A Study discussing the future outlook of REITs after the REIT modernization act

Amit Verma
The Factors Which Led to Paired Share REITs since 1994. REIT Modernization Act introduced in August 1999, has put an end to their multiple acquisition culture. This research will discuss the advantage a Paired Share REIT had, and what the investor thought before investing in their stocks.

By

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Submitted to the Faculty of RIT
In Fulfillment of the Requirements
For the Degree of Master of Science
In Hospitality/Tourism Management

January, 2000
Name: Amit Verma---------------------- Date: 11/24/1999--------- SS#: ________________

Title of Research: The factors that led to the fast growth of Paired Share REITs since 1994. REIT Modernization Act introduced in August 1999, has put an end to their multiple acquisition culture. This research will discuss the advantages a Paired Share REIT had, and what the investor thought before investing in their stocks.

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A Study discussing the future outlook of REITs after the REIT Modernization Act

ABSTRACT

Real Estate Investment Trust, which originated in 1960, gained popularity since 1991, when a large number of real estate companies went public. Paired Share structure, has been underscored throughout this thesis, as the whole research was limited to few companies named Starwood, Patriot American, Meditrust, and First Union who used this structure aggressively to acquire corporations. Paired Share REIT Structure refers to the REIT and a C-corporation being traded together under one symbol in the stock market. So, the investors get the combined profits from both the companies, which makes this structure extremely popular among the shareholders. Paired Share REIT Structure was abolished in 1984 because of the abuse of tax system. But the government allowed 5 existing Paired Share REITs to continue. This grandfathered status gave this five companies an advantage over all other REITs as well as non-REITs. Therefore, the only way to become a Paired Share REIT was to acquire one of these five existing Paired Share corporations. This study is strictly a Finance Topic, which discusses cognitive dissonance between REITs with Paired Share structure and REITs with no Paired Share structure as well as non-REITs.

As this topic needs a highly specialized knowledge, therefore the size of the survey population was selected to be small. The questionnaire was designed with the assistance of Mr. Todd Dunda, Director of Finance for Marriott International. The survey was conducted in August 1999, administrated to Real Estate Analysts, Finance Officials
working with REITs and non-REITs and the data was finally analyzed one question at a time in a very streamlined fashion by projecting coherent grouping of the answers by all the candidates.

Marriott International and Hilton Hotels raised their voices when they saw Starwood Hotels winning the bid on ITT Sheraton Inc. Starwood raised $13.3 billion through their paired share structure. Hilton, who could only raise $8.3 billion lost the battle. This study took more than one year, as I was waiting for the results for the appeal in front of Congress to abolish the Paired Share Structure completely. REIT Modernization Act was introduced in August 1999, which strictly ruled out any more acquisitions under a Paired Share Structure. The companies could maintain their Paired Share formats, but they were not allowed to acquire companies. The Share Prices for these Paired Share Companies fell down by more than 50%. Patriot American was close to Bankruptcy. Starwood managed to survive by converting into a C-corporation. The moral of this story is that Maintaining a Balance Sheet is equally important as expanding your company limits.
ACKNOWLEDGEMENT

I would like to thank Mr. David Crumb for assigning me this topic and assisting me in streamlining the entire thesis. Also, I would also like to thank Mr. Edward Marecki, for his time, guidance and continual support for my thesis. Late Dr. Richard Marecki, whose self-possessing personality always inspired me, not only in my thesis but also during my first job experience. I would always remember him. To me, he embodied the best qualities of a teacher. A hearty thanks to the committee of course of thesis study, and all the faculty and staff at the School of Food, Hotel and Travel Management for their assistance throughout my Master Degree Studies.

A million thanks to Mr. Todd Dunda, Mr. Gary Filip, Mr. Robert Kalchik, Mr. Warren Gump, Mr. Michael Dowd, Ms. Michelle White, Mr. Brian Flannagan, Mr. John Dee and Mr. Paul Reeder for filling out the questionnaire and guiding me throughout the research. And final thanks to my parents for their encouragement throughout my studying at Rochester Institute of Technology.
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CHAPTER 1

INTRODUCTION

Introduction

We come in contact with it everyday which might be an apartment building we live in, an office building we work in, a grocery store where we shop or the high rise hotels we see everyday. Have you ever wondered who owns these properties? Are they owned by a group of wealthy individuals or pension funds? Could you ever imagine that you could also own a share of this commercial real estate? How many of us really invest our money in the share market? If yes, then how many of us know what a real estate investment trust is? Real Estate Investment Trust is a company that invests its assets in real estate holdings. They are publicly traded companies, which invest in and manage portfolios of commercial or mortgage loans. Today, the REITs invest in all kinds of commercial property: apartment buildings, regional malls, neighborhood shopping centers, office complexes, industrial parks, health care facilities, hotels, motels, self-storage facilities, factory outlet centers and even golf courses. Today, buying a share in Real Estate Investment Trust (REITs) is becoming a favored way to own commercial property. As an investor, you get a share of the earnings, depreciation, etc. from the portfolios of real estate assets that the REITowns. Thus you may get many of the same benefits of being a landlord. You also have a much more liquid investment than when you directly invest in the real estate. But the downsides are that you do not have a direct control over the assets nor regarding the managing of the assets. REITs generally don’t
pay any tax (corporate tax), provided they distribute 95% of their income to the shareholders.

**HOW ARE REIT STOCKHOLDERS DIFFERENT FROM THE COMMON STOCKHOLDERS?**

Common Stocks are ownership shares generally in the manufacturing or service businesses. For example: Owning a share in Microsoft will be like owning a share in a manufacturing business. REIT shares on the other hand, are the same, just engaged in the holding of an asset for rental purposes, rather than producing a manufactured product. It can be a land, building, or land and building both. In both the cases, though the shareholder is paid what is left over after business expenses, interest/principal, and shareholders’ dividends are paid. An interesting thing about REITs is that they have probably the best inflation rate. Investing in REITs can be considered as a conservative investment and the long-term returns are lower than common stocks of other industries. The stock prices for REITs will not suddenly rise, unless the company is acquiring properties at a fast rate. Rather they have a tendency to stay stagnant for a long time. *But why are REITs still a hot product in the market? Because land and buildings is considered long-term asset, and the investors think that "security" in the long run.* But those who want quick profits, invest in the manufacturing businesses, because *REIT income is based on the rental revenues coming in on a regular basis, which do not usually vary as much as revenues at a manufacturing or service firm.*
WHEN DID THE REITS ORIGINATE?

Real Estate Investment Trust came into being in 1960. Legislation was passed in favor of the small investors so that they could also own the real estate through the ownership of shares. In short, owning a share in REIT is equal to owning a share in land, building or land and building both. Thus, the smaller investors are able to afford the capital commitment necessary to purchase hotels, parking facilities, shopping malls, apartments, etc.

Owning a share in REIT = Owning a share in land, building or land and building both

In the initial stages, not many REITs thought of entering the stock market. Most of them stayed private. It was in 1991 that the number of public REITs started increasing. KIMCO Realty, a New York based private real estate company made a bold decision to go public. When the company goes public, its decisions are second-guessed by the stock analysts, business writers and shareholders. KIMCO gathered $135 million in its first public offering. With that amount of money, KIMCO was capable of purchasing some exclusive commercial properties. Since 1992, the size of REIT industry has expanded to over 200 firms.

WHAT DOES A PAIRED SHARE MEAN?

REITs' income depends on the rental revenues they receive and they are not allowed to operate their properties such as hotels, golf courses, etc. So they have to hire the services of a management company to run their properties. The (REITs) owners' interference in managing the property is limited to a minimal amount. This format hold the potential for conflicts between the owners of the real estate and the owners of the
management companies. In short, the REIT and the Management Company are two different corporations, running the same property. The shares of both the companies are traded separately in the stock market (under two different symbols) Do we possibly see a solution to this problem? The only way this conflict is reduced is if the same organization owns the REIT as well as the C-corporation. *It was in 1972 when the First Union Trust created a unique “stapled stock” or “paired share” structure.* The establishment of “First Union Management Inc” eliminated all kinds of potential conflicts between the owners of the real estate and the management of that real estate company. *The Board of Directors for the Trust is the same as the Management Company. In other words, when a share of First union is purchased or sold, an equivalent ownership interest in FUMI (First Union Management Inc) transfers with the share of beneficial owners of the management company, thereby eliminating any real or perceived conflicts created from property management contracts between both companies.* While we use Hotels as an example, other potential types of profitable uses for the paired share structure are parking facilities, amusement parks and senior citizen centers.

**Background**

REITs were created by congress in 1960 to make it easier for investors to pool their capital in order to invest in commercial real estate. To qualify as a REIT under section 856 of the Internal Revenue Code (IRC), a business must comply with several requirements, like:

- # Organize as a corporation with fully transferable shares
- # Be managed by a board of directors or trustees
- # Distribute at least 95% of taxable income
# Have no more than 50% of stock owned by five or fewer individuals

# Have a minimum number of 100 investors

# Have at least 75% of its gross income from rents from real property

# At least 75% of its assets should be real estate assets

Reit is basically an income-producing real estate and in most cases can operate their businesses. But the business should only be a rental business such as apartments, shopping centers, offices and warehouses where they can lease their space to a third party.

In short, so long as-

- The company’s assets are primarily composed of real estate held for long term
- Their income is mainly derived from real estate
- They pay out at least 95% of its taxable income to the share holders
- They are exempt from corporate tax

**NET BENEFIT OF BEING A REIT**

- Exempt from corporate tax

**NET COST OF BEING A REIT**

- They distribute 95% of their income as dividends. So they are left with little or no earnings to expand their business. The only way then they can buy more properties is by issuing more shares to the public
Why did REITs play a very limited role for over 30 years?

In the very initial stages, REITs were permitted only to own real estate and not operate or manage it. So, they had to hire third party to manage the property.

The tax reform act introduced in 1986 relieved REITs from many limitations they have been facing, but the act also imposed some rules on REITs in order to keep a check on their tax payments.

<table>
<thead>
<tr>
<th>BEFORE TAX REFORM ACT OF 1986</th>
<th>AFTER TAX REFORM ACT OF 1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The taxpayers were using high debt level and aggressive depreciation schedules to reduce his or her taxable income.</td>
<td>The Tax reform act limited the deductibility interests, lengthened the depreciation schedules and also restricted the use of passive losses.</td>
</tr>
<tr>
<td>• The Marketplace was not comfortable with this kind of arrangement</td>
<td>The Tax reform act of 1986 permitted REITs to operate and manage most of the commercial income-producing properties (other than the hotels, health care facilities, and some other activities, which need Professional management).</td>
</tr>
<tr>
<td>• Before tax reform act, the REITs were not allowed to manage any kind of real estate</td>
<td></td>
</tr>
</tbody>
</table>

Before tax reform act, the REITs were not allowed to manage any kind of real estate.
REAL ESTATE BEGAN RECOVERING IN 1992

In 1992, many private real estate companies decided that the least way to access capital was through the public marketplace using REITs.

Why are REITs growing so fast?

- They distribute 95% of their income to their shareholders. So investors want to be a part of their growth.
- The only way REITs can buy portfolios is by issuing more stock in the market. Buying more properties means increase in the stock price. Investors can also call themselves the ‘landlords’ when they buy REIT shares.
- The management of modern REITs has a 10% ownership stake in the company. This makes the investors comfortable with the structure.

ARE REITs HERE TO STAY?

Yes, because smaller real estate investors are given three important benefits through modern REITs, which were previously never accessible to them. These benefits are:

1. Liquidity: Investors can buy and sell interests in commercial real estate portfolios on an instantaneous basis.
2. Security: Because real estate is a physical asset with a potential of producing income throughout its long life, investors consider real estate as an investment option with security.
Low Level of Debts practiced by REITs also mean greater security.

Investors also have access to the information like-

- The company and its portfolio
- The management and its business plan.
- The property markets and their prospects

3. Performance: REIT market performance has been roughly comparable to Standard and Poor’s 500 index.

In the late 1970’s and early 1980’s, certain REIT owners stapled their stock with an operating C-corporation. Under a stapled structure, they were able to trade a REIT and a C-corporation as a single unit. The main reason behind all this was to avoid the tax obligations. The REIT is exempted from federal corporate tax. But it has some limitations when it comes to managing the property. Ultimately, they have to lease the property to a management company. The management fees for that is decided by a percentage from the gross revenue. In addition, there are some incentive fees charged by the Management Company when the owners introduce some new products. Plus, there can be conflicts of interests among the shareholders of these two separate companies. Paired Share is a solution to all these limitations. When a REIT owns its own management company (C-corporation), it saves money on the management lease. Now, one company (REIT) is tax exempted and the other (C-corporation) is not. So, the management can do income shifting from C-corporation to a REIT in the form of costly rental fees. This way they pay minimal amount of tax for C-corporation. This is the second advantage they get when they have a paired share status. In 1984, Congress realized that the paired share structure was adopted by the companies simply to abuse the U.S tax system. In a paired share
entity, the company's officials preferred the profits to be realized in the non-taxable entity (REIT) rather than in the taxable entity. Congress determined that it would not allow these companies to disrespect the tax system. The tax clause passed in 1984 abolished the paired share structure in order to end the tax abuse it caused. But it did not erase the few existing paired share structures (please see the definitions). The grandfather clause refers to the law, which determined the existence of the five paired share companies and ruled out any further formation of a paired share corporation. This clause enabled these 5 companies to gain preponderance over other REITs. But, nobody thought of taking advantage out of these five companies till 1992. Was the Hotel Industry the only target for these grandfathered corporations? The growth of paired share REITs in 1997 as well as early 1998 have proved to be quite devastating for many other REITs as well as non-REITs. Many companies were then planning to plunge in that game of fortune, thereby enjoying the tax advantages.

Until 1992, paired share REITs were almost behind the scene and the total value was $500 million. But in the next five years, when some companies named as Starwood Hotels & resorts and Patriot American Hospitality Inc. realized that by buying one of these five existing paired share companies, they could save a lot of money on taxes, they started investing at an incredible rate. It was the tax shelter they were mainly concerned about. In 1997 the total value of paired share REITs became $33 billion and recently it was estimated a little less than $20 billion. Starwood Corporation, which was worth just $200 million in 1994, has made acquisitions worth $20 billion in the last five years. They achieved the power of acquiring through a paired share structure. In 1994, Starwood purchased Hotel Investors Trust as well as Hotel Investors Corporation, which was then,
a paired share company. This enabled Starwood to adopt a paired share status and the bonus was all the tax advantages. The profile of the hotel investors Group gave them the power of acquiring properties at a fast rate. The next question is why would an investor value paired shares? Because they were concerned with the combined profits of the two companies. The Clinton Administration plans to limit the growth of this passive investment vehicle. The views that paired share might not exist anymore led to a decline in the stock prices. Starwood’s share prices went down by 6.27% in February 1998 as compared to January 1998, thus furthering the doubts of their survival.

Problem Statement

Reits are basically an income-producing real estate and in most cases can operate their businesses. REITs have been very aggressive in the past 5 years. They had been acquiring at a very fast rate. These mergers and acquisitions kept pushing their share prices higher and higher. REIT pays 95% of its earnings to its shareholders. So they are left with no option but to issue more shares if they want to expand. On the flip side, they are exempt from corporate tax. Paired Share REITs who owned both the REIT as well as the Management Company benefited from this structure. They could do the income shifting from C-corporation to the REIT in the form of rent so as to save maximum amount of taxes. They have limitations when it comes to acquire properties at a fast pace. They are allowed to invest gradually over the years. But they have broken those rules and regulations and by taking the advantage of the tax benefits, they have acquired a large number of properties at a significant rate.
Purpose

The explosive growth of paired share REITs have threatened the purchasing power of other REITs as well as non-REITs. The purpose of this study is to estimate the future viability of REITs. In mid 1998, Clinton administration decided to end the paired share structure completely, which meant a limited growth for paired share structure. The end of paired share structure can sharply limit the growth of REITs. Will the investors continue investing in REITs anymore? Will the REITs be able to hold on to its value in the stock market? Will the investors continue to take gamble in light of new potential government controls or will they decline the risk?

Significance

The paired share status is presently enjoyed by four companies (see definitions of terms). These companies enjoy a tax-exempt status, which gives them access to manipulations involving income shifting and exemption from corporate taxes. Erasing the paired share structure would give the government more tax revenues worth $132 million and the other REITs as well as non-REITs a big relief who were not able to acquire the portfolios as fast as the Paired-Share REITs. The paired share had more acquiring power thus an advantage over other REITs. The Hotel Industry might have been their first but not the last target.
**Definition of Terms**

**REIT**

Real Estate Investment Trust

**Paired Share**

When the stock of the REIT and an operating corporation are traded together under one symbol

**Privileged Five Stapled Share Companies**

Number 1: “Starwood”

<table>
<thead>
<tr>
<th>Name</th>
<th>1984</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hotel Investors Trust</strong></td>
<td></td>
<td>Starwood Hotels &amp; Resorts Trust &amp; Starwood Hotels &amp; Resorts Worldwide Inc.</td>
</tr>
<tr>
<td><strong>Hotel Investors Corp.</strong></td>
<td></td>
<td>Own and Operate Hotels, Resorts &amp; Gaming</td>
</tr>
<tr>
<td><strong>Business</strong></td>
<td>Own and Operate Hotels</td>
<td>Own and Operate Hotels, Resorts &amp; Gaming</td>
</tr>
<tr>
<td><strong>Hotels</strong></td>
<td>8</td>
<td>650 (with ITT)</td>
</tr>
<tr>
<td><strong>T. Assets</strong></td>
<td>$100 million</td>
<td>$1.3 Billion (December 1996) +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$439 million – HEI Hotels acquisition +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$470 million – Flatly Co. acquisition +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$1.8 Billion – Westin Hotels &amp; Resorts +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$13.3 Billion – ITT Corp. Acquisition</td>
</tr>
</tbody>
</table>
### Number 2: “Patriot American”

<table>
<thead>
<tr>
<th>Name</th>
<th>1984</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>California Jockey Club &amp; Bay Meadows Operating Co.</td>
<td>Own &amp; Operate a Race Track</td>
<td>Patriot American Hospitality Inc</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Patriot American Hospitality Operating Co.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Own &amp; Operate Hotels, Resorts &amp; Casinos</td>
</tr>
<tr>
<td>Hotels</td>
<td>0</td>
<td>455</td>
</tr>
<tr>
<td>T. Assets</td>
<td>$ 17.4 million</td>
<td>$ 760 million ( December 1996) +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 210 million – Carefree Resorts Acquisition</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 1.1 Billion – Wyndham Hotels acquisition</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 485 million – Carnival Hotels &amp; Casinos +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 2.1 Billion – Interstate Hotel acquisition</td>
</tr>
</tbody>
</table>

### Number 3: “Meditrust”

<table>
<thead>
<tr>
<th>Name: Santa Anita Reality Enterprise &amp; Santa Anita Operating Co.</th>
<th>1984</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Own &amp; Operate a race track</td>
<td>Own &amp; Operate Hotels ( &amp; Nursing Homes)</td>
<td></td>
</tr>
<tr>
<td>Hotels: 0</td>
<td>270 ( with La Quinta)</td>
<td></td>
</tr>
<tr>
<td>Total Assets: $ 106.8 Million</td>
<td>$ 2.6 Billion + $ 2.9 billion – La Quinta</td>
<td></td>
</tr>
</tbody>
</table>
Number 4: “Hollywood Park”

<table>
<thead>
<tr>
<th>Name:</th>
<th>1984</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business:</td>
<td>Thoroughbred Racing</td>
<td>Thoroughbred Racing &amp; Casinos</td>
</tr>
<tr>
<td>Hotels:</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>T-Assets:</td>
<td>$148 Million</td>
<td>$205 Million ( December 1996) + 212 Million- Boomtown acquisition</td>
</tr>
</tbody>
</table>

Number 5: “First Union”

<table>
<thead>
<tr>
<th>Name:</th>
<th>1984</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Union Real Estate Investors Trust &amp; First Union Management Inc.</td>
<td>First Union Real Estate Investors Trust &amp; First Union Management Inc.</td>
<td></td>
</tr>
<tr>
<td>Business:</td>
<td>Malls &amp; Office Buildings</td>
<td>Malls, Office Buildings &amp; Parking Garages</td>
</tr>
<tr>
<td>Hotels:</td>
<td>-1- sold in 1984</td>
<td>-0-</td>
</tr>
<tr>
<td>T. Assets:</td>
<td>$600 million</td>
<td>$459 million ( December 1996)</td>
</tr>
</tbody>
</table>
Limitations

This study will include more of general views and less surveys, as it is a study about the general economic conditions. It also holds a chance of getting updated very often, as it is a current topic. This is a study about present economic conditions and will be dependent upon the news articles, which are being discussed at the moment.
CHAPTER 2

LITERATURE REVIEW

Imagine a REIT suddenly leaping into limelight with a $ billion acquisition. The share prices go skyrocketing and the investors are getting more than they had ever expected. But this company was not an ordinary REIT; it was a paired share REIT. Now, this situation leaves us in a state of dilemma regarding undue power as well as advantages enjoyed by this grandfather clause of trading as a paired share in the stock market.

Hotel REITs have been vigorously involved in the acquisitions for the past two years. Three years ago, Starwood never dreamt of competing with Hilton Hotels Corp. It was almost running into a bankruptcy with 24 hotels, worth $200 million. But in 1998 it was a company with more than 800 hotels valued at over $20 billion and it is still one of the largest hotel companies in the world. Four years ago in 1994, Starwood traded at less than $5.00/share, but during the year 1998, the share prices skyrocketed to $61/share with earnings growing at a rate of 30% a year. The unique paired share structure gave this hotel big company financial leverage. But the question is: IS THE GROWTH OF THIS COMPANY TOO MUCH TOO FAST?

*What is a REIT and why would an investor invest in REITs?*

The best quality REITs always organically grow earnings/share from their existing portfolios at respectable rates of increase, rather than mainly through acquisitions. **Real Estate Investment Trust** was launched to enable the small investors
with limited funds to participate in the real estate market. The difference between a REIT and a normal real estate company was the high degree of liquidity in REIT. If you think you need to do some looking around before buying a REIT, you are right, but not many people do that, apparently because each REIT is more miraculous than the next. Most of the investors think REIT to be a profitable investment whether or not they really understand it. Real Estate is considered to be a cyclical business and most REITs had been enjoying a profitable part of the cycle. The legislation that produced REITs was signed in 1960, but for almost 3 decades, REITs were unnoticeable. Even now, there are just 195 publicly traded REITs, with a market capital of $140b, which means the entire public traded component of the industry is less than the size of the Microsoft.

**What do REITs own?**

Real Estate of course, but in different forms, different places with different relations to economic cycles. There are 5 major problems that seem to occur with the Real Estate investment,

1) Illiquidity,

2) Negative Leverage,

3) Non-diversification, usually caused by undercapitalization,

4) Speculative nature of the investments,

5) Cyclic values. These drawbacks should be thoroughly understood by the investor, but REIT is free from all drawbacks. The REIT that owns Hotels is the most traditional one and has been in the news recently. There are three kinds of REITs:
a) *Equity REITs*, which constitute 89% of the REIT industry,

b) *Mortgage REITs*, which constitute half of the remaining REITs. This category of REITs never buys properties but lend money to builders and property owners. In the 70’s, there were plenty of mortgage REITs who suffered from problem loans and potential loan losses. The construction costs were rising rapidly but rents were not rising at all. The builders were finding it difficult to survive because of high interest rates, direct cost overruns and tight money markets. To fight back these problems, companies like Atlanta’s Cousins Mortgage and Equity Investments decided to disqualify itself as a trust. *The real estate crunch of late 1973 and 1974 as well as high interest rates led to a depressed stock market.* The interest rate structure was unfavorable to the industry’s expansion. In the year 1976, stock prices of REITs started rising steadily. This was due to the regular payments of dividend to the shareholders. Most of the REITs stopped functioning as Mortgage REITs thus preferring the status of Equity REIT. *According to an investment analysis done in 1980 by Thomas Cullen and Brian Blake, ownership of shares in a REIT is a good way to diversify in large portfolios over the long run.* The Tax Reform Act of 1976 permits an 8-year "carry-forward" period for REIT losses, thus helping out some loss-plagued REITs. In early 1980’s people were more interested in equity REITs as the properties purchased in the early 1970’s were now worth much more than its book value.
c) The remaining are called the *Hybrid REITs* which own properties and also loan money. Here is a simplified version of how a REIT is set up and operates. The process begins with an initial public offering. Assume that the REIT management sells ten million shares of $10 each. Then it borrows another $25 million. With that $125 million, they buy some income producing property. Most likely, they will buy apartment complexes, Hotels or Shopping Malls. Income is in the form of rent from the people staying in the apartment complexes, Hotel management companies or stores in malls. Cheaper Financing to REITs has also encouraged them to construct new properties. REIT has a lack of choice regarding the money it earns. It pays no federal income tax. But on the flip side it distributes at least 95% of its earnings to the shareholders as dividends. Mortgage REITs succeed only if the interest rates don’t go sharply up or down and borrowers don’t default. Investors are better off with equity REIT. If you own shares in equity REIT, you are a landlord. If you own shares in a mortgage REIT, you are a moneylender, who merely depends on interest rates. Till recently, Retail sector owned maximum number of REITs with a market capital of $21 billion. But the Hotel REIT consolidated various hotel properties and acquired assets worth $22.8 billion in 1997. The Paired Share status in a REIT enabled this handful of hotel REITs to gain so much of popularity. The next popular REIT is the office REIT. Growth in any market is decided by the revenue generated by them. In the Hotel Sector, medium to lower segment hotels...
has been performing moderate. RevPAR compared coming from these hotels is still lagging behind as compared to the full-scale business class hotels. Investors investing in REITs are satisfied with the growth rate. But if we look more closely, this high growth rate have been seen in just a few hotel companies and two of them are paired share. But in 1998 the Clinton Administration decided to freeze the paired share because only five companies were benefiting from this grandfathered clause. What do you think will be the alternative? Paper Clip? The day the decision of Clinton was announced, investors’ belief in this paired share structure was shaken up and there was a decline in the share prices. Now these companies are trying their best to reassure the public. The mergers and range of assets included in REITs in such a short span of time have contributed a high % accretion to the earnings by these companies.

The National Association of Real Estate Investment Trusts (800-3-NAREIT or www.nareit.com) is the source for data on the REIT industry. NAREIT’s industry-wide index showed a total return of 35.75% in 1996- 12.79 % points better than the Standard and Poor’s 500 stock index. The best performer on the equity side was the office group with a total return of 51.82%. Hotels came second with a return of 49.19%. Regional malls were third with a return of 44.63%. The REITs have been investors’ favorites, but now the performance is downsliding. The level of competition is rising and not too many options are left for REIT management to save on their earnings.
How does an Investor go about evaluating REITs?

Study their portfolios, the level of maintenance and find out if they command good prices. In case of Hotels, study the occupancy levels, rates and above all the growth opportunities for that chain of hotels. The best REITs would always want to grow- buy more properties. That’s not an easy talk. A REIT distributes 95% of its net income as dividends. It cannot hold its dividends down for a few quarters in order to buy a property. So the question is how does a REIT grow?

It borrows money. It pays minimum dividend allowable by law and acceptable to its shareholders and try to retain maximum amount of its earnings. Leverage is a basic fact of real estate investing. Aggressive REITs had been taking best advantage of their financial leverage. Conservative REITs don’t like to see their debt levels rising above 40% of their total asset value. Selling a property can give earnings a kick only if the money is used efficiently to buy another property with a better value usually an exchange with no taxable gains. The worst kind of stock issue is one used to support faltering or prop up the dividend. The investment a REIT makes should increase or at least not reduce REITs’ overall rate of return. The difficult part about investing in REITs is figuring out how to value them. Ideally an investor would want to multiply average cash flow in recent years by the typical rates of return for properties in the areas in which a REIT has a stake. However, REIT experts thinks there are a simpler way. The net worth of Equity REITs is usually understated by rampant inflation. Therefore, the experts add back accumulated depreciation to get a more real valuation.
The main reason why an investor should feel better while investing in REITs is that the managers of REIT have a financial stake in it. The management owns minimum of 10% of shares in the company. The base salaries to the managers are less but that is compensated with a lot of stock options. Thus the managers have to strive hard to achieve the goal of financial success which would benefit them with increased stock prices, ultimately benefiting all the shareholders.

A SERIES OF ACQUISITIONS IN THE PAST THREE YEARS

Real Estate Investment Trust came into being in 1960 but it played a limited role for more than three decades. Now that suddenly the Real Estate market has taken a decisive turn, REITs are being considered an important means to control assets.

REITs have enjoyed tremendous popularity over the past two years; during 1996, equity REITs on average outperformed the S&P 500. This success was driven by a strong real estate market, favorable interest rates, and a vibrant commercial rental market. Current REIT performance generally does not move in tandem with the stock market.

The following table compares the annualized total returns on equity REITs to those of the S&P 500 (data is for noted periods ending Dec. 31, 1996).

<table>
<thead>
<tr>
<th>Years</th>
<th>Equity REITs</th>
<th>Standard and Poor 500</th>
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</thead>
<tbody>
<tr>
<td>1 Year</td>
<td>35.27%</td>
<td>22.96%</td>
</tr>
<tr>
<td>3 Year</td>
<td>17.17%</td>
<td>19.63%</td>
</tr>
<tr>
<td>5 Year</td>
<td>17.14%</td>
<td>15.18%</td>
</tr>
<tr>
<td>10 Year</td>
<td>11.67%</td>
<td>15.27%</td>
</tr>
<tr>
<td>20 Year</td>
<td>16.13%</td>
<td>14.55%</td>
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</tbody>
</table>
REIT is a company, which owns and in most of the cases, operates the assets. But there are restrictions on managing the properties like Hotels, Hospitals, etc. In those cases, the property is leased to a management company, which is a C-corporation. C-corporation means a regular corporation with many stockholders who pay corporate tax on their net earnings. The assets in a REIT are mainly composed of Real Estate held for a long term. Congress created REITs to enable small investors to make investments in a large-scale real estate companies. To qualify for a REIT status, the property must be leased to an outside management firm on a contract basis. The disadvantage is that these leases are based upon the gross revenue and not on the net operating income. Therefore, there are bright chances that the interests of the REIT owner and the Management Company coincide. C-corporations solve this problem by owning as well as managing the properties themselves or they lease the property with incentivized lease contract. But then they pay the corporate tax. REITs have an advantage of avoiding the corporate tax. In fact, some REITs lease their properties to a C-corporation, which is owned by the same management as of REITs. This leads to a complete alignment of interest. This also leads to the possibility of self-dealing to draw the profits from the operating company. A Paired Share REIT is an extreme example of a REIT structure in which the operating company and the REIT are stapled and traded as a single entity. A handful of companies has been trading as a paired share REIT. 1984 Tax Law had granted these companies the permission to trade as a Stapled REIT. This grandfathered status enabled them to enjoy the tax advantages not enjoyed across the board by all corporations. The Paired Share formation under a REIT status increases the purchasing power of the REIT and also
facilitates cheaper financing, thereby devitalizing the efforts of the other Hotel REITs. To summarize, Paired Share REITs are at unique advantage because

1) better access to equity market,

2) can skip one level of taxation and,

3) Take advantage of the income shifting from the C-corporation and reduce the tax liability even further. Now that there is no law that permits the formation of a new paired share REIT, the only way to become one is to buy one of the five privileged paired share companies. Patriot American Hospitality Inc. acquired the company (California Jockey and Bay Meadows operating company, a paired share REIT) in order to acquire a paired share status. Later, they announced their purchase of Wyndham Hotels thus becoming the largest Hotel REIT with a market capital of $3 billion. Patriot-California Jockey-Wyndham is now a combination of a Hotel REIT, Paired Share and a Hotel Operating Company. It was May13, 1997, when Hollywood Park Inc. also started looking into the possibility of reversing its structure to a Paired share again. Hollywood Park Inc.’s stapled status was relinquished in 1992 by their own consent. Secondly, they wish to join the rest of the paired share candidates in the game of acquisitions. But the decision was more in the hands of IRS who has been raising a question against this grandfather clause of becoming a paired share entity. Starwood seems to be a major candidate in this field. October 20,1997, Starwood Lodging Trust became the largest Hotel REIT after the purchase of Sheraton was finalized. The deal was a war between the Hilton Hotels Corp. and Starwood. But Starwood, due to its
advantage of being a paired share could gather more money from the stock market. The deal was quite profitable for them. Hilton refused to raise another bid after that and Starwood finally took over ITT corp. after a long 10-month battle with Hilton Hotels Corporation who could not raise more than $8.3 billion for the transaction as compared to Starwood who were able to raise $13.3 billion. Questions are being raised against the paired share structure of Starwood, who offered $82 on a per share basis, $12 per share more than Hilton's offer. Paired Share have made them financially more stable in the stock market, thus giving them a cutting edge over its competitors. Starwood, now the largest Hotel REIT as well as one of the largest Hotel Operating companies currently owns five prominent franchise names- Westin, Sheraton, CIGA, Four points and The Luxury Collection. Starwood still remains prominent in the stock market, thus giving them more domestic as well as international opportunities for future acquisitions. Starwood, Patriot and MediTrust owned assets collectively worth just over $4 billion at the end of 1996; in 1997 the three companies acquired $22.8 billion worth of hotel assets- a collective growth of over 500%!!! Meditrust acquired the grandfathered Paired share REIT, Santa Anita Realty in 1997 for $458 million.
Recent growth in the total market capitalization of publicly trade REITs

REITs don’t pay corporate taxes provided they pay out at least 95% of their taxable income as dividends to their shareholders. Therefore, REITs are considered good stocks for investors who seek income. REITs are changing ways; a company owns, sells and manages properties. But they have to follow various strict government rules. Opportunities for continued expansion through acquisitions had enabled a few REITs in the past to trade at a premium over net asset value. Stock Prices were really being rewarded for the deals they do. Different options lie in front of the company for the purpose of its growth- Repurchasing Stock, Spinning off Assets and the creation of Real Estate Investment Trusts. Station Casinos became the first game company to convert its assets into a REIT. Starwood’ success is an outstanding reason for the growth of REITs (January 12, 1998). We all witnessed some stunning mergers and acquisitions in the last few months of 1997. After the acquisition of ITT corp. Starwood is one of the strongest global players in the upscale hotel sector. All these acquisitions were made in a short span of time and this really puts a lot of pressure on the competitors like Marriott, Hilton and many other Hotel REITs. All this happened due to Starwood’s awareness of the loopholes in the 1984 Tax Law. Starwood’s Chairman and CEO, Barry Sternlicht acquired Hotel Investors Trust and its sister operating company Hotel Investors Corp. in order to adopt a paired share status (Jan 12, 1998). This gave them a better access to the stock market. MediTrust who was a non-hotel Paired Share REIT agreed to acquire La Quinta Inns for $2.1 billion, which is four times its revenue. MediTrust, which has mainly focused on HealthCare Industry, and has been a passive investor, was tempted to own and operate Hotel properties with the advantage of being a paired share. A merger
with Santa Anita Corp made them one of the five REITs in the country with a grandfather clause of a paired share status. In January, when the Clinton administration planned to propose some restrictions on the expansion of the paired share REITs, arguing that it gives them an unfair advantage over their competitors. REITs increased in volume in 1997, and the share prices also soared high due to the huge mergers and acquisitions. Investors were suddenly interested in REITs because of its liquidity in the stock market. REITs distribute 95% of their earnings to the shareholders. And when it comes to Paired share REIT, investors are concerned with the combined profits of the two companies. Hospitality and Office have become the two hottest sectors in the REIT universe (FEB 02,1998).

Clinton’s decision to freeze the expansion of Paired Share REITs has given a sigh of relief to other Hotel REITs. Steve Bollenbach, Chairman and CEO of Hilton Hotels Corp. lost its takeover battle for ITT to Starwood Lodging and Hotels due to the latter’s paired share status. The Clinton administration’s 1999 budget plan includes the proposals regarding restricting the growth of “Paired Share REITs”. The proposal do not focus on completely restricting its growth, but on imposing limits on their ability to use their tax structure to expand. The bill, introduced on 25th March,1998 in the Senate and House by Senate Finance Committee Chairman William Roth and House Ways and Means Chairman Bill Archer would apply to the acquisitions of assets after March 26,1998. (WSJ 03/26/98). This Legislation won’t affect the REITs who are already operating as a passive investment vehicle. Nor it strictly follow any of the five publicly traded paired share REITs which included Patriot American Hospitality (PAH), Starwood Hotels and
Resorts (HOT), First Union Real Estate (FUR), MediTrust (MT) and Simon DiBartolo Group (SPG). (Feb 02, 1998)

03/19/98… According to a Wall Street Journal News, Clinton’s proposal for curbing the special tax status of paired share REITs would bring in only $132 million of tax revenues over five years- barely an inkspot on his $1.7 trillion fiscal 1999 blueprint. But to the companies, who were involved in this battle, the stakes were enormous. Starwood Hotels and Resorts Worldwide Inc. is one of only a handful of paired share REITs which has caught everybody’s attention by its ambitious expansion plans. Starwood, with its purchase of Hotel Investors Trust had one of the 1984 exceptions. Starwood executives argued that they pay 95% of their earnings to their shareholders instead of paying corporate level tax. Working against them were some of the Starwood’s biggest rivals in the Hotel and Gambling industry, Marriott International Inc. and Hilton Hotels Corp. The proposal regarding restricting the paired share status is basically in a broad set of recommended revenue raisers. Not much focus has been made on that. So Starwood Lobbyists tried to prove their point that the Clinton administration won’t benefit much from restricting paired share status. The Treasury Official had no intentions of challenging the ITT deal when the proposal was leaked out in January. Starwood hired the best Senators as their Lobbyists to fight their case because any sort of restriction to their present status would harm the future expansion plans.

02/09/98… Comments regarding the recent treasury proposal potentially impacting tax status of REITs

1) The Current proposal would limit the growth of the paired share but not specifically follow the five-paired share REITs.
2) The proposal also impacts closely held private REITs.

3) Taxation of non-qualified subsidiaries operated by REITs will have impact on REITs. Critical measure of REITs performance is Funds From Operations (FFO) which is calculated by taking operating Net income plus non-cash charges primarily real-estate depreciation and amortization. Typically, a REIT also pays out a portion of its depreciation along with the net earnings as dividends to their shareholders. Return of Capital, which is that portion of the dividend that exceeds the REIT’s net earnings, is taxed at capital gains tax rate- deferred until the shares are sold. The remaining portion of the dividend is taxed at the ordinary income tax rate by individuals. The capital gains tax rate is much more favorable than the normal income tax rate. Tax changes in 1997 reduced the capital gains tax rate to 20% on the condition that the shares are held for more than 18 months. The point is that when REIT’s dividend has high return of capital, investors benefit as a result of both tax deferral and tax savings. And that REITs have been investing in large portfolios so far; shareholders find it worthwhile to invest in REITs. The last three years have been the best when a handful of REITs who took advantage of being a paired share, bought a large number of properties, leading to astonishing rise in the share prices. REITs are finding different ways to remain in the win-win situation. Paired Share was the first major weapon with the REITs. But now that the Clinton’s Administration is issuing proposals against the fast expansion of Paired Share REITs, Paper Clip might be an alternative to that. According to an article in Hotel and Motel Management, two companies
named MeriStar have been formed out of a merger of CapStar and American General Hospitality Corp. Both these companies have been aggressive in the field of acquisitions of full-scale hotels during the recent past. The Merger was the lodging industry’s first Paper Clip REIT. The reason for creating a Paper Clip structure is to combine the advantages enjoyed by a paired share REIT and the operating flexibility of a taxable C-Corp. This would allow them to acquire more full-scale premium hotel sectors. MeriStar Hotels and Resorts will be the C-Corp, managing the hotels (220) in 31 states. Out of which, 110 hotels will be owned by MeriStar Hospitality REIT, formed after a merge in with American General hospitality as a tax-free organization (April 06, 1998). Paper Clip, where the REIT and the operating company trade differently, is the closest alternative to the paired share. In this, the company issues different shares for REIT and the operating company. The combined company can preserve tax for at least a part of the income. The shareholders have a disadvantage, as there are conflicts of interests. The Operating Company can decide to skip the payment of dividends. Compared to that, a Paired Share REIT has to pay 95% of its taxable income.

04/17/98...According to a Wall Street Journal News report today, a person close to Host Marriott said that it had been difficult for Marriott to compete with its tax-free competitors without adopting a REIT status. Host Marriott, which had been a real estate company since 1993 has converted itself into a REIT, in order to enjoy the tax, advantages. This decision was made simultaneously with its decision of buying a portfolio from BlackStone Group. The Marriott family will control just 9% share of Host
Marriott after the acquisition. BlackStone Group will have the largest share in Host Marriott (18%). Paying a high dividend instead of corporate taxes will boost its stock price and make the acquisitions simpler. The REIT structure Marriott has adopted leads to a no risk proposition. The Operating Company and the REIT has different management. Before adopting this kind of structure, Host Marriott considered various REIT options, such as buying a rare paired share REIT or becoming a paper clip REIT. Finally, they chose to become a traditional REIT who would lease the hotel properties to an independent tenant, which will then hire Marriott International or some other company to operate them.

**PAIRED SHARE WILL PUT THE SPOTLIGHT ON ALL REITs**

The Clinton Administration’s proposal strongly protests the explosive growth of Paired Share REITs. All other REITs are demanding a change to this grandfather clause. While all this happened, another set of REITs came into the limelight. These are the non-qualified subsidiaries, which do not trade like paired share but they do behave like them. They are also driven by the tax-driven practices and are no different than paired share REITs. The subs borrow from the parent REIT and pay rent, interests and dividends on preferred stock to the REIT. REITs can control the amount of rent and interests that are owed by the sub and can control the prices of property the sub sells to the parent REIT.

Marriott’s recent spin-off from the Marriott International (Now Sodexho Marriott Services Inc.) on March 27, 1998 focuses on maximizing the value of their lodging, senior living and distribution services business. The spin-off will further classify the advent of numerous options in the Hotel Industry to maximize earnings as well as consolidation of assets. March 1997- Purchase of Renaissance Chain of Hotels was the
largest acquisition Marriott has ever made. It was worth $1billion which appears to be small amount if compared to Starwood’s $13.3 Billion acquisition.

During 1995-1996, Real Estate Investment Trusts have been very aggressive in buying properties. Like any other business, REIT is a cyclical business and but everybody in this business kept on assuming that the stock market conditions would always stay permanent for them. During 1997, REIT stocks were comparable to standard and poor’s 500 index. But in mid-July 1998, REIT stocks went sliding down the road thus underperforming the S&P’s 500 index. Since that time, Reits have been facing difficulties in raising capital from the stock market

**IS IT THE RIGHT TIME TO BUY THE PROPERTIES?**

This change in market conditions has led many REITs to slow down their aggressive purchasing schedules and they started reconsidering the developments of the properties they already had. Their slowdown has reduced upward pressure on property prices. We are talking particularly about the large portfolios of properties, on which REITs were always the major bidders.

**Why were REITs always the major bidders?**

They had a greater access to the stock market than the other companies. The analysts say that this is the perfect time to buy a property, as there are no major bidders present at this time of the cycle. Other types of buyers such as advisors and individuals are replacing REITs as the most aggressive in the market.
Growth of paired share REITs slow down

During 1996-1997, real estate investment trusts have been very aggressive in buying properties. Especially, when we talk about the lodging industry, the REITs took a tremendous plunge into the consolidation of hotel industry. Starwood and Patriot, two of the five paired share REITs, had been busy buying portfolios. But they never understood that a stock market condition is always a cyclical business. They were then on the profitable part of the cycle. But that was only till early 1998. The share prices for REITs have been falling since then.

Why have REIT share prices failed to keep up with the S&P stock prices in 1998?

It was “hot money” from the stock market that was helping REITs to gallop in the stock market. They were buying new properties and all that money was coming from shareholders. They were issuing new stock every time they were buying a portfolio. Patriot, a paired share REIT, was unable to close the acquisition deals on time, and was too aggressive in buying property after property. Shareholders started loosing interest, when Patriot slowed down because of the pending deals. Patriot also had high debt levels, which proved to be devastating for them.

When the news of the downfall of REITs was out in the stock market, the shareholders started selling their shares, which brought the share price of most of the REITs to the ground.

How would you recognize the best quality REITs?

_The REIT class as a whole has reached nowhere._ The best quality Reits are those that can grow their earnings from their existing portfolios at respectable rate of increase,
rather than mainly through acquisitions. REITs in the past have been maintaining their stock price by acquiring huge portfolios at a fast rate. And now that their share prices have fallen down the hill, they are in high amount of debt.

**Recent Outlook of REITs**

REITs are facing a crisis at this time of their business cycle. Clinton’s Administration is designing a provision to stop the advance of the Paired Share REITs in the stock market. A Paired Share REIT combines a conventional corporation with a real estate investment trust. REITs are limited to passive investing in the real estate, which means they may own hotels but cannot operate them. The Operating Companies leases the hotels and run them. REITs don’t pay taxes on their earnings. The operating company pays corporate tax. But when the C-corporation (operating company) is paired with the REIT, it can pass the bulk of its revenues to the REIT in the form of rent. The legislation passed will allow paired share REITs to continue operating their existing properties within the paired share structure, but prohibited paired share to buy any more assets within this structure. March 26, 1998 was the last day for the paired share to enjoy their stapled structure.

The most crucial argument made against Starwood Hotels and Resorts was that the Paired Share Reits was a very exclusive club with only five members. Only these five members had an extraordinary advantage over the other non-members. The semi-stapled will be open to everyone

Clinton Administration intends to close corporate tax loophole for real estate investment trust. Using this tax advantage to but more properties is an abusive transaction, which threatens the corporate tax base. Clinton Lobbyists were debating that
they will be able to collect $132 million in taxes after ruling out the paired share REIT status. But Starwood lobbyists were arguing that $132 million would be just an ink-spot as compared to the $1.7 trillion worth of taxes collected. But Starwood ultimately lost the battle against the Clinton lobbyists on June 23, 1998. They were trying to prevent a technical change in the legislation. After the whole issue was over, they examined nine alternatives to the paired share structure they had. They claim that the cash flow in their company won’t be affected by this decision of Congress. The company will be converted to a standard (C- Corporation) from a real estate investment trust. They expect to gain at least $800 million over the next three years, after taxes.

- They estimated that they would save $1.5 billion in dividend payments over the next three years. Earlier, the company was distributing 95% of its earnings in dividend payments.
- The quarterly dividend will be 15 cents per share instead of 52 cents/share
- The money saved from the dividends will be taxed
- The real estate investment trust will no longer be publicly traded
- Even after taxes, Starwood expects the corporation to have an additional $800 million to $1 billion that can be used for acquisitions and the company as well as the company’s buyback program
- The corporation (Starwood) expects the earnings per share to double over a three year period
- Starwood would also become a part of S&P 500
- The choice of new structure will be important, as it will be followed by other three-paired share companies.
1997 as well as early 1998 has been very successful for lodging companies, especially the paired share REITs. Throughout the time, these paired share companies were busy acquiring properties. Starwood Hotels, Patriot American, and three other Paired share REITs had their eyes on every possible portfolio.

The owners and executives of the paired share REITS have touted the benefits of their unique structure.

Barry Sternlicht, Starwood CEO, has always been confident on his strategies on acquisitions. Industry analysts call him deal making whiz kid because of his unique competitive expansion of his company. Their major competitor has always been Host Marriott (Real estate Investment Trust). In the case of Marriott, Host Marriott buys an asset (land and building) and Marriott International manages it. So, these are two different companies involved in the whole process. Paired Share structure has a competitive advantage, because it is Host and Management Company combined. In a Paired Share REIT, which consists of a REIT as well as the Management Company, the host REIT buys an asset and Management Company runs it. But the Board of Directors on both the companies is the same. So they can manipulate with the income shifting between C-corporation and REIT in order to save taxes. But this, so called an unfair advantage can be enjoyed just by a handful of companies. According to legislation passed in 1984, no more companies could incorporate themselves under a paired share structure.
What went wrong with Patriot American, a paired share REITs since the last few months of 1998?

**Patriot Made Some Poor Bets**

In 1997 as well as in early 1998, Patriot American was on a buying spree hoping to become the largest Hotel Company in the world. But during the last quarter of 1998, they had to take a decision to sell some of their hotel assets in order to pay off their debts. The Share prices went tumbling down 14%. They were on a $4.5 billion buying binge when real estate investment trusts received a setback. These paired share REITs also received a severe threat from the competitors. The paired share was loosing its control in the stock market.

**What Actually Happened Behind the Scene?**

It was in January 1998, when Mr. Paul Nussbaum, chief executive officer of Patriot American Hospitality Inc. invited about two dozen of Wall Street Analysts to Puerto Rico for a lavish banquet at El Conquistador resort, which Patriot was buying. The fact that Patriot American had assembled a $7 billion empire in less than three years had been disturbing the peace of mind of the rest of the lodging industry. The moneylenders and the financial institutions were very much in favor of lending money to Patriot and other four paired share REITs. Poor Bets:

- Patriot American Hospitality Inc. had constructed a 450-hotel portfolio-ranging from the Wyndham chain of hotels in U.S. to Boutique Hotels in England- in less than three years. They financed that buying spree with a large number of SHORT-TERM DEBTS and also EQUITY FORWARD
CONTRACTS. An equity forward contract is a very unusual financial instrument. In this contract, the company pays the loan back with its stock. Now, before signing this contract, it is always assumed that the share prices would climb in future. Patriot did the same thing. They assumed that the stock of their company would keep on rising, as they will be more properties in the near future. But they were wrong.

- But the share prices went on declining in 1998. The company had to issue more shares to cover its equity forward contract. This diluted its existing pool of stock, thus pushing its share prices into a fatal nosedive. By the end of the last year, the stock market prices for Patriot lost 79% of their value( which is more than $3 billion of their market capitalization)

- In the early February 1999, Apollo Real Estate Advisors of NY were planning on infusing $1 billion capital in the company. But then they demanded 47% stake in the company. They have also asked Mr. Nussbaum to step down as the C.E.O. He will be succeeded by Mr. James Carreker, a long time head of the Wyndham Hotel Corp. of Dallas, which Patriot acquired last year.

- Mr. Nussbaum himself lost at least $50 million of personal net worth in the past 1 year, because of the downfall in share prices. He also took out $7 million loan from the bank to exercise his stock options. But now the worth of that stock is just $2 million. Because Mr. Nussbaum won’t be the C.E.O of the company anymore, so Patriot will buy that personal loan from him. Now the departing C.E.O. ( Mr. Nussbaum) will have six years to pay off that loan to Patriot.
The Present events that are hurting Patriot.

1. They are suffering a big credit crunch because of the fall in the share prices. So, it is difficult for them to refinance its short-term debt.

2. Legislation has eliminated its special tax status.

3. Hurricane Georges did a damage worth $30 million to their El Conquistador property in Puerto Rico.

In the first half of 1998, Patriot had two financial officers. One for its REIT company and the other for its C-Corporation. In March 1997 he hired Mr. William Evans, a former investment banker, to maintain the flow of the capital, while Patriot was acquiring properties. The other two financial officers were ignored, while Mr. Evans became a decision-maker. He was continuously pressing on the fact that in order to maintain their stock prices, they have to keep on acquiring properties. Due to all these arguments, the other two financial officers quit their jobs.

Paine Webber Inc., Patriot’s main advisor warned them, when they were thinking of signing Equity Forward Contracts. They were recommending that Patriot should rather sell their shares instead of taking more loans. But finally they had to lend $125 million to Patriot when they saw Patriot signing a $95 million equity forward contract with UBS, and $125 million contract with NationsBank Montgomery Securities, San Francisco.

- Patriot was being warned repeatedly by PaineWebber that Patriot American would be unable to raise any more money from the stock market, if they don’t improve their accounting and forecasting
• The Interstate Deal, which Patriot was signing in 1998, got delayed thus lowering the stock prices. They were also deciding on buying the Inter-Continental, but they were out-bid by Bass PLC

• Following the downslide in the stock market and the fact that their short-term debts were becoming due, they decided to issue more shares. They were wrong again. Their share prices fell down to $12.13 in the end of the year.

Hilton’s chief executive, Stephen Bollenbach and Marriott International chairman J.W. Marriott Jr. successfully brought Congress’s attention to their fast growing competitor’s advantage.

ALTERNATIVES

Semi-Stapled REITs: To be considered as a paired share REIT, at least 50% of the value of two corporations should be stapled. But if we staple 35% of the stock of its operating company to the 100% stock of the REIT or vice-versa, it won’t meet the definition of the paired share REIT. Semi-Stapled REITs will be very much permissible under the tax code. *WHY 35% AND NOT 49%?* Because the stock market fluctuates a lot. So they want to play safe in case the value of the company stock value increases.

ANTICIPATED INVESTORS’ OPINION

In a Paired Share REIT, two companies are traded together in the stock market under one symbol. So investors have just one piece of paper, but he knows that that is two companies stapled together. So, he will get combined profits from both the companies.
In a semi-stapled REIT, the two companies will be traded separately. In this the investor will have two pieces of paper. He would be able to buy or sell each security separately.

Up until now, Patriot American, Starwood Hotels, Meditrust Corp., and First Union Real Equity & Mortgage Investments have enjoyed tax advantages associated with the paired share structure.

**REIT MODERNIZATION ACT**

REIT Modernization Act introduced in August 1999 relinquished the status of the Paired Share REITs. No more acquisitions will be allowed under this format.
CHAPTER 3

METHODOLOGY

Real Estate Investment Trusts (REITs) are supposed to be fairly passive real estate owners and only four publicly traded REITs had the special grandfathered structure called “Paired Shares”. REITs are not allowed to manage the properties, which involves specialized knowledge. These properties include Hotels, Golf courses or any other real estate, which is leased short term. Paired Share Corporation takes place when two companies (REIT and the Management Company) trade in the market under the same symbol. This means both the companies will have the same board of directors which will give an end to any kind of conflict between these two companies with a paired share, REITs can manage the properties they own.

Other benefits of a paired share structure were:

a) **Recapturing the profits otherwise made by the management company and franchiser**: Those fees paid to the managers in excess of the actual operating costs are called “leakage”. Traditional REITs, due to being prohibited from operating their properties, tend to endure a certain amount of leakage. But with a paired share it gets something like 20% more yield on every dollar it invests in a hotel.

b) **Acquisition power**: In 1994, Starwood Hotels and Resorts was a $200 million company trading at less than $5/ share in the stock market. It was then when Starwood’s CEO Sternlicht bought a paired share concept and started taking
advantage over other REITs. The Share price zoomed to $55/share in less
than 48 months. He was taking advantage of the tax benefits. REITs are
exempt from corporate tax and the paired share concept he bought included a
REIT and a management company. Patriot American Hospitality followed the
footsteps of Starwood and bought an existing Paired Share REIT.

In order to complete my graduation at Rochester Institute of Technology, I had to
select a topic for my thesis. I had always intended to do a research in financial topics. My
research on Real Estate Investment Trusts started in March 1998 when Mr. David Crumb
directed me to this newspaper article about Starwood’s battle against the government
over their Paired Share Status. First reading of that newspaper article left me totally blank
about the entire story behind that small article. But I was eventually drawn to this article
as well as the paired share REIT story. The Late Dr. Richard Marecki, instructor in the
Thesis class, approved my topic and I started working on it.

This study has been a very complex one and therefore if does not involve any
extensive surveys. It basically deals with general topics published in newspapers and
magazines. I had always focused on studying this topic deeply and then design my
questionnaire based on the present situation of Paired Share REITs. In May 1999, when I
designed my REIT survey with the assistance of Todd Dunda, Director of Finance at
Marriott Lincolnshire Resort, I also determined the size of my survey population. Mr.
Edward Marecki, my thesis instructor, has been giving useful suggestions since I started
with my thesis and also has been editing my thesis from time to time. The size of the
survey population was decided to be ten based on the following decisions:
a) Not every individual in finance had this specialized knowledge about the Paired share REITs.

b) The study progressed on the basis of everyday news in the newspapers, magazines and aggressive research on the Internet.

c) The final conclusion about the study would never depend on the answers through surveys, but the decision of the government to abolish the paired share structure or let them rule.

d) The purpose of doing a survey is just to get a general view about Paired Share REITs from economists, finance officials in Paired share companies and high-level officials working in companies against Paired Share structure.

The investigation about the Paired Share REITs took more than a year. I was also waiting whether the government’s new legislation on paired share REITs would a kiss from the prince that turns Starwood’s battered shares into a beautiful prince or a curse that would force the company to convert paired share company to C-corp. But Starwood CEO Sternlicht really did not believe that C-Corp conversion would sharply affect the value for their shares. In 1997, when Starwood’s (NYSE: HOT) stock prices went up 67% because of their grandfathered REIT status, they used their hefty stock price to win a tough takeover war for ITT Sheraton. Patriot American Hospitality (NYSE: PAH) also owned a paired share REIT company and their stock prices also went up but only 32%.

Differences between Starwood Hotels (NYSE: HOT) and Patriot American Hospitality (NYSE:PAH):
Patriot American Hospitality is a real estate investment trust involved in owning, franchising, managing and leasing approximately 400 hotels in North America, Caribbean, and other parts of Europe. It owns brands like Grand Bay, Carefree Resorts, Wyndham, and Clubhouse.

1. **Outperforming Starwood:** - Like Starwood, Patriot had the same advantages of skipping corporate taxes by owning a paired share REIT company. They tried to compete with Starwood and tried to make multiple acquisitions in order to reach an unrealistic goal.

2. **Interstate Hotels:** Patriot delayed to finalize the flagship acquisition of Interstate hotels. Marriott claimed that it had the right of first refusal on many Interstate assets. Due to this delay, the stock prices for Patriot began to fall.

3. **Equity Forward Contracts:** In order to keep the stock prices up and cover the delayed acquisition of Interstate Hotels, Patriot American Hospitality planned to add more hotels to its claims through a very risky derivative financing called “Equity Forward Contracts”. They already had a billion in debt, which was maturing in the next 12 months. With equity forward contracts, it borrowed another $350 million from Wall street houses and promised to either pay it off in cash or issue more stock at the present price at the time of payment. This form of payment was an addition to their short-term debt, which made them over-leveraged in 1998.
Congress was heavily lobbied by some non-REITs like Marriott and Hilton. They were against the Paired Share REIT structure, because only four companies were taking advantage of that paired share concept, and no other company was allowed to incorporate a new paired share REIT company. Finally, Congress had to pass a bill against Paired Share REIT structure, which said that no existing Paired Share REITs will be allowed to acquire as well as manage properties under that structure. Although, they can still maintain their paired share structure, but there would be no more acquisitions under that structure. This act finally took place in July 1999, but investors were already aware of the downfall of paired share REITs since Marriott and Hilton started lobbying against Starwood and Patriot for their acquisition power in 1998. This whole assumption of their downfall led to a 41% decline in REIT stock prices in 1998. Patriot, who had an “Equity Forward Contract”, was left with no option but selling some properties in order to pay part of the debt in cash and the rest with stock. Their stock prices were so down, that if they had tried to pay off their entire debt with stock, they would have to dissolve all their shareholders and they would loose control over their company.

Meditrust, another paired share company had undergone an asset-reduction plan in order to pay off $500 million of the company’s outstanding debt. It sold its golf-related real estate as well as some other properties in order to be on the safe side. In 1998, Meditrust had plans to acquire La Quinta Inn chain in 1999, which never happened because of the new legislation that Congress passed against the acquisition power of real estate investment trust.
The following people made their contributions towards my thesis by answering my survey:

a) Gary Filip is a front desk employee at Marriott Lincolnshire Resort in Illinois. He is an optimistic REIT investor and he has been observing the fluctuating graph of the REITs since the start of the acquisition battle for ITT Sheraton between Starwood Hotels and Hilton hotels.

b) John Dee is a REIT analyst with First Union Trust. First Union Trust was one of the favored Paired Share REITs, but they remained conservative throughout.

c) Todd Dunda is the Director of Finance at Marriott Lincolnshire Resort in Illinois. He gave his valuable contribution in designing the questionnaire as well as gathering useful data in the REIT sector for my thesis.

d) Brian Flannagan is a REIT analyst with www.reitanalyst.com. He had a lot of REIT information to share and thus was a great help for my thesis.

e) Robert Kalchik is the Vice-President of Finance with Marriott International. His comments had a lot to say about Paired Share REIT structure which was very helpful.

f) Mr. Paul Reeder is the Director of Research for REITs at SNL securities.

g) Mr. Warren Gump is a REIT analyst with www.fool.com.

h) Mr. Michael Dowd is also a REIT analyst with www.fool.com. His screen name at fool.com is TMF Yorick.

i) Ms. Michelle White, who is a REIT analyst with Federal Realities, gave her valuable suggestions for my thesis.
j) Mr. Edward Marecki, who is also my thesis advisor, participated in filling out the questionnaire. He has been evaluating my thesis from time to time in order to include the updates.
CHAPTER 4

TABULATION AND ANALYSIS

Investors have always considered REIT as a long-term asset because it involves investing in land and building. So, it works as a security for them in the long run. REITs originated in 1960 when legislation was passed in the favor of small investors. Ownership of REITs would enable an investor to own the real estate through the ownership of shares.

There are limitations for REITs when it comes to managing the properties. They are only allowed to manage the rental-based properties such as apartment complexes, shopping malls, and other similar properties where the income is only based on rent. When it comes to managing Hotels, Casinos, Golf courses and other assets which involves specialized services, they have to hire a management company (C-corporation) to run the business for them. So, there are chances of conflicts between the management of C-corporation and the management of the Real Estate Investment Trust. The Owners’ interference in managing the property is limited to a minimal amount. The only solution to end all these conflicts is that the same company owns the REIT as well as the C-corporation. This structure is called a Paired Share REIT Structure, where shares of one company are traded simultaneously with the shares of the C-corporation.

REIT is basically an income-producing real estate, where they lease their space to a third party. As discussed in Chapter 1 and 2, they pay out at least 95% of their taxable income to their shareholders. They also are exempt from the corporate tax.
Investment Trusts have been doing very well for the past five years. This is because of the paired share REITs had been very popular since 1994. The Paired Share Company owns the REIT as well as the Management Company. They can do a lot of income shifting from the C-corporation to the REIT. *This saves them taxes, and they have a better control over their assets.* In 1984, Congress realized that the paired share structure was used by some companies to abuse the tax system. So, they decided they would abolish the paired share structure in order to increase the tax revenues. But, they did not erase the existing five Paired Share REITs. That grandfather clause determined the existence of those few paired share companies and ruled out any further formation of a Paired Share Corporation. So these grandfathered companies had a big tax advantage over the other REITs as well as non-REITs. The only way to become a paired share REIT after that clause was to buy one of those existing paired share REITs. *Starwood as well as Patriot American Hospitality bought one of those existing paired share companies in 1994-1995 and were very soon on the fast track of acquisitions.*

A REIT distributes 95% of its taxable income among its shareholders. Investors want to invest in a REIT because they get dividends on a regular basis. So, REIT can be considered a good investment during the long run.

*The only way a REIT can buy more properties is by issuing more shares.* The share prices for that REIT are bound to rise after the acquisitions. Increased share price means higher purchasing power. Higher purchasing power means more acquisitions. But if a company issues more shares in order to pay the dividends, then it is not worth investing in that company.
Legislation finally cracked down the stapled REIT status mystery in March 1998. Real Estate Investment Trust used Paired Share status as their tax shelter. They avoid paying corporate income tax on a large share of profits from Hotels, Casinos, racetracks and similar entities by shifting profits to their non-taxable entities. Starwood Hotels & Resorts Worldwide alone estimates that it saved about $150 million a year in annual taxes due to its stapled REIT structure.

“While Starwood is a large company domestically, it’s a relatively small company on the global scale. Big hotels are expensive and require a lot of capital to acquire. With the recent turbulence in the European and Asian markets we expect it to be exciting and very exciting opportunity for us to acquire real estate at very attractive prices off-shore.” These were the exact words of Barry Sternlicht, C.E.O. of Starwood Hotels & Resorts Worldwide, recorded during a conference call on October 20, 1997, when his real estate investment company was in the prime time of the real estate cycle. Real Estate has always been a very cyclical business and during that time (1997), REITs were worth a lot of money.

Unlike traditional corporations, REITs have never paid federal income taxes on their earnings. To qualify under REIT status, a company can only own the assets.

The Problem Statement discussed here was the potential abuse of the Paired Share Structure, which further led to the abuse of the tax system.

Congress outlawed the structure in 1984, but allowed a few existing paired share REITs to run their businesses. The then five existing REIT corporations were:

1. Hotel Investors Trust and Hotel Investor Corporation
2. California Jockey Club and Bay Meadows Operating Company
The following is the analysis and discussion about the survey regarding Paired Share REITs. As discussed in Chapter 3, there is a total of 10 people who were invited to fill out the questionnaire. The selection of these participants was based on their vast knowledge about this subject.

The questionnaire designed for the purpose of getting feedback from these individuals consisted of 8 questions. Each one of them had a different perspective towards the paired share structure. The answers to the questions have been organized in a manner which is easy to read as well as understand. The answers from all the participants will be discussed one question at a time.

1. Gary Filip, a senior Front Desk Associate at MLR, IL had mixed views about the first question. According to him, the new legislation might hammer the growth of Paired Share REITs, but they will still be able to gather a large sum of money from the stock market. John Dee’s answer to the first question was affirmative. He is positive that REITs will be able to raise funds though not at the same pace. According to him, Paired share had not been the only weapon with REITs for raising money during the last five years. Investors have always had the benefit of the dividend distributions. Now that Paired Share Structure has gone, the big returns for the investors might take some time. The real estate owners should focus on becoming great managers and should squeeze the operations for improved revenues and better balance sheets. Todd Dunda,
the controller at MLR, IL said that Paired Share REITs had been operating with an advantage over other corporations which allowed them to show huge profits. This strong future earning potential also allowed them to acquire capital easier than their competitors. With the tax law changes, their advantage has come to an end and now they will be competing for capital on a level playing field. Brian Flannagan does not agree with the premise that the tremendous growth in REITs has been due to the paired share structure that a few REITs had. According to him, the growth in REITs is primarily due to the advantage of the REIT form of ownership such as availability of capital, diversification and professional mgmt. Robert Kalchik, VP of Finance for Marriott International underscored that REITs will have a more difficult time obtaining equity financing in the future because of the elimination of the paired share REIT structure. Because the REIT is tied to the real estate values, in a down market they will find it very difficult to obtain equity financing without relinquishing a large share of the company. According to Paul Reeder, SNL Securities, paired share format was largely an irrelevancy as there were only 5 paired share REITs and over 200 others. According to Michael Dowd, a REIT analyst at www.fools.com, Paired Share REITs were not the only REITs who saw the increase in their market capital during the last five years. He also underscored that there were many real causes that triggered the downturn for REITs. One example is the Russian Debt Debacle. Another is the decrease in the easy pickings of distressed real estate that had been available from US banks, FDIC, etc. Warren Gump, a REIT analyst at www.fool.com, expressed
that buying a distressed property into an improving economy tends to be an excellent economic endeavor. In addition, he also said that real estate can never be a permanent growth industry. According to Michelle White at Federal Realty, Paired Share REIT structure has no bearing on the money from Wall street.

2. The second question is somewhat related to the first one. According to Gary Filip, real estate markets are very cyclical, so there are chances that REITs rise again. John Dee’s comments were similar to Todd Dunda’s. He said that it will be hard for REITs to keep coming up with new and innovative types of REITs to get the investors excited and creating demand for more owners to form REITs. Brian Flannagan answered negative for the second question. Paul Reeder believes that the period of buying properties below replacement cost is gone and he also says that the legislation is very irrelevant. Robert Kalchik does not agree that the REITs will proliferate the way they have in the past two years. The tax law changes will definitely affect their growth. According to Mr. Dowd, US REIT market cap growth has already slowed and a rapid recovery is not expected to the growth rates of the mid 90s. Mr. Gump said that the number of REITs might not increase, but they might have a larger asset base five years from now. The industry has been consolidating and this tends to happen in most industries after a period of rapid growth. Ms. Michelle White expects same growth pace for REITs in the next five years. She says that the fundamentals of the Real Estate Industry have never been
better. Most companies still have reasonable levels of debt and attractive dividends.

3. Third question asked about any pending laws in the future, which would affect the growth of REITs. Gary Filip, Todd Dunda and Mr. Kalchik were not aware of any pending laws for the year 2000. Mr. Flannagan, Mr. Reeder and Mr. John Dee had similar comments. REIT Modernization Act which was introduced in August 1999. According to this current tax act passed by the Congress, REITs will be allowed to set up taxable subsidiaries for non-qualified REIT activities and will also lower the minimum dividend requirement to 90%. Michael Dowd and Mr. Gump was not aware of any pending threats to REITs. According to Ms. White, REITs will be allowed to own companies that offer services to its tenants. This law would be effective in the year 2000.

4. Gary Filip, Todd Dunda, and Mr. Dee highlighted the same point. Mr. Filip said that the main reason for the REIT investment was the dividend they were offering. The investors were being offered 95% dividend. Investor expectations of higher returns from paired share REITs, being able to do more things with their corporate structure than regular REITs. According to Todd Dunda, REITs are income producing real estate and had very impressive returns in the last few years, largely due to their tax advantage over all corporations. Investors were basically looking at the higher returns when investing in REIT assets. Mr. Brian Flannagan said that the tax advantage allowed REIT to make multiple acquisitions, attract larger capital as well as
attract the investors. Mr. Kalchik believes that there has been a high level of interests by investors in paired share REITs due to the quick growth in stock prices of REITs as well as high level of dividend payout. Both opportunities provided an above average return on investment. Mr. Dowd underscored the same point as Mr. Kalchik. He said that the expectation of a high total return drove the paired-shares. According to Mr. Warren Gump, Acquisition at a fast rate was the reason why investors believed in Paired Share REITs. The advantage of the paired share REIT was that it was able to hold both ownership and management contract, avoiding the leakage of other REITs. Under this structure, it was believed that the paired share guys would have an advantage in virtually any asset acquisition contemplated. This advantage led to higher perceived growth opportunities, which in turn led to much higher stock prices. The new legislation has obviously killed those expectations. According to Michelle White, Investors always invest in a stable Real Estate Company with ownership of high quality irreplaceable assets and earn a huge dividend.

5. Starwood and Patriot have been very popular in past two years because of their multiple acquisition strategies. This particular question mainly focuses on the strategy used by the Starwood management to keep themselves in control while Paired share were on the verge of downfall. According to Mr. Filip, Strategy regarding acquisitions was the step Starwood remained most cautious about and which kept them in the race even after they had converted their REIT into a C-corporation. Unlike Patriot, their stock buy-back program
and maintained balance in their debt structure helped them from going into bankruptcy. According to Mr. Flannagan, Starwood was never as sick a company as Patriot. Patriot made the rookie mistake of financing their acquisitions with short-term debt. After their stock price declined they were unable to refinance and thus had to get an extremely expensive equity infusion. Starwood’s capitalization was never that bad. The company only had to make a few restructuring moves. Mr. Kalchik and Mr. Dowd believe that there was one big difference between the Starwood investment strategy and that of Patriot’s. Starwood used stocks to make purchases, thus they used their current equity in the company to add new assets to its portfolio. Patriot on the other hand used what is known as forward contracts. These contracts are similar to derivatives- a device that uses the future value of the company’s stock to pay for their assets. Patriot’s strategy was highly leveraged and it contributed to their financial demise over the last six to ten months. Starwood has assimilated their investments into their portfolio, even with a failing stock price. Patriot has had to sell assets as well as an equity interests in the company to obtain cash to pay off their creditors. In addition, Wall Street also decided that Patriot had messed up the documentation of the Interstate Acquisition, which cost it a law suit with Marriott. It kept missing consensus FFO estimates. It did not have the brand name strength or property portfolio of an ITT Sheraton. As a result, the market utterly lost faith in Mr. Nussbaum (C.E.O. of Patriot). According to Mr. Reeder, Starwood enunciated its strategy far better and was not forced into adopting any particular strategy by financial
mismanagement (Unlike Wyndham acquisition by Patriot). Mr. Warren Gump believes that Starwood had far less short-term debt than Patriot. They had to divest their non-strategic assets to pay off some of the outstanding short-term debt. But Patriot with their equity forward contracts were unable to survive the stock market fluctuations. Ms. Michelle White views about both the companies were mixed. According to her, Starwood’s management has no track record of outstanding management, but they have better assets than Patriot. Both the companies tried to clone Marriott, which is a management company far stronger than either.

6. Mr. Gary Filip would consider all the options in question 6 before investing in REITs, plus his basic hunch about the market and economy. Mr. John Dee repeated that it would be package of all things that he will consider before investing in REITs. Moreover, he would look into the “Top Management structure” along with their strategic plan. According to Mr. Dunda and Mr. Kalchik, Future Acquisition Capability is the most important aspect of any company. This is where the future growth of the company is going to be measured. In addition, Mr. Kalchik said that REIT is an “income” Investment as opposed to “growth” investment( produces high dividends as a return vs. high growth in the stock price). Mr. Flannagan believes that profitability always comes #1, and quality of management, quality of assets next. Mr. Warren Gump prefers to look at the quality of properties first before investing in REITs. Then comes the Valuation relative to market and historical norms, manageable debt levels and future acquisitions capability. According to Ms.
White, strength of the operating business is very important. That depends on the quality of CEO and management team. She also added that Mr. Barry Sternlicht (CEO of Starwood) had never operated a business, therefore he has no capability of managing the most management intensive business (hotel industry).

7. According to Mr. Gary Filip, Starwood Hotels is a very high profile company. It has been in the news all the time. Nearly everybody has heard of their acquisition capabilities and their chain of properties. Mr. Dunda believes that strong Board of Directors with a clear vision is very important for a growing company. He also added that a REIT that reduces its risk (to survive a downturn in the market) is prosperous in a strong economic environment. Mr. Flannagan comments were somewhat similar to Mr. Dunda’s. He said that management and quality of assets are a key to company’s success. He also said running a hotel is not a passive activity, it is a very challenging business that requires top managers. Mr. Kalchik and Mr. Reeder share the same views about a high profile REIT company. Mr. Kalchik believes the better quality REITs are the ones with good real estate investments that can hold their value in their downturn as well as grow in value in the good economic environment. This will allow the stock price to grow and provide the REIT the capability to take on new assets by issuing equity. Mr. Reeder added that quality of operational and financial management, exposure to overbuilding and luck are three very important things when running a successful organization. According to Mr. Warren Gump, Host Marriott has many excellent properties
with high barriers to entry and a great management team. Ms. Michelle White further adds that Host Marriott has an excellent management team, but Starwood needs good leadership.

8. Almost everybody shared the same views about this last question. They said the paired share REITs had the tax advantage which gave them a lower cost of capital and allowed them to outbid anybody for assets. This tax advantage was a threat to all the other REITs as well as non-REITs. Mr. Bollenbach and the Marriott feared that the paired-share REITs low cost of capital would enable them to eat all the good deals. The avoidance of corporate taxes and the maintenance of management company revenue fundamentally led to the paired-shares being able to pay higher prices for the same assets.
For many years, we have had a love-hate relationship with real estate. We love our homes and expect that they will appreciate in value. What would you call a perfect investment? The one which would make you an instant billionaire overnight or the one would pay you a consistent six to seven percent in quarterly dividends that go up 6 or 7 percent annually as surely and steadily as if they were rent.

REITs are no longer different from any other industry that is dependent on access to the capital markets. During the 1980’s, direct real estate investments were made on the basis of recommendations of consultants and appraisals of the properties. But in REAL ESTATE INVESTMENT TRUST, real estate investments are simplified through the purchase of stock. This method of buying stocks related to real estate, thus becoming an indirect landowner, is termed as Indirect Investment. The Capital availability to the real estate industry will always be governed by the rules that apply to all the other participants in the capital markets.

LIQUIDITY is primarily the most important factor encouraging the investments in real estate investment trusts. The new REITs represents an asset class in the capital markets that has permanently changed institutional investment in real estate and simultaneously encouraged individual investors to participate in real estate. MERGERS and CONSOLIDATIONS have been happening in the recent years. Starwood Hotels and Patriot American Hospitality had a vision of taking over the entire hotel
industry through their paired share REIT structure. Their stock prices zoomed up more than 10 times after they made multiple acquisitions through Paired Share REIT status. Paired Share REIT status allowed them to get 20% more yield on every dollar invested, thus giving them a advantage over their competitors.

Different players in the REIT business are confronted with the responsibilities of running a public company and operating it in fashion that will attract capital. The successful REITs are the ones that can be characterized as operating companies versus a collection of properties. Real Estate Investment Trusts have always been trying to create both availability of real estate equity options and liquidity for investors.

In short, real estate investment trust are a vehicle to own a commercial piece of real estate through ownership of shares. The REIT concept has always been a good one. As Congress enunciated in the committee report accompanying the legislation creating the REIT tax vehicle in 1960:

"Your committee believes that equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated investment companies undesirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with large resources. These advantages include the spreading of risk of loss by the greater diversification of investment, which can be secured by pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly."

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For many years, Real Estate Investment Trusts have always largely been disciplined by basic supply and demand, but since early 1990’s, the real estate tax shelter partnership, which are called paired share REITs, have broken the rules. Under that status, tax shelter drove the investment and over-development of commercial real estate. Investors were getting a $4 tax deduction for every $1 invested in REITs. Nobody cared about the tax shelter violation or supply/demand disciplines had reached a preposterous disequilibrium. Before the tax reform act of 1986, real estate investment trusts were not allowed to manage any kind of properties. So, they used to look for partners who could manage as well as serve their interests of saving dollars for further investment. They used high level of depreciation, in order to escape taxes. The Tax Reform Act of 1986 imposed restrictions on the amount of depreciation every year, but it allowed REITs to manage their own properties, except the ones, which need management with some specialized knowledge.

In the case of property management with specialized knowledge such as hotels, golf courses, etc. REITs have to hire an outside management company and pay them costly fees for that. Investors have always wanted the manager’s accountability and participation in REIT management. REIT has always been an efficient corporation that receives a dividend-paid deduction and thus can avoid a corporate entity level tax resulting in a single tax on the income stream at the shareholder level. Owning shares in a public REIT as opposed to individual assets allows for liquidity without the company selling any of its assets. This proved compelling for two reasons:
1. Tax Efficiency

2. Allowed these entities to enter a form in which a company could outlive its founder.

WHY STAPLED REITs OR PAPER-CLIP REITs?

In order to avoid corporate level income tax, hotel REITs must lease their hotels in compliance with a variety of tax rules. Chief among them is that the tenant must be left with a profit potential after paying the rent, management fees and operating expenses. The efforts to recapture this loss of earnings (called leakage) for the REITs’ shareholders has driven the recent evolution of the hotel REIT structure. Under a stapled REIT status, the REIT and the corporation trade together in the stock market. They have the same shareholders as well as the Board of Directors. The shareholders always get combined of both the companies (REIT as well as the Management Company). It also eliminates any kind of conflicts between the property owner and the Management Company. REIT can transfer huge amounts of profits as rent from the Management Company and save taxes on C-Corporation. REIT as we know is already exempt from the corporate taxes, so both the companies if combined into a Paired Share REIT can save taxes on both the companies.
KIMCO laid the foundation stone of the REIT IPO market. In 1991, it gathered $128 million in its first offering and they conducted themselves in a very investor friendly manner throughout thus positioning themselves for future capital raising. REIT market’s future mostly depended on the success of KIMCO’s IPO. And their success proved that a REIT IPO could be completed and is profitable.

The following are the questions, an investor needs to answer before investing in REITs:

a) How are the properties constructed and managed?

b) How are they located and managed?

c) What kind of rental growth exists?

d) What is the competition?

e) Are all the assets in one sector?

f) Plans for growth?

g) Is the management knowledge about the projects?
DEBT LEVELS

A debt to total market capitalization of 50% or less is required for a REIT IPO. If the ratio is 35% or less, then the company has room to grow by taking on modest additional debt after the IPO with the more conservative investment balance sheet. A good place to start a REIT would be a “PERFECT BALANCE SHEET”.

Patriot American Hospitality, a paired share REIT like Starwood Hotels, had the advantage of not paying the corporate taxes thus getting more yield out of a dollar. With an unrealistic vision of making multiple acquisitions of hotels, they increased their debt level to the maximum point. They also signed the “Equity Forward Contracts”, which proved devastating for the company.

According to these contracts, they can pay back in cash or with their stocks, whatever the present value of the stock would be. They were very confident that they could pay the loan off with their shares, because the stock prices for Paired Share REITs were rising steadily in those times (1998). But Clinton’s legislation affected the stock prices to a great extent. And the stock prices for Patriot went down by 79%. The big lesson Patriot learned at this point in the real estate cycle is that managing the balance sheet is equally important as managing the properties. Patriot reshuffled the management after this business tragedy. They restructured the debt and sold $200 million worth of its non-core hotels and the interstate management operation to an affiliate of its financial advisor, Paine Webber. They also replaced Paine Webber as its financial advisor. Now, that they have reduced the amount of debt, they are not in danger of any kind of bankruptcy. They had to delay their third quarter dividends in 1998, in order to get a control over their debt. The CEO of the company was replaced in 1999. Mr. Paul
Nausbaum, former CEO for Patriot American Hospitality, realized his mistakes and did not fight back before he was removed from the CEO position.

Starwood hotels and resorts on the other hand, had become one of the largest hotel operators in the world, because of their paired share REIT status. They bought a paired share company when they were merely a $200million company. Within 3 years, the company’s worth zoomed to $20billion. In March 1998, when Congress decided to look into the grandfathered status of the five remaining Paired-Share REITs. This news break-up among the investors led to a steep stock value decline for all paired-share REITs, including Starwood Hotels. Total Return (%) for Starwood in the year 1998 was <60.81%. Their total debt/ total capitalization as in December 1998 was 59.84%. Starwood as a result had to dissolve their REIT status in favor of a more traditional C-corporation structure. With that structure, they will save $300-$400 millions in dividends but will pay corporate taxes. It also has got a good rating on its debt and was able to cut down its borrowing costs. Starwood’s position in the market was favorable as compared to Patriot American Hospitality because the reduced amount of debt.

Meditrust, another paired share REIT, sold its $1billion in assets in order to implement upon their restructuring plan. They did not shed their REIT status like Starwood, but split its operations into two separate REITs – HealthCare properties and Lodging properties.

First Union also had the paired share REIT status but they never really took advantage of their structure nor did they take any drastic step to restructure their debt.
REIT MODERNIZATION ACT

According to National Association of Real Estate Investment Trust (NAREIT), Real Estate Investment Trusts became the mainstream investments in 1997. During the twelve months ending December 31st, 1997, REITs had set all-time, annual capital raising records by completing over $45 billion in security offerings, including 289 secondary offerings raising about $26 billion, and 26 initial public offerings raising a little over $6 billion. A total of 210 REITs had an equity market capitalization of nearly $141 billion compared to $16 billion from 142 REITs five years ago.

A lot of privately held commercial real estate was transferred into the portfolios of publicly traded REITs. REITs outperformed the S&P 500 index and the Russell 2000 index in second half of 1997, providing the investors with a 12.17% annualized total return compared with the S&P’s 10.58% and the Russell’s 11.03%. For the past 20 years, REIT performance has been very close to S&P 500. An economic turmoil in the Asian financial market also led to the sudden growth of REITs in 1997.

According to many real estate analysts, “paired share” REITs were not the only REITs that were raising money in the last five years. Investors wanted to invest in REITs because they wanted to enjoy the benefits of dividend distributions before Uncle Sam took a big bite on taxes. With a strong opportunity for future acquisitions, the dividends for any company can grow and produce a fair return for the investors. Paired Share REITs were exempt from 35% of corporate tax and also can do income shifting from C-corporation to the REIT to save even more in corporate taxes. The major Hotel Chains felt that the paired share REITs were a threat because they did not have to use the same economic market forces that the chains had to use to expand and provide a fair return to
their owners. The REIT tax advantage gave the paired share companies a growth strategy that could not be matched by the chains. Starwood survived the new tax legislation but Patriot ran almost into a bankruptcy. The biggest difference between the two companies was their capital structure. As a percentage of assets, Starwood had less debt with short-term maturities and a smaller amount of forward equity sales. While the past year had been hard on Starwood, most of their debt was long-term. Patriot was stuck with too much short term debt and forward equity sales because of the Interstate and other acquisitions. Problems with Marriott related to the IHC purchase delayed and complicated the situation. The company could not roll its short term obligations into long term debt. The only option left with them was to dilute prior-owners ownership stake. They have been doing a little better this year.

REIT stock prices were driven up above normal trading multiples and provided management with quick financing. With this tax advantage eliminated, the REIT must compete for equity funds similar to all other investment options—it must be a good investment that produces a fair return over time. Certainly, the growth that we have seen in the past 5 years will not continue strongly, but this is due to real estate industry maturing rather than to changes in tax laws.
Recommendations

The REITs have been very popular in the past five years because of the high-profile acquisition power of the paired share REITs. They had been able to get equity financing easier than other REITs as well as non-REITs. Congress passed a new tax legislation which has completely abolished paired share REIT structure. The study was focused on only four paired share REITs and the future outlook of REITs was also discussed. Investors are now “lukewarm” on real estate- it’s an attitude of “I’ve invested in you, now where’s my big return?” Well, the big returns might take some time. This study can be an eye-opener for the companies who ignore the management part of their organization:-

- This research shows that Starwood and Patriot American abused the tax law system in order to fill their own pockets. But unlike Starwood, Patriot was not able to take the harsh blow from the government, which came in the form of REIT Modernization Act.
- This study proves that real estate owners should spend time to improve their operations for improved revenues and better looking balance sheets.
- Investors always had had the “Herd-Mentality”- people studying this thesis should focusing on new alternatives in real estate industry for a while and look for loopholes in Internet stocks, medical stocks, and technology stocks.
- Patriot made the rookie mistake of financing their acquisitions with short term debt. After their stock prices declined, they were unable to refinance and thus had to get an extremely expensive equity infusion. Short term debts can be a threat to the management capabilities of any company.
There is a theory of investing that when you’re first with an idea to the market, you get a better price than the next guy does. Well, I think, Paired Share REITs were the latest sensation in real estate industry, and it will be hard to keep coming up with new and innovative types of REITs to get the investors excited. But always keep your eyes and mind open to new ideas and if you find another loop-hole, don’t tell anybody, go ahead and make a few bucks.
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APPENDIX A: Questionnaire

Please answer these questions with as much details as possible.

Question 1:

The REITs have been very popular in the past five years because of the high acquisition power of the Paired Share REITs, which has been drawing a great deal of money from the stock market. Now that the paired share structure has been completely abolished, do you think REITs will be able to gather as much money as they did in the last five years?

Question 2:

Kimco Reality was one of the first few REITs who went public in 1992. Since 1992, the size of the public REITs have grown to 200 firms. A change in the legislation has hindered their fast growth. Do you think they will grow at the same pace for the next five years? Reasons if possible.

[ ] YES  [ ] NO
Question 3:

My research could not detect anymore pending laws, which could affect REITs, positively or negatively. Are you familiar with any? If yes, what are they?

Question 4:

The investor has been highly interested in investing in REITs, especially Paired Share REITs. Why do you think investor was investing in Paired Share REITs?

a) Management had 10% ownership stake in the company

b) Acquisition at a fast rate, which made their share prices go up

c) High Dividends- Paired Share REITs distributed 95% of its taxable income as dividends to the shareholders

d) Other

Question 5:

Two of the biggest Paired Share REITs Starwood Hotels & Resorts and Patriot American Hospitality saw their stocks dramatically decline due to the Clinton Administration’s declaration of abolishing the paired share structure completely. Since that time, Starwood Hotels have been able to keep their share prices steady and Patriot American Share price has continued to decline 79%. What has
Starwood done differently than Patriot American in the following items or categories?

a) Board of Directors

b) Strategy regarding Acquisitions

c) Other

Question 6:

Out of these, what would be your number 1 priority before buying the stock of a Hotel REIT.

a) Debt Level

b) Future Acquisition capability

c) Past History

d) Board Of Directors

e) Other
Question 7:
How would you categorize the best quality REITs? What REITs do you think are the top performers and also can survive a downturn in the present lodging industry. What characteristics of these top performing REITs differentiate themselves from the other.

Question 8:
Why do you think Marriott, Hilton, and other non-REITs felt a threat from paired share REITs like Starwood and Patriot America Hospitality?
a) Because they were exempt from 35% of corporate tax plus they were saving taxes from the c-corporation
b) Income shifting between the REIT and the management company
c) Aggressive Acquisition Power
d) All Three
e) Other