APRIL 25, 2019

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How Much is Your Management Company Worth in a REIT Roll-up Transaction?

by Sherry Cefali of Duff & Phelps

In REIT roll-up transactions, the value of contributed real estate assets is generally understood, as investors are usually comfortable with the well-established methodologies underlying real estate appraisals. The value of the management company is less straightforward, however, and often becomes an area of inordinate focus in roll-up transactions. So why is the management company a source of value and how is that value best determined?

This article is an update to our studies performed in 2014 and 2016 that explores management company valuations from the following perspectives:

- Why it is important to convert to internal management prior to a REIT going public
- The reasons why a manager has value in a roll-up
- Historical trends regarding management company valuations in REIT roll-up and internalization transactions
- The use of a discounted cash flow analysis to value management companies
- Factors that impact the values of management companies

The Need to Convert to Internal Management

Many private real estate entities operate as a series of limited life partnerships or LLCs, with an "external"[1] management company overseeing each of them in exchange for an asset management fee and a carried interest participation in the ultimate profits of each entity (also known as a promote interest). Many of today's noteworthy publicly traded REITs were formed as a result of roll-up transactions in which a series of these finite-life funds are reorganized into a newly formed REIT at the closing of the IPO [2].

It can be very difficult to generate sufficient investor interest to go public if an equity REIT [3] continues to use an external manager. Therefore, REITs are strongly advised to internalize their management company prior to, or concurrent with, its IPO. "REIT investors are generally very focused on making sure their interests are fully aligned with management's interest when it comes to buying stock and pricing an IPO," says Jeff Horowitz, Global Head of Real Estate, Gaming & Lodging Investment Banking for Bank of America Merrill Lynch. "To achieve maximum investor demand and optimum pricing, we typically recommend REITs internalize management and be fully integrated, self-managed and self-advised."

Under most external management agreements, the managers are paid a base fee on assets under management. This means that the external managers may be incentivized to build larger portfolios, even at the expense of quality or profits. Furthermore, a number of managers hold board seats on multiple managed companies' boards, resulting in further potential conflicts of interest. As a result, even if an externally advised REIT is successful in completing its IPO, we found that it will often trade at a discount to its internally managed peers.[4]

Given the market's preference for internally managed REITs, the path to achieving the highest returns for investors in a roll-up REIT IPO often includes converting to an internalized management company.[5] To do this, the investors in the funds and the owners of the management company must agree on the valuation of the manager interest, and that often creates some of the most significant issues in the roll-up.

What Value Should be Assigned to the Management Company?

So why does a management company actually have value and how is that value best determined?

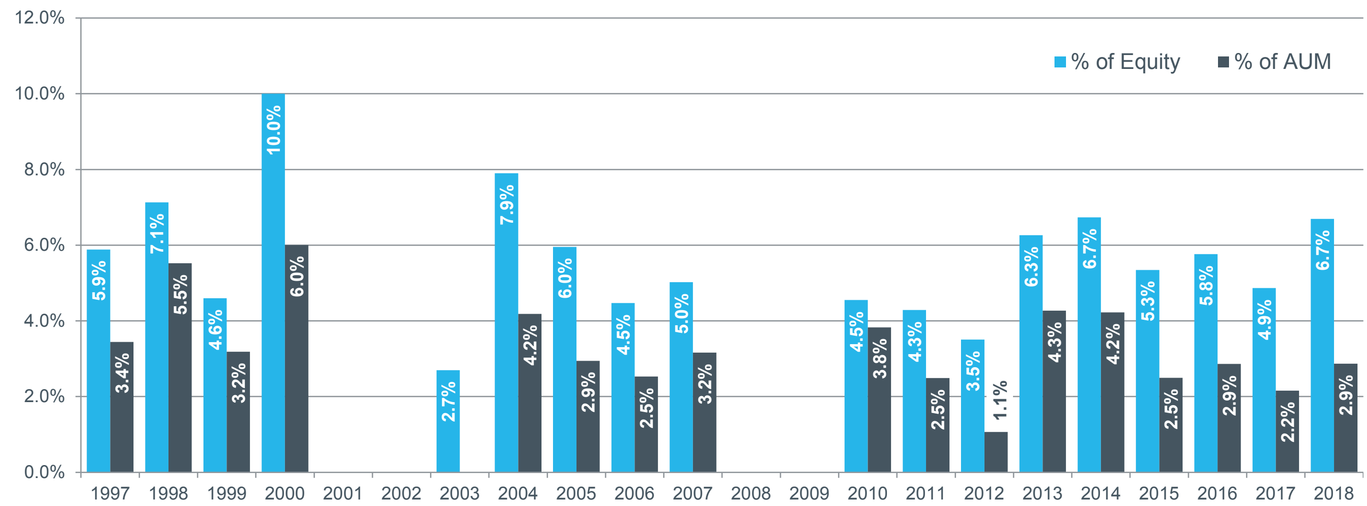
In the world of privately-owned real estate investments, the manager has a contractual right to property and asset management fees, generally for the term of the fund. In the typical roll-up, the manager exchanges these contractual future rights, any carried interest, and (where applicable) its operating platform for shares or units of the newly formed REIT. After the roll-up transaction with the management company, the newly formed REIT will no longer incur fees payable to the manager for property management, asset management, and other services under the advisory agreement.

The number of REIT shares allocated to each partnership is typically based on third-party appraisals of the real estate properties, adjusted for other assets and liabilities contributed to the REIT, such as mortgage debt and cash, to determine each partnership's contributed net asset value ("NAV"). The number of REIT shares allocated to the management company is estimated using generally accepted valuation methodologies, including an analysis of management company values in REIT roll-up and internalization transactions, as well as a discounted cash flow analysis.

While the participants can use real estate appraisals to get comfortable with the relative value of contributed real estate assets, the value of the management company is much less transparent.

"Investors easily understand that their properties are valuable but tend to forget that internalized REIT management requires the management entity giving up future property and asset management fees," added Peter Linneman, CEO and founder of American Land Fund and KL Realty and current board member of Equity

Advisor Value as a % of Total Equity and AUM*



*Excludes transactions where the external advisor was internalized with no fee

Source: Duff & Phelps database of 58 internalization transactions compiled using publicly disclosed information and proprietary deal intelligence

CommonWealth REIT, Regency Centers and Paramount Group.

Analyzing Other Management Company Transactions

One of the best ways to estimate the value of a management company is to analyze other REIT roll-up and internalization transactions. The market price paid for the management company (the "Manager Value," also sometimes referred to as the "Internalization Fee") is analyzed relative to the management company's profitability, as well as relative to the value of the REIT.

Most of time, the manager is acquired just before, or concurrent with, the REIT going public. Therefore, there may not be any disclosure requirements regarding the manager's profitability or price paid for the management company. However, the value received by the management company can be determined if the REIT disclosure documents include the number of REIT shares or units the manager received as consideration in the transaction. In addition to the consideration paid to the manager at closing, there may also be a contingent component if certain targets are achieved, as was the case in the acquisition of the respective management companies by Cole Credit Property Trust III and by American Homes 4 Rent. While these "earn-out" payments may be difficult to quantify, they often represent a meaningful portion of the total price paid for the manager.

There are three valuation ratios that are readily calculated based on the sale of other management companies. The first is the Manager Value relative to the REIT's Market Value of Equity.[6] The second is the Manager Value relative to the REIT's Invested Capital.[7] The final metric is the Manager Value relative to the manager's trailing 12 month EBITDA.[8]

As shown in the chart below, the price paid for management companies relative to the size of the REIT appears to fluctuate from year to year based on the ratios of Manager Value to the Market Value of Equity and Invested Capital. This is primarily due to the fact there are relatively few REIT roll-up and internalization transactions that occur each year, making it important to not focus on the data from any single year, which may be driven by very few transactions.

The ratio of Manager Value relative to the REIT's Invested Capital is considered one of the most important metrics, as it adjusts for the impact of varying amounts of debt within REITs, and more closely approximates the ratio of Manager Value to assets under management (AUM). The ratio of Manager Value to Invested Capital over the entire period analyzed[9] averaged 3.0%, however the ratio over the 3-year period ended December 31, 2018 averaged 2.6%.

The ratio of Manager Value to Market Value of Equity of the REIT is higher than the ratio of Manager Value to Invested Capital. This is due to the fact that Market Value of Equity is net of debt (similar to NAV), whereas Invested Capital is calculated before subtracting out debt. The ratio of Manager Value to Market Value of Equity of the REIT over the period analyzed averaged 5.6%.

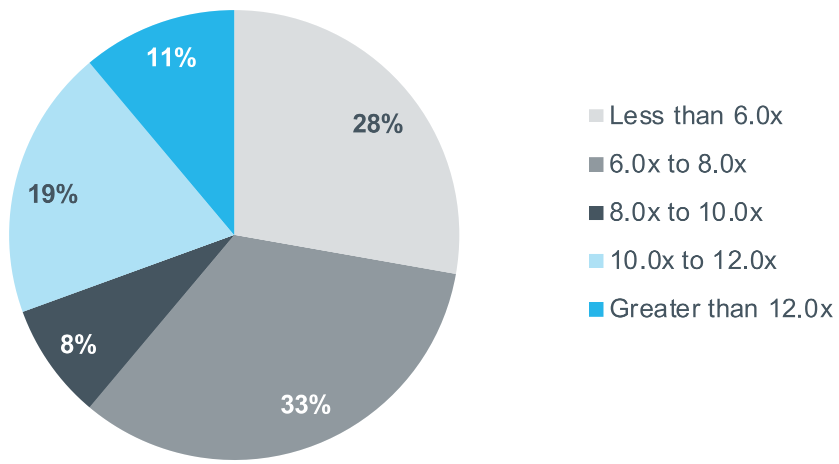
The trailing 12-month EBITDA multiples paid for management companies in REIT roll-up and internalization transactions ranged from 2.9x to 14.0x, with a mean of 7.9x and a median of 7.5x. As shown in the chart below, over 60% of the EBITDA multiples implied by the transactions analyzed were at or below 8.0x trailing EBITDA.

Discounted Cash Flow Analysis

A discounted cash flow analysis of the net management fees represents the other generally accepted methodology used to value the management company.

A discounted cash flow analysis estimates the net present value of the projected after-tax cash flows generated by the management company. The projections are typically developed assuming that the manager continues to operate as an independent company and is not internalized into the REIT. If the management company has a history of raising new capital or funds, the projections will often reflect future

Advisor Value to Advisor EBITDA Multiples*



* The table above is based on 36 transactions where the manager EBITDA was disclosed or from proprietary deal intelligence. Transactions were excluded if the external manager was internalized with no fee or the manager EBITDA was not disclosed.

new funds anticipated to be raised. The projections also generally include asset and property management fees, along with any acquisition, disposition and financing fees in a manner consistent with the manager's existing agreement, historical activity and expected future fundraising activity. The projections typically do not include any carried interest participation (promotes) on existing or new investments. The in-the-money promotes at IPO are typically handled separately from the manager valuation in accordance with the waterfall calculations in the management company agreements.

What Factors Create Differentiated Value for Management Companies?

What creates greater value in a management company and why do some managers end up with a larger ownership percentage of their REIT than others? Duff & Phelps' experience and research reveals that higher valuation multiples are typically associated with management companies with: (1) a proven track record of delivering high IRRs to investors, resulting in value to carried interests and follow-on funds, (2) a focus on lucrative niche markets with a unique strategy, (3) a talented management team able to execute on that strategy, and (4) a history of generating strong profits. Conversely, management companies that underperform tend to be acquired for little to no Internalization Fee.

The investors in the real estate partnerships and the owners of the management company ultimately need to reach an agreement as to the appropriate valuation of the manager for the transaction to move forward and for the management company to be internalized. The partnership investors do not want to pay an excessive Internalization Fee for fear that the internalization transaction will be dilutive to their property interests when they become REIT shareholders after the roll-up.

"The valuation of the manager is complicated by the inevitable fear that the current management fee is too high," says Linneman. "However, without an aligned and incentivized management team, which requires management internalization, the contributed properties will not obtain full valuation."

Conclusion

One of the most important and debated aspects of a REIT roll-up transaction is the value of the management company. There is often concern among the investors about the pitfalls of paying an overly generous price for the management company, which could be dilutive to their investment. The management company should be valued using appropriate, generally accepted methodologies that capture the future expected cash flows of the manager and result in a value that can withstand scrutiny when compared with the management company values in other REIT roll-up and internalization transactions. Given the market's preference for internally managed REITs, the path to achieving the highest returns for investors in a roll-up REIT IPO includes an internalized management company.

[1] An entity is externally managed when its management team is employed by separate business on a fee-for-service. Often an external manager will provide services to a series of different entities. An entity which employs its own management team is "internally managed."
[2] For example, the three largest REIT IPOs to date, Paramount Group, Douglas Emmett and Invitation Homes, were all formed in roll-up transactions.
[3] Equity REITs refer to companies that hold real property. There are more externally managed mortgage REITs than equity REITs due to the fact that more than one mortgage REIT will often hold paper in the same investment, creating economies of scale if the manager analyzes the same investment for multiple mortgage REIT clients.
[4] Duff & Phelps identified 20 publicly traded equity REITs that are externally managed and advised. As December 31, 2018, the externally managed and advised REITs traded, on average, at a 15% discount to NAV.
[5] When a REIT internalizes the management services provided by an external advisor, this transaction is often referred to as an "internalization" transaction.
[6] Closing price per share multiplied by shares and units issued and outstanding plus the value of any preferred stock
[7] Market Value of Equity plus interest bearing debt
[8] Earnings before depreciation expense, interest income and expense and taxes
[9] Duff & Phelps analyzed transactions that occurred from 1997 through 2018. Duff & Phelps did not include the periods from 2001 through 2003 or 2008 through 2009, due to the paucity of REIT IPO activity and the lack of internalization transactions that could be identified by Duff & Phelps immediately following the economic downturns of 2001 and 2008.

About the Authors

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Sherry Cefali is a Managing Director in the Transactions Opinions Group and is the head of the Los Angeles office of Duff & Phelps. Duff & Phelps is a global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, and other governance-related issues. Duff & Phelps has rendered relative fairness opinions on numerous roll-up transactions, including the three largest REIT IPO transactions to date—Paramount Group, Douglas Emmett and Invitation Homes. To learn more, visit www.duffandphelps.com

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