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REIT IPOs Flounder As Investors Remain Skittish

By **Kaitlin Ugolik**

Law360, New York (April 25, 2012, 3:12 PM ET) -- The real estate market is on the mend and capital market conditions are showing improvement, but one further indication of recovery in the sector has yet to materialize, puzzling some real estate lawyers.

Under current conditions, private real estate investment trusts would be expected to be tapping the markets and launching initial public offerings, attorneys say. But so far, IPOs for REITs have mysteriously been in short supply.

Brookfield Realty Capital Corp. joined a growing list of REITs that have withdrawn their IPOs, when it took back its $500 million offering April 18, blaming bad market conditions. And investors in the Empire State Building are so opposed to the creation of a REIT and accompanying IPO that they have filed at least three lawsuits challenging the owners' plans.

Although existing public REITs seem to be serving their investors well — with at least 35 percent paying out improved dividends in the last two fiscal quarters, according to SNL Financial — investors seemingly are skittish about new offerings, experts say. In fact, many are seeking deep discounts that REITs simply won't accept.

“There's a suspicion that property values are more specious than in the past, and REITs have a sense that their portfolios may be worth more than the street is willing to bear it,” Seth Weissman, a real estate partner at Jeffer Mangels Butler & Mitchell LLP in California, told Law360.

Some of the investor reluctance stems from poor performance in the last round of REIT IPOs, which suffered from a lack of leverage when asset prices increased unexpectedly last year, according to a veteran banker with 11 years of REIT experience.

In one instance, major shopping center REIT Retail Properties of America Inc.'s IPO opened lower than expected at $8 per share, leaving investors who paid $10 per share a few years ago disappointed and prompting investigations into possible legal claims.

During the downturn, many managers and advisers rushed to create so-called blind REIT IPOs, looking to buy up distressed properties with the expectation that investors would be more comfortable putting money into real estate companies that hadn't been around to suffer from the crash. But this plan backfired when asset prices rose much more quickly than expected, leaving the leveraged companies that had initially been perceived as underwater in a better stock position than the new REITs, the banker said.

As a result, investors are more comfortable with established public REITs and private real estate companies, and REIT IPOs have received the [improper] label that they “just don't work,” creating a dysfunctional environment, he said.

An increase in regulatory oversight and the expectation of new, harsher rules in the near future has also dampened REITs' efforts to take on the arduous IPO process. Last fall, the SEC announced that it was considering the creation of new rules governing REITs and other mortgage-related pools under the Investment Company Act of 1940.

Nothing has yet been set in stone, but Michael Zuppone of Paul Hastings LLP, who is participating in discussions with the SEC about possible rulemaking as part of a National Association of REITs task force, said the announcement likely derailed many IPO plans, particularly with regard to mortgage REITs.

“It caught a lot of general investors in the sector off guard,” Zuppone said.

For some REITs, the solution has been to turn to mergers and acquisitions instead of IPOs. An M&A transaction can provide the opportunity to increase liquidity or deleverage assets without the risk to investors that a stock will price low or perform poorly, according to David Lari of Cox Castle & Nicholson LLP.

Others have decided to hold off entirely and maintain the status quo until market conditions improve all around and investors are no longer looking for such steep discounts.

Those still interested in going public are closely watching IPOs in other industries, particularly technology. Real estate data company Zillow's July 2011 IPO was seen by many analysts as a harbinger of good things to come for other real estate-related offerings: Zillow issued 3.7 million shares at $20 per share and was initially valued at nearly $1 billion.

And managers and advisers in all industries are looking to the highly anticipated Facebook Inc. offering for reassurance that an IPO is once again a safe bet, Zuppone said.

Meanwhile, a backlog of potential REIT IPOs sits in limbo at the SEC. Hard numbers were not immediately available, but anecdotal reports from various real estate attorneys suggest that several billion dollars worth of the IPOs that make up the current SEC backlog belong to REITs that are waiting for the right time to offer their shares.

“How many of those ultimately end up going forward is difficult to predict,” Lari said. “You generally need good timing on a macroeconomic basis, coupled with strong financials and a quality management team going, for you to get the institutional investors behind you and have a successful listing.”

--Editing by Christie Smythe and Eydie Cubarrubia.