Strategy in focus: REITs

High-yield investment products are this year's draw and the trend may be leading activist investors to target companies with significant real estate assets. Here, Activism Monthly examines why activists are calling for a separation of real estate.

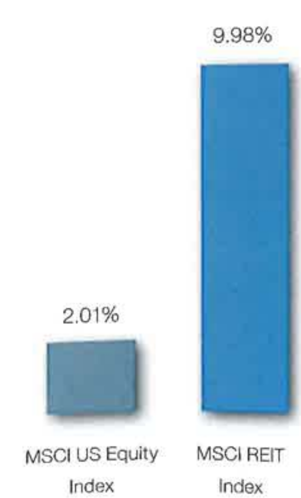
Supermarkets, restaurants and retail chains beware, those real estate investments you hoped would cushion you in an economic downturn may attract an activist investor. In late 2013 and early 2014, a number of activists have called on firms to be more creative with their property assets, and experts suggest it could be part of a growing trend. In what might be considered a test case at Darden Restaurants, which directly owns nearly half of its restaurant locations, two activists have been calling for the company to create a real estate investment trust (REIT).

An era of low interest rates

Gregg Feinstein, Head of US M&A at the investment bank Houlihan Lokey, says the recent rash of activists calling for companies to separate their real estate is primarily a function of the spread between the multiples of many publicly-traded companies versus those enjoyed by high-yield investment products such as REITs (see chart). "We live in an era of artificially low interest rates," he told Activist Insight recently. "Investors are desperately searching for higher yields, whether through Master Limited Partnerships [MLPs], high-yield bonds, or REITs."

> "Everyone is trying to get higher yields"

Indeed, REITs have been both a popular focus for activism recently. Feinstein points to three different kinds. First, existing REITs are being targeted by activists who want property management to be internalized to save costs and align incentives (InnVest and CommonWealth are two recent examples). Second, activists may try to pressure companies into converting to REITs in search of lower taxes or higher multiples. The IRS is currently investigating one such company (Boston, Massachusetts-based Iron Mountain) and GAMCO Asset Management has included a shareholder proposal on conversion to a REIT or MLP as part of its proxy contest at Griffin Land & Nurseries.



Equities versus REITs: Q1 2014 total returns

The op-co/prop-co spin-off

Finally, there are the companies with hidden real estate value, and activists have identified several they believe would benefit from shifting these assets into a new 'prop-co' (see box). At Bob Evans Foods, Sandell Asset Management has come out in favor of a sale and leaseback to take advantage of high property valuations. In the UK, Elliott Management is believed to have lobbied grocery chain WM Morrisons to sell a big chunk of its mostly directly-owned stores. However, the most significant case concerns Darden Restaurants. In plans drawn up by Barington Capital Group, whom Houlihan Lokey advises, the recommendation for a REIT was based on extensive analysis by industry experts. Now, with the publications of two hundred-page reports into the benefits of a real estate spin-off prepared with the input of Green Street Advisors, Starboard has begun to agitate towards that goal.

Prop-co & op-co

One way for companies with significant real estate assets to finance growth is to sell these assets to a subsidiary company (prop-co), which can command higher yields or may be a target for an acquisition by a property investor if prices rise. Real estate is then leased back to the op-co, which conducts the company's main business.

The tactic is not without its critics, and relies on the op-co having a steady revenue stream, or low rent from the prop-co. However, the latter can reduce the attractiveness of the prop-co as an investment.

Despite the length of Starboard's reports, the rationale is actually straightforward. The company trades at an earnings multiple of 9.4x, whereas the REIT average is 18.2x. By separating its real estate, the company loses the benefit of the implied subsidy on rent but the valuation of that subsidy almost doubles as an investment product in a REIT. As a result, shareholders would receive a windfall. Darden says that its real estate would trade at a discount to the REIT average, but Starboard assumes that the gap is large enough to take care of this.

Activists are clearly paying attention. Dirk Aulabaugh, a Senior Director of the Advisory and Consulting Group at Green Street, says his firm has seen an increase in the number of activists interested in similar campaigns. "We've worked on quite a few assignments of this type during the past few years," he told Activist Insight. "What makes Darden unique is that our work was published. Typically, we operate behind the scenes."

Conflicts of interest

Despite interest in the idea of property spin-offs gaining traction over several years, Aulabaugh says conflicts of interest—real or perceived—have tended to put these deals on ice. Put frankly, firms need to ensure their prop-co is at arms-length from the op-co to ensure fair negotiations over rent.

One activist toyed with the idea of forming a REIT at The Pantry, a chain of convenience stores, after talking to Barington. Ultimately, getting seats on the board took priority, and the REIT campaign was dropped in a standstill agreement. However, Aulabaugh notes that the idea has been successful at Penn Gaming, and in Canada with Loblaw Supermarkets, where investors are more accepting of conflicts of interest than US REIT investors.

Unlocked potential

Even so, both Aulabaugh and Feinstein think that there are cases in the US where a spin-off campaign could work. "Given the high valuation of real estate versus historic norms," Aulabaugh says, "we expect that we will continue to see creative investors evaluate strategies to unlock real estate through transactions of this type." Feinstein says the Darden campaign could highlight the potential for creating value by forming REITs, although both make the point that the trend is dependent on the valuation multiple of REITs continuing at elevated levels.

Case Study

Elliott Management reportedly took positions in a number of UK supermarket chains earlier this year on the basis that it could push for real estate separations in the manner of Loblaw in Canada. So far, it only appears to have made a significant effort at WM Morrison and with limited success. In March the company said it would sell a small amount of real estate, but would rather focus on market share than shareholder value.

Analysts in the UK have been downbeat on the prospects of the grocer spinning off its property, one even suggesting the government might intervene to prevent an action that could put one of the big four at risk. So far the company has proceeded cautiously, opting for the sale of around £500 million in property this year.