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REITs May Focus on "Tactical Mergers" and Co-Investment Deals in Coming Months

REIT M&A activity in 2019 hasn't matched last year's impressive levels. That may be because the REITs are changing direction.

John Egan | Oct 18, 2019

M&A activity involving publicly-traded equity REITs soared to nearly $76.3 billion in 2018, a peak not reached since 2007, Nareit data shows. With a little over two months remaining on the 2019 calendar, it's highly questionable whether last year's impressive level of M&As will be matched this year though.

Through Aug. 31, Nareit had recorded just four REIT M&A deals, valued at nearly $5.8 billion. That tally includes the $2.7 billion merger of Park Hotels & Resorts Inc. and Chesapeake Lodging Trust , and the $2.3 billion marriage of Cousins Properties Inc. and TIER RIET Inc. Those two mergers were public-to-public transactions.

So, what will happen with REIT consolidation through the rest of this year and into 2020? Experts say the possibilities range from executing "tactical" mergers to eschewing M&As in favor of co-investment deals.

Scott Robinson, director of the REIT Center at New York University's Schack Institute of Real Estate, says REIT mergers will likely become increasingly "tactical" in nature—what he calls "mergers by choice."

"The REIT industry has evolved tremendously over the past decade with governance, investment strategies and balance sheet stewardship all in solid shape. Plus, transparency and liquidity remain solid," Robinson says. "So, I don't anticipate a wave of consolidation driven by distressed situations."

Any near-term REIT M&A will be tempered by economic and political affairs, according to Greg Ross, national managing partner of the construction, real estate, hospitality and restaurants practice at accounting firm Grant Thornton LLP.

"While real estate indicators remain strong and consumer confidence remains high, the disruption and lack of a consistent message from Washington have impacted the overall outlook and trajectory of real estate market performance," Ross says.

Institutional, private equity and high-net-worth (HNW) investors remain confident in U.S. markets, Ross adds, "but we can expect the lingering trade issues with China and other global issues to have an impact on U.S. values."

Although there's been significant buzz this year about go-private transactions in the REIT industry —chatter buoyed by NAV discounts relative to stock prices—few go-private transactions are actually getting done, notes Spencer Johnson, head of the REIT practice at Atlanta-based law firm King & Spalding LLP. Through Aug. 31, just one public-to-private REIT deal (valued at $250 million) had been carried out, according to Nareit .

"You have to make sure there is real value to be unlocked from moving away from the public sector, get your financing lined up, tie up the transaction and then deal with the go-shop or other market-check mechanism," Johnson says. "It is a long way from here to there."

Rather than the privatization floodgates bursting open, Johnson says REITs will likely focus on expanding their platforms. This could include M&A, as well as co-investment deals, he says. Johnson offers this example of a co-investment arrangement: a joint venture that enables a REIT to retain control of assets it contributes to the JV.

"We believe this expansion is fundamental for REITs as this cycle gets longer in the tooth , and co-investment structures offer the most flexibility in accomplishing these goals."

Still, NYU's Robinson says 2020 could turn out to be a solid year for REIT M&As, thanks to falling interest rates, economic uncertainty, stock market volatility, a growing demand for yield and an "incredibly deep pool" of dry powder.

In terms of dry powder, Maureen Blair, an audit partner at New York City-based accounting firm EisnerAmper, says undeployed capital held by private real estate investment funds (estimated in 2018 at $323 billion in the U.S.) and high valuations make it tough to find deals that generate targeted returns. As such, real estate fund managers are stepping up their pursuit of alternative yield-producing assets, says Chuck Gill, a partner at EisnerAmper. For instance, he says, some are switching from value-add to opportunistic approaches to assume more risk and conceivably reap greater returns.

Aside from dry powder and related considerations, Robinson believes a potential rise in REIT M&A activity next year will stem from:

- A "Darwinian effort to rationalize the landscape of poor-performing sectors," namely retail. He thinks that given that 32 retail REITs are listed on the FTSE NAREIT U.S. Real Estate Index , small-cap retail REITs are particularly ripe for consolidation.
- A desire within top-performing segments such as industrial to capitalize on economies of scale.
- Rare "tactical" mergers like the Cousins-TIER REIT deal.

"As long as interest rates remain low , there will be consolidation in the real estate sector," says Patrick Healey, founder and president of Caliber Financial Partners LLC, an investment advisory firm in Jersey City, N.J. "In particular, we've seen a lot of private equity firms that are raising a boatload of investor capital, both institutional money as well as individual or retail money, and that money needs to be put to work."

All in all, publicly-traded equity REITs "are likely to prosper in an environment of easy monetary policy," according to the recently released *Emerging Trends in Real Estate 2020* report from the Urban Land Institute (ULI) and professional services firm PwC.

"The REITs have little to worry about from 'end of cycle' concerns. Debt discipline is the REITs' saving grace: low balance sheet indebtedness and a 'laddering' of maturities that spreads risk," an unidentified REIT dealmaker told ULI and PwC researchers.

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