

How to Structure and Operate a REIT

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In 1986, private letter rulings from the Internal Revenue Service allowed Real Estate Investment Trusts (REITs) to assume responsibility for selecting investments and managing assets, and to obtain “self advised” and “self managed” status. Since then, we have seen the birth of approximately 170 public REITs in the United States, which currently own roughly one-third of all U.S.-based commercial property, with a combined asset value estimated at more than \$500 billion. REIT performance has been impressive over the last six years with returns of approximately 180 percent.

REITs today are well capitalized, highly structured, and disciplined and they have created great investment vehicles for investors who want liquid investments in brick-and-mortar assets yielding a steady dividend. Overseas, REITs are still in the early development stage, and their future opportunities are significant.

Qualifying for REIT Status

To qualify as a REIT, a company must comply with certain code provisions within the Internal Revenue Service Code. The Tax Code requires that a REIT company’s features include:

- taxed as a corporation;
 - managed by a Board of Directors or Trustees;
 - fully transferable shares;
 - a minimum of 100 shareholders;
 - no more than 50 percent of the shares held by five or fewer individuals during the last half of the taxable year;
 - at least 75 percent of the total assets invested in real estate;
 - at least 75 percent of its gross income derived from rents from real estate property or mortgages on real estate property;
 - no more than 20 percent of its assets consist of stocks in taxable REIT subsidiaries;
- and

- pay at least 90 percent of its taxable income annually in the form of shareholder dividends

There are both private and public REITs. Private REITs are not subject to accounting and reporting standards such as Sarbanes Oxley (SOX); however, a private REIT can lack liquidity and be difficult to value properly. Public REITs, on the other hand, generally have significantly better access to capital, greater liquidity, and more stringent reporting guidelines and standards.

There are REITs that own and, in most cases, operate income-producing real estate in product types such as apartments, shopping centers, offices, hotels, warehouses, prisons, and golf courses, among others. Most REITs specialize in one product type and spread risk by being in multiple markets. Public REITs are generally traded on a major stock exchange such as the New York Stock Exchange or NASDAQ.

Dividends and Tax Losses

A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate tax bill. As a result, most REITs remit 100 percent of their taxable income to shareholders and therefore owe no corporate tax. Taxes are paid at the shareholder level on the dividends received and any capital gains. Like other businesses, but unlike partnerships, REITs cannot pass tax losses through to their shareholders.

Operating a public REIT requires strong infrastructure in accounting, finance, SOX compliance, investor relations, and corporate governance. The estimated annual cost for a REIT to be public can be up to three percent of its funds from operation (FFO).

Taking Highwoods Public

My experience in forming a REIT came when I was with Highwoods Properties, Inc. (NYSE:HIW), which our partners took public in June 1994. Highwoods was founded in 1978 in Raleigh, North Carolina. While the company had grown over the succeeding decade by building and managing office buildings in the area, by the early to mid-90s, banks were hesitant to lend funds for speculative or partially pre-leased real estate development, and the United States was in the midst of a recession. We felt that we needed better access to capital in order to expand our business. Our partners evaluated the REIT structure and studied the prospectus of the first pure public office REIT in the United States—the Carr REIT, headquartered in Washington, DC.

After studying the REIT vehicle, we spent considerable time talking to financial and real estate experts to determine if becoming a public REIT was the best course for Highwoods' future. We began working with Merrill Lynch in New York to take our Raleigh-based company public.

We realized that in order to succeed in our initial public offering, we had to achieve critical mass by increasing the size of our portfolio. Over a one-year period, we assembled a portfolio of 41 buildings. We decided that an UPREIT (Umbrella Partnership REIT) structure was best suited to our needs as this allowed owners of buildings we were acquiring to receive their proceeds in units (similar to shares of stock) where taxes were deferred until converted to common stock or the building was sold. For approximately 12 months, we worked around the clock to prepare for our IPO. Countless financial statements were run and each building and land parcel was thoroughly analyzed. During this process, one of the areas in which we invested significant resources was accounting. We hired seasoned financial personnel, and our company grew rapidly.

Merrill Lynch also spent a significant amount of time understanding Highwoods and Raleigh-Durham's rapidly growing office market. The next step was to prepare our prospectus which was

followed by an extensive and intensive roadshow where we met with potential investors. Key Highwoods' officers visited with potential shareholders throughout the United States and Europe telling the Highwoods story and emphasizing the company's strengths as a real estate developer and owner. During that time, we learned that *Fortune Magazine* had named Raleigh-Durham the number one place to live in the United States.

On June 6, 1994, we learned that our IPO was significantly oversubscribed and Highwoods was scheduled to begin trading on the NYSE the following day. The stock opened at a price of \$21 per share, and our initial market capitalization was approximately \$250 million. The Highwoods Properties partners at the time were the first shareholders, with each purchasing 100 shares on opening day.

Since its IPO, Highwoods has grown significantly and is now operating in 11 Southeastern markets. As of December 31, 2006, according to reports published by Highwoods, the company owned or had an interest in 392 office, industrial, and retail properties and had a total market capitalization of \$4.2 billion. In 2006, Highwoods generated a 50.6 percent total shareholder return and a 124.8 percent five-year total return.

REITs Offer Diversified Portfolio

The success of REITs continues today. They are considered a core part of a diversified investment portfolio as they offer large and small investors the opportunity to own hard assets, with a predictable revenue and income stream.