M&A Update

Market Pressures, Favorable Law Spur REIT Conversions and Spinoffs

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Urged on by activists and institutional shareholders, a large number of companies with real estate holdings pursued real estate investment trust (REIT) conversions or spinoffs in 2014. At least half a dozen companies completed REIT transactions last year, including cell tower company Crown Castle International, which converted into a REIT, and outdoor advertising REIT Outfront Media, which spun off from CBS. At least four more companies announced plans for REIT transactions in 2014, including retailer Sears and Windstream, which intends to spin off its copper and fiber-optic cabling in the first-ever telecom REIT. Several deals have closed or are scheduled to close this year, including the long-awaited REIT conversion of records storage company Iron Mountain.

Companies in various industries have become REITs, including many in "nontraditional" industries. Hotels, healthcare companies, self-storage companies, data centers, telecoms, utilities, cell tower operators, prisons and casinos all have engaged in REIT transactions. Other industries will likely see their first REITs soon.

REITs Are a Focus for Activists

In several cases, activist investors have pushed REIT transactions as the solution for slow-growth or poorly performing companies and have clashed with management teams that opposed this path. For example, Iron Mountain initially opposed the REIT conversion proposal of Elliott Associates before adopting its own conversion plan. Barington Capital urged Darden Restaurants to consider a REIT transaction, and Darden's board resisted, contributing to the board's eventual ouster. Most recently, in February 2015, Sandell Asset Management publicized a proposal to the board of Brookdale Senior Living to explore a REIT spinoff.

REIT Benefits

REITs, which generally avoid corporate tax, generate relatively high yields attractive to investors and enjoy a competitive advantage over taxable corporations. A REIT transaction can unlock the value of a company's real estate assets, which may be worth much more than is apparent from the balance sheet. In addition, in the case of a REIT spinoff, separating into a "pure play" operating company and a REIT can attract positive attention from analysts and investors and allow both companies to raise capital more efficiently.

The performance of participants in some recent REIT transactions demonstrates these benefits. For example, Penn National Gaming spun off its casino properties into a subsidiary, Gaming & Leisure Properties (GLPI), which elected REIT status. Penn and GLPI entered into a long-term leaseback of the properties, and now have a combined value over 85% higher than Penn's pre-spin value.

REIT and Spinoff Tax Requirements

REITs receive a deduction for dividends paid and therefore generally pay out all their income to shareholders each year to avoid corporate tax. In exchange, REITs must satisfy a number of different rules. For example, REITs must hold most of their assets in real property and must earn most of their income from rents and certain other related sources. Current law defines "real property" and "rents" relatively expansively, allowing REITs to hold assets such as cell towers and billboards and to derive significant amounts of income from providing services.

REIT spinoffs must also satisfy a number of separate rules to qualify as tax-free. Each transaction must have a legitimate corporate business purpose outside of obtaining REIT status and each spun-off REIT must continue to operate an active trade or business. In addition, before a "C" corporation converts into a REIT, the C corporation must distribute all of its earnings and profits as a dividend. Several Internal Revenue Service rulings confirm that properly structured REIT spinoffs can satisfy these tests.

The growing pace of new REIT transactions has produced some criticism in Washington. In the last Congress, Rep. Dave Camp, then-Chairman of the House Ways & Means Committee, introduced a bill that would have significantly restricted REIT transactions. However, the Camp REIT proposals were not adopted, and no similar legislation appears likely to be enacted in the near future.

Takeaways

2014 was an exceptional year for REIT transactions, and a number of new deals are on the horizon. Companies with significant real estate holdings have concluded that a REIT transaction can create substantial value for their shareholders. Even companies that prefer to avoid REIT status have realized that they need to understand the advantages and disadvantages of REITs in order to address proposals by interested parties in support of a REIT transaction.

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