to $153 million during 2017 and 2018, as the market remained receptive to larger offering sizes for attractive property portfolios.

Worldwide Announced REIT IPOs at Decade Low in 2018

Announced REIT IPOs from 2001 to 2018



Private Markets are Stepping In

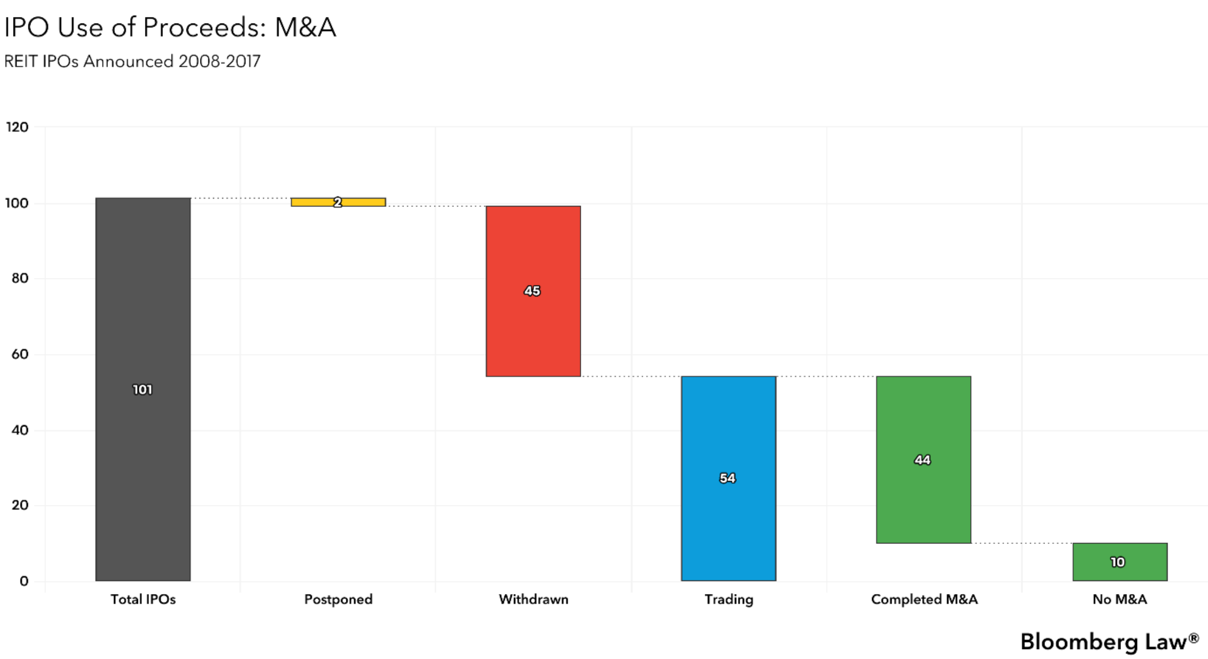
As a result of the difficult IPO market, late stage private capital raises for privately-held companies became the preferred method of financing for many new companies, including REITs, in 2018. Privately-held REITs, after considering their liquidity options, have more often turned to late stage private placements as an alternative to IPOs. Late stage private placements with institutional investors, cross-over investors and strategic investors eliminate a number of the issues associated with an IPO and often provide more capital to the REIT than an earlier stage financing. Privately-held REITs can also set up or sponsor liquidity programs for their early investors, employees and consultants to address concerns resulting from the lack of a public trading market.

Uptick in REIT M&A Transactions

Notwithstanding the slowdown in the REIT IPO market, the value of REIT M&A transactions increased substantially in 2018, with significant M&A activity. While the number of deals in 2017 and 2018 decreased slightly from the high of 475 deals in 2014, the total transaction value of REIT M&A transactions was $81 billion during 2018 compared to $67 billion during 2017. Most of the M&A activity was driven by the persistent undervaluing of REIT properties by the public market, which resulted in natural consolidation and going-private transactions. The acquisition of GGP Inc., a shopping mall REIT, by Brookfield Property Partners LP for a total transaction value of $27.1 billion represented the largest REIT M&A transaction in 2018.

How do REITs Use IPO Funds?

We analyzed the stated use of proceeds in REIT IPO prospectuses. M&A financing was cited as the principal intended use of proceeds, outside of general corporate purposes.



Over 80% of currently trading REIT IPO issuers that identified M&A as one of the stated uses in their use of proceeds did indeed successfully complete an M&A transaction of one million USD or more after going public. Again, it is interesting to note the high percentage of withdrawn IPOs.

Despite the high rate of IPO withdrawals, out of 76 withdrawn REIT IPOs (all U.S. IPOs, not just the ones listing M&A in their use of proceeds), only seven became targets of an M&A deal. That might not be enough to conclude that an M&A exit by would-be REIT IPO issuers is a popular alternative to an IPO.

Regulation A is a REIT Magnet

In lieu of the traditional REIT IPO, Regulation A offerings have become an increasingly important capital-raising tool for REITs. Regulation A is an exemption from registration for public offerings with two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period. For the three years from effectiveness of the amendments to Regulation A in 2015 through September 30, 2018, 257 offerings were qualified and nearly $1.3 billion was raised in Regulation A offerings. Real estate and REIT offerings account for the largest percentage of these transactions.

Another Alternative: Forward Sale Arrangements

REITs also increasingly opted to use forward sale arrangements in order to raise capital in 2018 due to uncertainty relating to increased market volatility. Forward sales allow REITs to sell their shares in the future at a specified price, less a discount, by entering into a forward sale agreement with a forward purchaser as part of the REIT's follow-on offering. The forward purchaser borrows shares from the market in order to allow the affiliated underwriter to sell the REIT's shares in the follow-on offering. The number of REIT forward sale issuances increased substantially in 2018. During 2018, there were nine REIT forward sale issuances, which raised an aggregate of approximately $5.2 billion with a median forward term of 12 months.

REIT Sector Performance

Despite the difficult market conditions, the best performing REIT sectors in 2018 were freestanding retail REITs and manufactured home REITs (13.9% and 11.4%, respectively), primarily due to their low valuations at the start of the year. The Diversified REIT category was the most active from 2002 to 2018, logging in 236 priced IPOs and raising $53.2 billion. The next most active REIT sector was the office property sector, which produced 81 IPOs and raised a total of $30.2 billion.

Commercial real estate markets broadly maintained momentum through the end of 2018, as net absorption continued at a high level across major property types. In particular, demand exceeded supply growth for office, retail and apartment markets. With respect to REIT sector performance, the number of REIT IPOs in the warehouse/industrial sector continued to increase primarily due to the continued expansion of e-commerce, limited supply of properties and rising rents.

Warehouse/Industrial REITs

There was only one warehouse/industrial REIT IPO in 2015 and there were three in 2016, but the number went up to 7 in 2017 before dipping down to two in 2018. The 2017 uptick may be explained by the fact that the e-commerce industry (including Amazon) continues to require additional warehouse and industrial space to satisfy increasing customer demand. This trend may result in another uptick in warehouse/industrial REIT IPOs in 2019. Industrial REITs include data center and distribution center REITs that are experiencing similar growth due to the expanding e-commerce sector.

Shopping Center REITs

Conversely, the number of shopping center REIT IPOs declined in 2018 with only four IPOs completed during 2017 and one in 2018.

Healthcare REITs

Healthcare REITs have also experienced a similar downward trend with only one IPO completed in 2017 and no IPOs in 2018 compared to three IPOs in 2015 and two in 2016. However, the already public healthcare REITs delivered a strong total return (7.58%) in 2018, suggesting a potentially positive outlook into 2019. The uncertainty of future U.S. healthcare regulatory policy has likely contributed to the overall downward trend in that REIT sector.

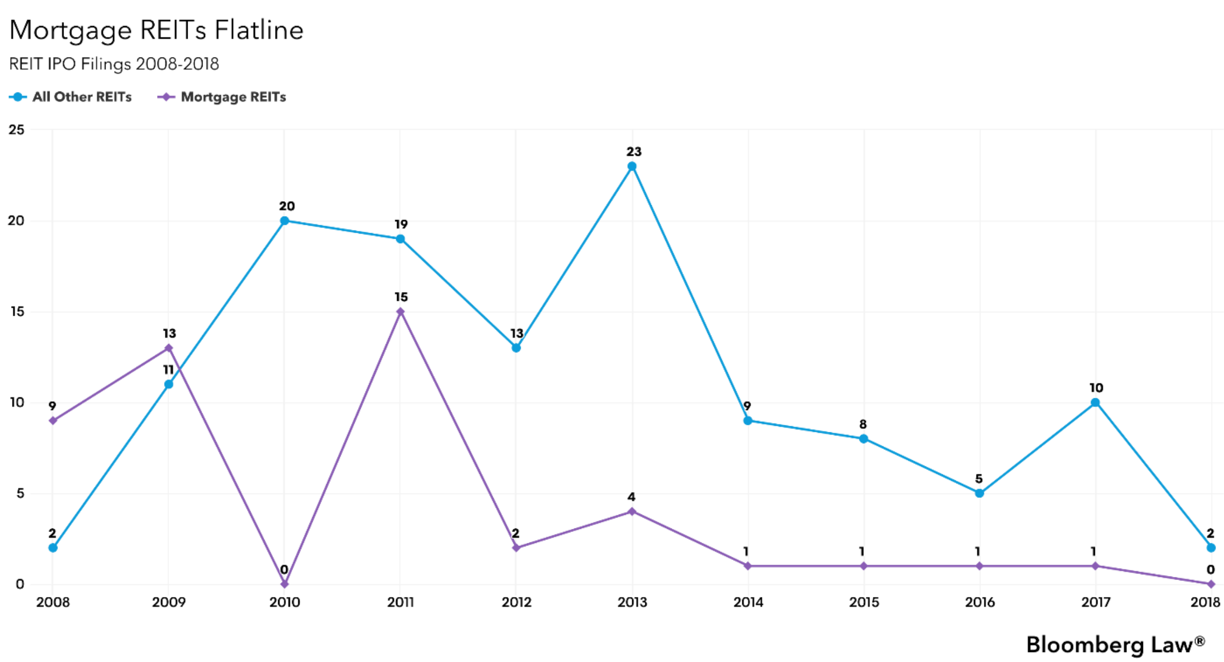
Mortgage REITs

Mortgage REIT IPOs continued their five-year slump in 2018. Between 2014 and 2018 there were only one or two mortgage REIT IPOs per year, a decline from between three and seven IPOs per year between 2009 and 2013 (with the exception of 2010, which did not produce an IPO). Unfortunately, U.S. regulatory constraints have limited the ability of mortgage REITs to expand into new mortgage-related asset classes. Mortgage REITs rely on the Section 3(c)(5)(C) exemption and related interpretations in order to be excluded from the definition of "investment company" under the

[Investment Company Act of 1940](#) ("1940 Act"). To qualify for the Section 3(c)(5)(C) exemption, a mortgage REIT must comply with strict asset tests, including having at least 55% of its assets consist of mortgages.

In August 2011, the SEC issued a concept release questioning the exempt status of mortgage REITs under Section 3(c)(5)(C) of the 1940 Act. The concept release did not propose any new rules but rather informed the market that the SEC was in the process of reviewing various interpretations of the 1940 Act exemption as it pertains to mortgage REITs. Due to the resulting regulatory uncertainty, the concept release generated significant negative reaction and a perception that mortgage REITs may be materially hindered or limited in the manner in which they have historically conducted their businesses. As a result, the mortgage REIT IPO market deteriorated significantly following 2011, as illustrated by the below graph. The SEC did not follow the issuance of the concept release with any specific guidance until the publication of the Great Ajax Funding LLC No-Action Letter in early 2018.

In that No-Action Letter, the Staff of the Securities and Exchange Commission ("SEC") indicated that a particular mortgage REIT's assets, sources of income, historical development, and public representations may evidence that the mortgage REIT is primarily engaged in the real estate finance business and, therefore, should be able to rely on the Section 3(c)(5)(C) exemption. Hopefully, mortgage REITs obtain confirmation from the SEC Staff regarding new mortgage-related asset classes in order to provide industry certainty and potentially reverse the prolonged mortgage REIT slump. Relatedly, legislation expanding the current Section 3(c)(5)(C) exemption to include all risk-sharing transactions, including credit risk transfer securities, was released by the House Committee on Financial Services for discussion in 2018 without any further development. This legislation is expected to be reintroduced in the current session of Congress.



Non-Listed REITs

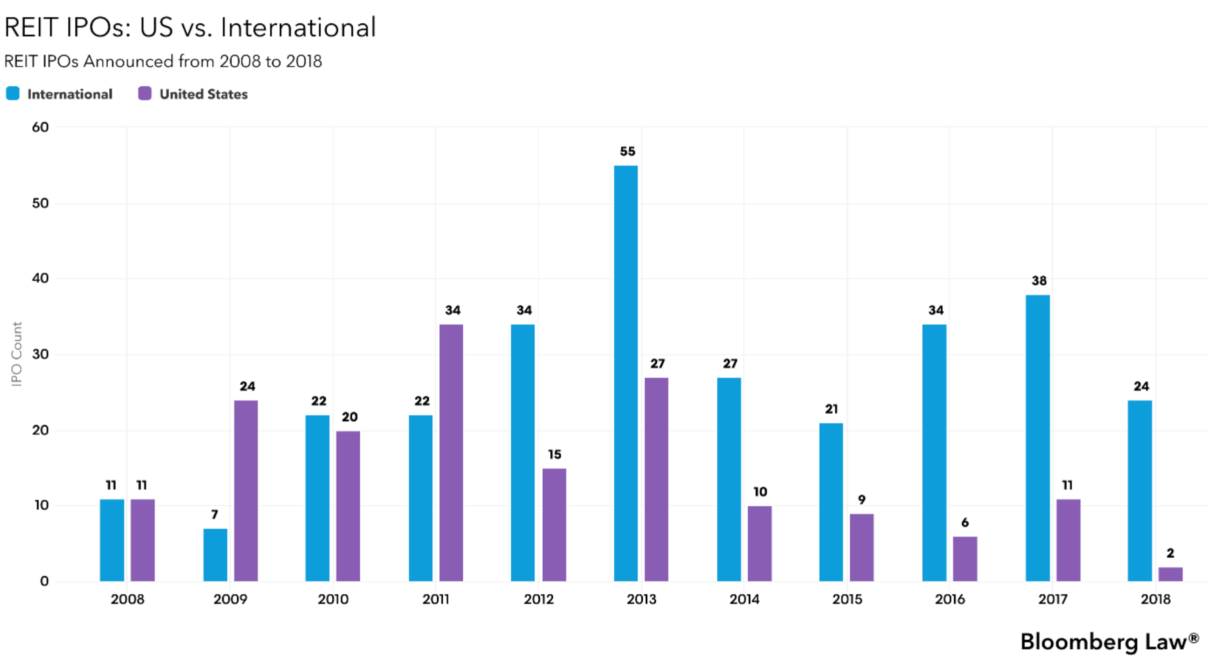
Despite the stock market volatility experienced in 2018, non-listed REITs had an encouraging year with strong fundraising as investors sought to increase their investment exposure to alternative assets. Non-listed REITs register with the SEC but their securities do not trade on a national securities exchange. Prior to 2018, financing in the non-listed REIT sector had been on a downward trajectory since the sector's peak in 2013. Importantly, the entrance of Blackstone into the non-listed REIT market in 2018 gave the sector a significant increase in liquidity and credibility. Additionally, the final repeal of the Department of Labor's fiduciary rule during 2018 removed a regulatory hurdle to investment in non-listed REITs.

Future REIT Performance in Light of New Tax Law

In the United States, the 2017 Tax Cuts and Jobs Act introduced several new measures affecting REIT taxation. One of the central features of the tax bill is a new 20% tax deduction on pass-through income. This deduction applies to businesses that operate as pass-through entities, including REITs, allowing REIT shareholders to benefit from the deduction. The tax bill is expected to indirectly benefit certain REIT sectors by generally increasing corporate profits and providing a stimulative impact on the U.S. economy resulting in an increased demand for REIT properties. Rising property demand is expected to lead to higher property prices enabling equity REITs to raise rents on higher quality tenants. Cyclical REIT sectors, such as hotel, industrial and office REITs, are expected to derive more indirect benefits from the U.S. tax reform than are less cyclical sectors, such as healthcare.

Non-U.S. REIT Market

While the United States remains the largest listed real estate market in the world, the listed real estate market is increasingly becoming a global phenomenon. The growth is being driven primarily by the appeal and success of the U.S. REIT approach to real estate investment. More than 35 countries have adopted the U.S.-based REIT approach to real estate investment, and interest rate trends are now more favorable to international REITs than to U.S. REITs. As a result, the number of REIT IPOs consummated outside of the United States has been growing. Comparing all announced international REIT IPOs to U.S. REIT IPOs, it is interesting to note the tide turning sharply in favor of international deals in 2011. Beginning in 2012, the international REIT IPO market has completely overwhelmed the continuously declining U.S. REIT IPO market, a trend that is likely to continue for the foreseeable future.



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