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Riding a Wave of REIT M&A

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Highlights

- Buyers ranging from private equity firms to sovereign wealth funds to public listed companies are paying attractive premiums to existing share prices to acquire listed REITs.
- The buying is being driven by a rising mountain of private equity capital resulting from investor appetite for yield and diversification, and the gap between listed values and the private market.
- REIT management may take steps to eliminate the disconnect in valuations that is fueling the takeout offers.

Significant demand for commercial property and attractive values in listed real estate companies have driven increasing M&A activity in recent quarters. We expect continued buyout activity to provide potential support for REITs for the foreseeable future.

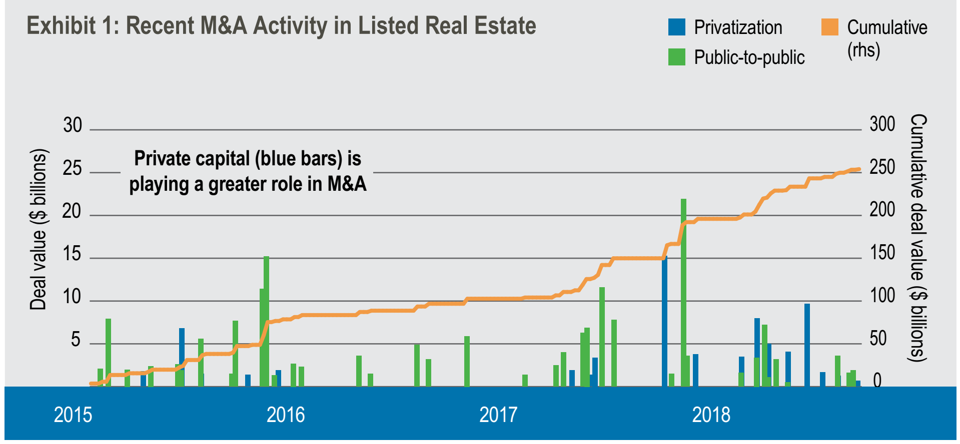
An Influx of Private Equity

Real estate mergers and acquisitions (M&A) activity in the U.S. is at levels not seen in more than a decade, while Europe, Australia and other markets are seeing heightened deal-making as well. The buyers increasingly include private equity investors, who see REITs as attractively priced compared to the private market values of their underlying properties (Exhibit 1).

Evolving deal focus. Through much of the recovery since the financial crisis, buyers typically acquired distressed or poorly managed companies with expectations of improving operations to boost profitability. But as occupancies, rents and cash flows improved with the economy, the easy targets disappeared and buyers increasingly had to pay greater prices to induce shareholders to sell.

Today's buyers are paying sizable premiums to spot prices for a range of opportunities: from core portfolios that can be enhanced through better management or expense control, to more opportunistic approaches in which buyers can turn around mismanaged or poorly positioned assets. Prices for recent acquisitions have on average occurred at a 20% premium to the stock prices of the target companies prior to the buyout offers, but they are always bought with the belief that more value can be extracted from them under new management.[a]

Exhibit 1: Recent M&A Activity in Listed Real Estate



At October 31, 2018. Source: Bloomberg, Cohen & Steers.
See page 4 for additional disclosures.

(a) Average premium bid relative to the 20-day average closing share price at the time of the initial offer for all deals in the 12 months ended October 31, 2018.

Buyers casting a wide net. Recent transactions have occurred across a wide range of sectors and regions (Exhibit 2).

Exhibit 2: Selected Acquisitions Announced in the Last 12 Months

Target	Country	Sector	Buyer	Deal Type	Deal Announced	Total Value ($ Billion)	Premium to Share Price[a]
Forest City Realty	U.S.	Diversified	Brookfield	Private	07/31/18	9.7	11
Education Realty	U.S.	Residential	Greystar Real Estate	Private	06/25/18	4.1	21[b]
Investa Office	Australia	Office	Oxford Property Group	Private	05/28/18	3.2	20
LaSalle Hotels	U.S.	Hotel	Pebblebrook	Public	05/21/18	5.0	48
Gramercy Property	U.S.	Industrial	Blackstone Group	Private	05/07/18	7.2	21
DCT Industrial	U.S.	Industrial	Prologis	Public	04/29/18	8.0	15
Hispania	Spain	Hotel	Blackstone Group	Private	04/05/18	2.3	8
Victoria Park	Sweden	Residential	Vonovia	Public	04/01/18	1.6	19
Pure Industrial	Canada	Industrial	Blackstone Group	Private	01/09/18	2.0	21
BUWOG	Austria	Residential	Vonovia	Public	12/18/17	3.6	23
Westfield	Australia	Retail	Unibail-Rodamco	Public	12/12/17	21.9	18
GGP	U.S.	Retail	Brookfield	Private	11/13/17	15.3	23

At October 31, 2018. Source: Bloomberg.
Data quoted represents past performance, which is no guarantee of future results. (a) Offer premium to the stock's 20-day average closing share price prior to the announcement. (b) Offer premium to the 20-day average closing share price prior to the company announcing it was for sale. See page 4 for additional disclosures.

Three Factors Driving M&A

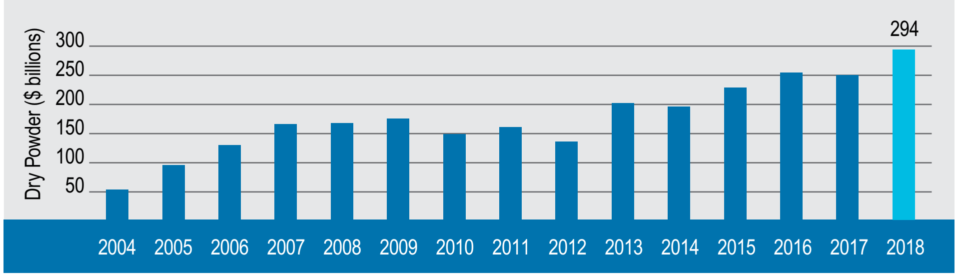
Soaring demand. Institutional interest in real estate has never been better, in our opinion. A recent survey of institutional investors in 29 countries found that real estate allocation targets rose to 10.4% this year, up from 10.1% in 2017, and are projected to rise further next year. Healthy demand is also evidenced by the sharp rise in private fundraising for commercial real estate. Private equity fund managers currently hold $294 billion of uninvested capital earmarked for real estate investment, according to market intelligence firm Preqin (Exhibit 3), and new funds are being raised every month.

This growing cache of "dry powder" is largely a function of the investors' never-ending search for income, total return potential, inflation protection and diversification. Investors are looking increasingly to public listed real estate, where they can deploy capital on a large scale, buying companies that are trading at discounts to underlying asset values. Why do these opportunities exist?

Recent underperformance. Although listed real estate has historically outperformed private real estate, the stocks have

A record $294 billion in assets is on the sidelines seeking to buy what REITs own

Exhibit 3: Uninvested Private Capital Seeking Commercial Real Estate



At September 30, 2018. Source: Preqin.

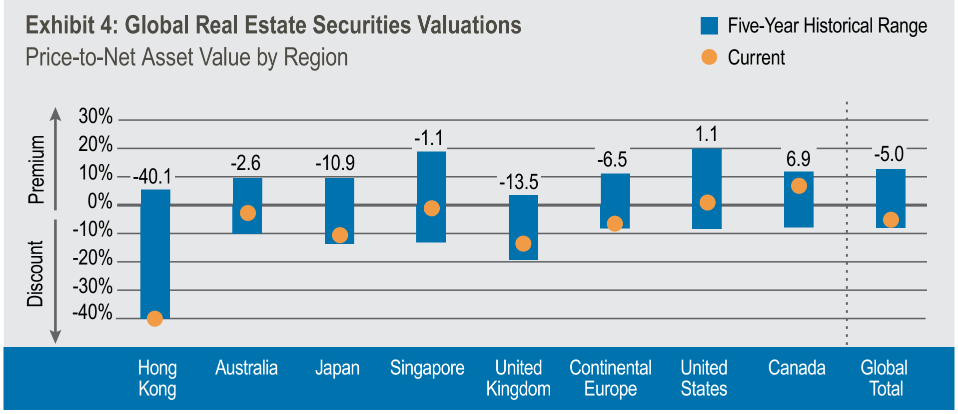
Dry powder is the amount of capital that has been committed to a private equity fund, minus the amount that has been called by the general partner for investment. See page 4 for additional disclosures.

underperformed both private real estate and the broad equity market since May 2013, when the U.S. Federal Reserve announced plans to taper its bond-buying program. Real estate securities have been unusually sensitive to interest rate movements and rate expectations, reflecting concerns that the transition away from quantitative easing may affect real estate more than stocks or bonds and leading to outflows from REIT mutual funds and exchange-traded funds. In many cases, the M&A activity occurring is due to buyers identifying arbitrage opportunities between private and public property prices in the wake of REITs' underperformance.

Attractive NAVs: Real estate securities can trade at premiums or discounts to their net asset values (NAVs). Currently, they collectively trade at a 5% discount to NAV (Exhibit 4), although there are many REITs trading at more significant discounts. This demonstrates that M&A opportunities still exist in markets where valuations may appear elevated relative to historical averages.

Many high-quality companies continue to trade at discounts to their underlying assets

Exhibit 4: Global Real Estate Securities Valuations
Price-to-Net Asset Value by Region



At October 31, 2018. Source: Cohen & Steers.

Net Asset Value seeks to calculate the net market value of all of a company's assets after subtracting liabilities. The 5-Year Historical Range is calculated using Cohen & Steers' valuation metrics and is based on the FTSE EPRA Nareit Developed Real Estate Index—net at the end of each month. Current numbers are calculated using Cohen & Steers' valuation metrics and are based on securities that are in Cohen & Steers' coverage universe, which represents a 97% overlap with securities included in the FTSE EPRA Nareit Developed Real Estate Index. Sectors, such as infrastructure, are covered by Cohen & Steers but are not in the FTSE EPRA Nareit Developed Real Estate Index. See page 4 for index definitions and additional information.

The Role of Leverage in Private Buying

Listed real estate may be all the more compelling to private equity investors given that potential returns can be enhanced through the use of leverage. Private "core plus" real estate funds, frequent buyers of listed real estate recently, historically have sought to earn an 8–11% annualized internal rate of return (IRR), net of fees, when assets are typically sold five to eight years after purchase. By employing greater leverage than the average listed REIT uses, private equity investors can generate a higher return on equity, which enables them to pay a greater premium to the share price than public peers and still expect to meet their IRR target. And if a private buyer can acquire a REIT at less than NAV, the leverage can potentially enhance its return even more.

The existence of opportunities for investors to acquire public REITs at parity to NAV or less is what is fueling the continued takeover activity by both public and private investors.

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What the M&A Means for REITs

Private equity buying publicly traded real estate companies at meaningful premiums is an indication of the value available today in REITs—values that are underpinned by the tangible real assets the REITs own.

As we move into the later stages of the economic cycle, the significant capital committed to real estate assets and the opportunities for acquisitions may provide a floor under listed real estate valuations, bringing them more in line with private real estate values. Combined with improving cash flow growth, this may serve to create greater total return potential in the next several years. In the meantime, where differences in listed and private equity valuations remain, REIT management teams may take steps to close the valuation gap, with measures such as:

- Buying back shares at a discount to NAV
- Selling properties at NAV or above to prove out valuations to the market and redeploy capital or pay a special dividend
- Selling the entire company to realize the full NAV

A less common, but powerful, tool to unlock potential is to replace the executive management of an underperforming REIT. While resistance can be formidable, responsible boards can and occasionally do replace management teams that have failed to close performance or valuation gaps over time.

Enhanced potential through active fund management. Applying insights on various property sectors and local geographies, active public REIT fund managers can add value by purchasing a basket of real estate securities, with strong fundamentals and trading at discounted valuations, that they believe offer attractive risk-adjusted return potential. Companies with these features are more likely to be targeted by asset acquirers, in our opinion.

Index Definitions. *An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.* The FTSE EPRA Nareit Developed Real Estate Index is an unmanaged market-weighted total return index which consists of many companies from developed markets who derive more than half of their revenue from property-related activities.

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