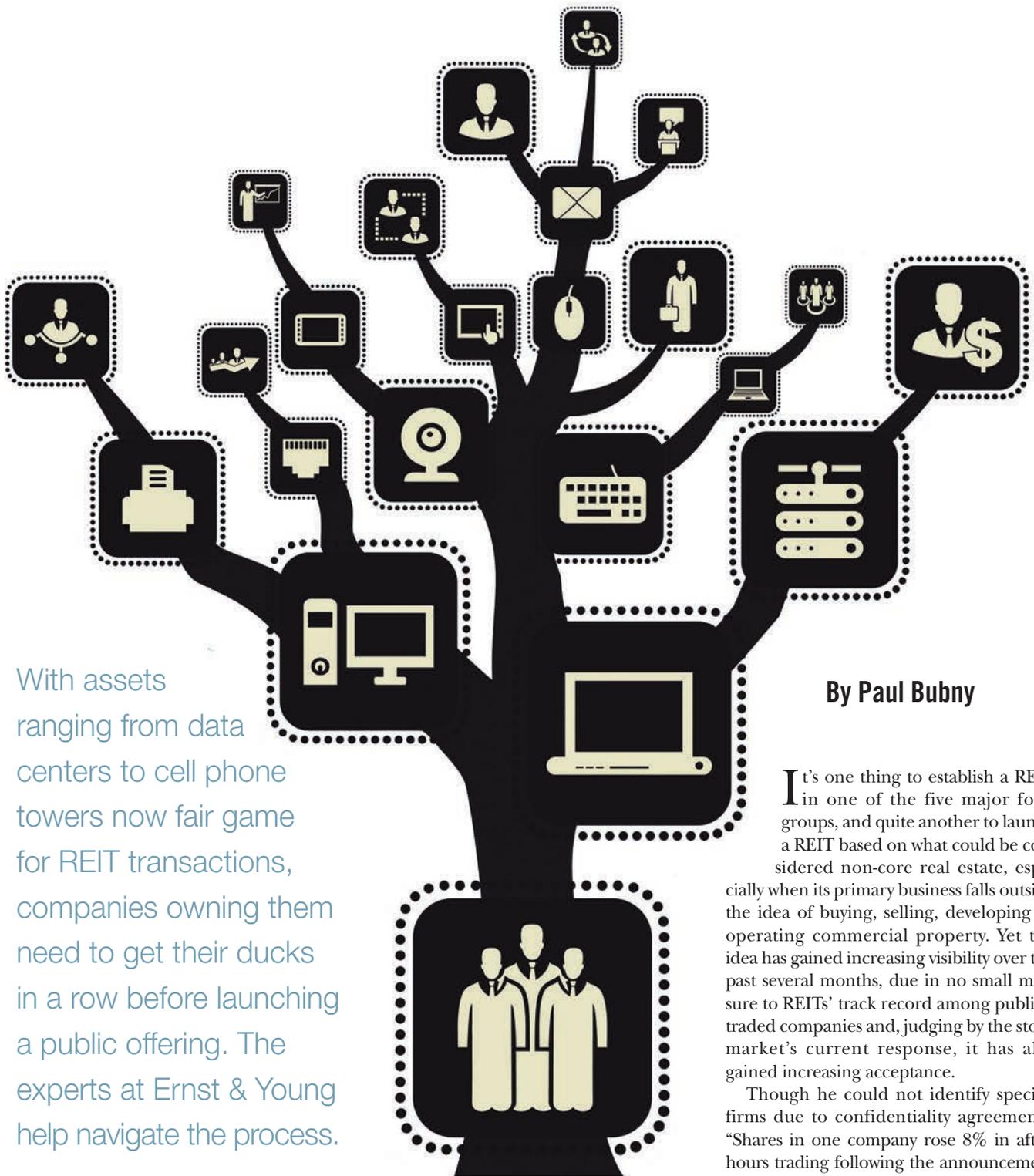


Unlocking Hidden Value:

The REIT Route for Non-Core Real Estate



With assets ranging from data centers to cell phone towers now fair game for REIT transactions, companies owning them need to get their ducks in a row before launching a public offering. The experts at Ernst & Young help navigate the process.

By Paul Bubny

It's one thing to establish a REIT in one of the five major food groups, and quite another to launch a REIT based on what could be considered non-core real estate, especially when its primary business falls outside the idea of buying, selling, developing or operating commercial property. Yet the idea has gained increasing visibility over the past several months, due in no small measure to REITs' track record among publicly traded companies and, judging by the stock market's current response, it has also gained increasing acceptance.

Though he could not identify specific firms due to confidentiality agreements, "Shares in one company rose 8% in after-hours trading following the announcement

of its intention to convert its outdoor sign company to a REIT,” Mike Straneva, Americas real estate leader at Ernst & Young, tells REAL ESTATE FORUM. “A gaming company saw its stock jump 25%” after announcing plans in May to spin off its real property assets into a publicly traded REIT. “However, regardless of the immediate market impact, the goal of companies adopting the REIT structure is to create sustainable shareholder value over a long period of time.”

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ROBERT LEHMAN, Global REIT Leader

ings to their shareholders. Robert Lehman, Ernst & Young’s global REIT leader, points out that taxes aren’t really the driver behind the growing interest in REITs. REITs are attractive to investors primarily because they create a yield-based investment option for shareholders and a potential “real asset” inflation hedge. “It has a lot to do with the fiscal policy that’s been set for the country and where interest rates are,” he says. “We’re really talking about the ability to unlock value from the real estate that may not be properly valued within the context of an existing business.”

The concept may be finding favor both with the public markets and with companies looking to derive greater income potential from their real estate, yet it’s not on account of being a no-brainer to execute. “This is a business and operational, and often transformational, analysis and decision,” says John Cullins, Ernst & Young’s Americas real estate tax leader. “So you’ve got to approach it from the standpoint of how this will impact all of your different stakeholders and how it affects the way you operate.”

Clearly, there are many questions to be

addressed, and Ernst & Young lately has taken the lead in educating its clients on just what these questions entail. Given that we’re living in a world where REITs are trading at a high number, “it makes sense for companies that aren’t necessarily real estate companies to at least evaluate the option,” Straneva says. “It may or may not make sense for companies to do. But it’s part of a business planning process today that people should consider.” That’s especially true when board members are asking about it, he adds.

When weighing the possibility of converting to REIT status, or spinning off part of the company into a separately traded entity, “you want to be sure that you evaluate it with people that really understand what REITs are,” says Straneva. “When you talk to non-REIT people, you talk about EBITDA. When you talk about the intricacies of how REIT FFO and AFFO work, and the type of disclosures that are required to be in that same peer group, it’s a different animal.”

Further, the tax treatment entailed by a REIT creates considerations of its own. Among them are the types of entities that would need to be set up to accommodate the REIT format, and obtaining a private-letter ruling from the Internal Revenue Service. “There’s a lot of value to create, but there’s certainly a lot of work to do,” Straneva comments.

It’s important to remember that “real estate is no longer four walls,” says Rick Sinkuler, Ernst & Young’s Global Markets Leader for the real estate practice. In addition to outdoor sign and gaming companies, these days real estate might be cell towers, data centers, pipeline facilities and prisons—all of which have been considered as the basis for a REIT structure. In addition to widening the circle of companies that might consider forming a REIT, it also widens the complexities associated with doing these types of transactions.

“You need to talk to somebody who’s knowledgeable, who’s done it before, who knows all the ins and outs of what works and what doesn’t,” Sinkuler says. “There’s a team of advisors. Start with investment bankers and corporate legal counsel, and tax professionals with non-core real estate and REIT experience; then, you need accounting professionals to understand the language and how the separate public company might trade and what’s different about it. If you have divestitures, you may have to look at contracts, legal arrangements and valuation to determine if you can meet the REIT test.”

The “core question,” says Lehman, is

this: does the company actually own real estate assets that would qualify for REIT treatment? “Then, it’s the nature of the real estate and how we use it,” he says. While a number of firms may not think of themselves as real estate companies, they may have assets on their books that put them “in the middle of the fairway” toward a possible REIT structure.

To determine whether those assets qualify, “you really look at the applicable tax authorities that have been established through the tax code as well as the regulations and court cases that interpret them,” says Cullins. In the big picture, he adds, “you need to be able to earn income for rental or for the use of the space. So then you start looking at how this real estate is used. Does it earn income from the rental or the use of this space? And if it doesn’t currently do that within your business model, can you perhaps restructure it to where it does?”

After determining the real estate’s value and income potential, “That’s when you really start looking at it from a REIT model standpoint,” Cullins says. “Numerically, does this make sense? Can it comply with the various income and asset tests that you have to meet in order to qualify as a REIT? Does it create enough shareholder value to justify transforming the manner in which the company operates?”

Once that question is answered, then there’s the matter of what type of REIT transaction makes most sense. The entire company could be converted to a REIT, for example, or a business line could be spun

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MIKE STRANEVA, Americas Real Estate Leader

off. There’s also a model in which the parent company forms a partnership with an existing or newly-formed REIT.

“There are differences in how you approach the structure,” Lehman says.



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RICK SINKULER, Global Markets Leader

Among the determining factors: how the real estate is employed in the business and the nature of the overall business itself. The real estate may be used to create a rental stream, or the entire company could be converted to a REIT—even if the company may then need to sell off non-qualifying assets or create taxable subsidiaries.

Ultimately, Lehman says, “This is a financial and operational assessment, and really no different from what any company goes through that’s considering some sort of corporate reorganization or transformation.” And if the company is going to be separated—as some of the public gaming firms plan to do, splitting itself into an operations group and a property-owning REIT—“you have to determine what both halves will look like for shareholders and for the new owners, if you decide to go that route.”

Next comes the matter of seeking a private-letter ruling from the IRS, and the first step in that process is a thorough analysis of the business, says Cullins. “You’re talking about reviewing agreements with customers, all the key foundational and legal documents with respect to how you’re organized, how you’re earning your income and how you’re conducting your business.” Making that determination may be “a one-to-two-month process; it’s not something you do in a day. You’re trying to do some fairly detailed modeling so that you have a clear understanding of the financial, operational and tax impacts to the company.”

After that analysis is completed, it’s time to pay the IRS a visit for a pre-submission conference. “The real key here is to be as transparent as possible, to really make sure the IRS can properly evaluate your circumstances and issue a ruling,” Cullins says. A company may need to follow up with supporting documentation about “the way you’re structured and the arrangements you

have with your customers. You may need to submit more information around the composition of your assets. So it’s a fairly extensive process,” one taking at least six months and typically nine to 12 months.

“This takes time, but if you think about it, you’re trying to come to an agreement with the IRS on how this will be viewed,” Cullins says. “So you want to make sure you’re properly representing your facts and they properly understand them. It’s a deliberate process and a very productive one.”

Although the IRS has issued more of these rulings lately, “they’re not redefining real estate,” Lehman says, but merely responding to an increase in questions from taxpayers. “They’re going all the way back to the original 1960 REIT legislation, which intentionally had a broad definition of real estate, and they’ve interpreted the law in a manner consistent with the statute and legislative intent. The IRS has been very careful about making sure that all these rulings tie to a very longstanding precedent. None of this is really new. All of this is real estate in the eyes of the law.”

Adds Cullins: “Non-core real estate like towers and railroad tracks was held to be real property over 40 years ago. Some of the questions being asked today are different than they may have been 15 years ago, in some cases because the businesses themselves are relatively new (for example, data centers and privately-owned prisons). But if you’d asked the same questions 15 years ago, you’d have gotten the same answers.”

Concurrently with working toward obtaining a ruling from the IRS, a company planning a public offering is busy on a number of other fronts. “Whether you’re doing a conversion or some type of separation or spinoff, you most likely will need to undertake a study of the corporation’s earnings and profits,” Cullins says. “You’ve got to go back and evaluate the accumulated earnings and profits inside the company, because in order to elect REIT status, you have to distribute those earnings and profits.” That’s why, he says, a REIT conversion or separation is often preceded by a large dividend going out to shareholders.

If that transaction will take the form of a separation, “you’ll need historical financials of what that business looked like historically,” says Lehman. “You’ll have to present it to get through the SEC process if you’re going to have that entity traded on its own.” Although that’s “a detailed process” in its own right, a taller order is determining what the company will look like in the future.

“There’s a series of reorganizational-type steps that will have to be gone through to see

how you’re going to manage this company going forward,” says Lehman. Frequently, a newly spun-off entity will need new management. “You’ll need a new CEO, a CFO and so on, and those people will have to have the right pedigree. All of that needs to be established before you actually float the offering, because you’re going to hit the ground running when the separation occurs.”

Getting to the REIT transaction is by no means the end of the journey. “Understand, and be prepared for, the post-implementation requirements,” advises Cullins. “There will be some things that are different, post-REIT conversion.”

For instance, REITs are required to distribute 90% of their taxable income each year, “so you need to make sure you put in place the right forecasting tools and processes,” Cullins says. “It’s going to cause you to rethink your dividend policies, because you’re going to need to make those kinds of distributions. It will also impact your ability to fund growth as the REIT cannot retain its earnings.”

Lehman notes that the REIT model imposes “certain restrictions in your ability to have non-real estate income and assets. It’s going to change the way you view your business going forward in certain types of ancillary things you would do.” Cullins pointed out that organizations will need to closely examine their shared services and intercompany transactions from a structural and transfer pricing standpoint. “Appropriate transfer pricing policies, and tax-compliant documentation for the transfer pricing policies being used, are essential for REITs.”

Once the transaction has taken place, “you’re going to be evaluated among the spectrum of REITs,” says Lehman. “The companies that are successful are the ones that prove they can produce stable growth. It’s really a complete mindset change. In many cases, you’re going to be judged as a real estate company.”

Within the company itself, Cullins says, “There’s an education component to this as well. We spend a lot of time with the financial, accounting and tax executives, but also with the business and operational people, making sure they understand the new parameters under which they need to operate. It’s not just flipping a switch. It’s not just a matter of changing your classification under the tax code to say you’re making a REIT election. You’re going to have to look at all your processes. You’re going to have to make sure all your people at all levels understand the differences.” ♦

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