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VALUE CREATION AND GOVERNANCE STRUCTURE IN REIT MERGERS

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Abstract

The Umbrella Partnership REIT (UPREIT) structure has become the dominant form of organization for U.S. REITs. We examine the utility of this corporate structure from a new perspective, finding evidence that convertible securities issued by UPREITs in payment for properties acquired from private sellers often function as instruments of corporate control, aligning the interests of new executives acquired in the transaction with those of the purchasing REIT's shareholders. We also find evidence that these financial arrangements are used to signal information regarding the firm's future prospects. We use a sample of 53 public-private mergers 1995-2001, in which the acquirer is a publicly traded REIT. We find that wealth effects from central managerial changes are positively related to the degree to which payment takes the form of convertible equity units of UPREIT subsidiaries, and to the minimum lock-up period for those units prior to conversion. The positive effects of longer lock-ups are evidence that financing structure can be used to reduce agency and information costs related to managerial restructuring in public-private mergers.

Key Words: Asian REITs, REITs, UPREITs, mergers, public-private mergers, corporate control, management incentives, convertible equity, lock-ups, capital gains.

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1. Introduction

There is little doubt that the rapid expansion of publicly traded, tax-advantaged Real Estate Investment Trusts (REITs) will extend to numerous key markets in Asia in the coming years. Although the "REIT Revolution" is primarily characterized by a dramatic growth in the market capitalization of these entities in the United States during the 1990s, we are currently observing an increasing presence of similar vehicles in Asia, and in other parts of the world. Australian REITs, often called Property Trusts, are well established. In Europe, REITs have been authorized in Holland and in Belgium.[1] In Asia, Japanese REITs have existed since 2001, and currently six of them are sold on the Tokyo Stock Exchange (Carnachan 2003). Korean REITs were authorized in 2001, and at the end of 2003 four K-REITs were listed on the Korean Stock Exchange (Carnachan 2003). The successful IPO of Ascendas REIT in Singapore late in 2002 was encouraging, and new REITs are under development in Hong Kong, Malaysia, Taiwan and other Asian countries (Buzz 2001).

This paper considers an organizational structure developed by U.S. REITs to defer the receipt of payment and the associated capital gain taxes in acquisitions of real estate from private sellers. The deferment takes the form of ownership units which are convertible to the acquiring company's stock, but that normally must be held for one year or more prior to conversion. The resulting organization form, the Umbrella Partnership REIT (UPREIT), has become the dominant corporate structure for U.S. REITs.

A potential advantage of the UPREIT structure that to date has not been explored in the literature is its usefulness in creating mechanisms for corporate control when large property acquisitions from private sellers occasion restructuring of central management. This restructuring often entails the addition of at least one selling manager to the acquirer's management team, and the new manager's acceptance of the acquirer's equity subject to a pre-specified minimum holding period. Although the financial instruments related to the UPREIT organizational structure were developed in response to local U.S. tax policy, we believe that they are often used in acquisition financing as a means of creating wealth-enhancing corporate control. At the same time, the selling manager's willingness to accept deferred payment in the form of the acquirer's stock may constitute a signal to mitigate information asymmetries regarding the prospects of the combined entity.

This study tests the question of whether or not equity market prices reflect the motivational benefits stemming from the contractual lock-up period for the acquirer's stock. Such potential benefits will be manifested in higher abnormal returns associated with major acquisition

[1] See Campbell and Sirmans (2002) for a discussion of European REITs.

announcements. We use a sample of 53 REIT mergers 1995-2001, in which the acquirer is a public REIT, and the target firm is privately held (public-private mergers). We examine the relationship between announcement-period wealth effects for acquiring firm shareholders, and two important aspects of the transaction. First is the decision regarding managerial restructuring, particularly the consequences of the acquirer's decision whether or not to include the selling firm's management in the central management team of the combined entity. Second is the manner in which the method of payment is structured. We explore the wealth consequences of using convertible securities in payment to the selling owners, and the effects of different required minimum holding periods prior to conversion, especially when private sellers who join the acquiring firm's central management accept these securities.

The analyses reveal that straight cash purchases of private firms seldom occur. In public-private REIT mergers, the most popular method of equity payment takes the form of convertible UPREIT subsidiary units that always entail a significant required holding period prior to conversion. The data evidence a wide range in the length of this lock-up period. We find that shareholder value is created when selling firm managers are added to the central administration of the acquiring REIT, but only when these seller-managers accept equity units in REIT subsidiaries that are subject to lock-up periods prior to sale or conversion to marketable REIT shares. The implication is that participation in management is not in itself sufficient to create value, and that shareholders look for selling managers to make long-term commitments to the company's fortunes through ownership stakes. In essence, we find evidence that the method of payment in public-private mergers can be structured so as to create value-enhancing incentive contracts for new senior executives, and to signal value to the market during times of major structural change.

Issues of information and governance are critically important to the development of REITs in Asia. Transparency problems are a serious concern in Asia. Jones Lang LaSalle publishes a Real Estate Transparency Index for Asia and other regions, classifying countries in accordance with a five-tier system. Among all Asian countries, only Australia and New Zealand are ranked equivalently to the U.S. Tier One, and only three others - Hong Kong, Singapore and Malaysia - are ranked as high as Tier Two. Other Asian countries have very serious transparency problems and are classified in Tiers Three trough Five. Transparency problems discourage international investment and undermine security value (Gelos and Wei 2002). Therefore, the success of REITs in Asia will to a large extent depend on their success in mitigating problems of incomplete information, and in developing effective mechanisms for corporate governence.

The remainder of the paper proceeds as follows. In the next section, we review the role of corporate control mechanisms in mergers and acquisitions. Section 3 is devoted to the discussion of the UPREIT structure and its impact on REIT valuation. In section 4, the institutional environment of REITs is discussed and hypotheses are developed. Data are presented in section 5, and results discussed in section 6. In section 7, we explore the implications of this research in the Asian context. Section 8 concludes.

2. Mergers and Corporate Control

The literature has for a long time recognized the potential for value-reducing agency conflicts in public companies (Jensen and Meckling 1976; Fama and Jensen 1983; Morck, Shleifer and Vishny 1988, 1990). This hazard is engendered by the separation between ownership and management, giving rise to the likelihood that courses of action that maximize the wealth of senior managers may not always be the same ones that maximize the wealth of owners.

The awareness of potential agency hazards has given rise to a variety of strategies intended to align managerial incentives more closely with the creation of shareholder wealth. Such strategies include the use of stock option compensation, bonuses, and incentive contracts. In the main, empirical research supports the view that such arrangements are effective in mitigating agency hazards and protecting shareholder wealth.[2]

Because managerial incentives are significantly related to shareholder wealth, the issue of managerial control becomes an especially important consideration in major corporate restructurings such as mergers, when the composition of the firm's central management changes. In the case of combinations between public companies (public-public mergers), it is normally the case that previously existing incentive contracts for target firm managers are carried forward when they join the central administration of the acquirer, since the acquisition of the target firm implies the acceptance of its existing contracts. As a result, the question of structuring incentive contracts in public-public mergers is interesting primarily from a technical standpoint, and generally does not have important theoretical implications.

The situation is quite different when the target is privately held (public-private mergers), as is frequently the case in real estate mergers. For the most part, in closely held companies the central managers are the primary shareholders of the firm. Therefore, incentive contracts to control management are not needed, and do not exist. When the managers of the acquired firm join the central management of the acquirer, the establishment of contractual incentives can constitute an important aspect of the acquirer's restructuring process. While the finance literature consistently confirms the existence of a positive relationship between shareholder wealth and the use of effective managerial incentive contracts, it is essentially silent on the matter of structuring incentive contracts for new additions to central management who join the firm as a result of restructuring caused by events such as mergers and acquisitions.

3. The UPREIT Corporate Structure

The acronym "UPREIT" stands for "Umbrella Partnership REIT". The essential feature of an UPREIT is that all of the firm's properties are owned by a subsidiary partnership or LLC. The partnership's units, in turn, are owned by the REIT and by the persons or entities that sold property to the REIT. The units of the subsidiary are commonly call OP units, or Operating Partnership units. OP units held by anyone other than the REIT itself are nearly always convertible into shares of the REIT or into their market price cash equivalent, after the expiration of some required minimum holding period.

Although the Operating Partnership may own all of the REIT's properties, the subsidiary itself has no employees. All managers and other staff work for the REIT, and of course the funds needed to cover managerial costs must be obtained primarily from the cash flows of the properties owned by the OP. The division of cash flows between the OP unit holders and the REIT itself is determined by contract, often by a complex set of contracts, a new one being written every time the REIT acquires a property for which OP units constitute a form of payment.

The reason for the development of this opaque and arcane organizational structure relates to taxes, and to capital gains taxes in particular. When a REIT purchases property for a price higher than its book value from a private seller in exchange for equity shares of the REIT itself, the IRS considers the capital gain to be realized, triggering the gains tax. However, when the property is transferred instead to a subsidiary partnership or LLC in exchange for OP units, the IRS chooses to regard the transaction as a change from one form of private ownership to another, and delays the gain tax until conversion occurs. This policy allows sellers to control the timing of their capital gains taxation (Grant 1994; Napoli and Smith 1999; Rubin, McIntosh and Forrest 1999).

The popularity of the UPREIT structure in the U.S. is evidence that REIT acquirers believe that their ability to arrange tax deferrals of this sort is valuable in the market. Today, 80 percent of all REITs use some form of the UPREIT structure. However, virtually all of the REITs that frequently purchase privately held properties use this structural form, even though they may not use OP units as a medium of exchange in all transactions. Sinai and Gyourko (2004) develop empirical evidence that the benefits of their flexibility in financing acquisitions is capitalized into increased equity valuations for UPREITs.

The central issue in our paper relates to a subtle, and to this point overlooked, comparative advantage of the UPREIT structure. This advantage is the opportunity it offers to REIT acquirers in public-private mergers to align the interests of new central managers with the interests of the REIT,

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[2] See, for example: Mehran, Nogler and Schwartz (1998); Tehranian, Travlos and Waegelein (1987); Smith and Stulz (1985); Mehran (1995); Hubbard and Palia (1995); Morgan and Poulsen (2001); Datta, Iskander-Datta,

by "locking up" convertible OP units offered in payment for extended required holding periods prior to conversion. At the same time, these instruments offer managers the opportunity to overcome information problems associated with the reorganization, since the willingness of the new managers to accept locked-up convertible securities reliably signals their confidence in the future success of the restructured firm.

It is a consistent feature of OP units issued to compensate the owners of a private target, that they are convertible into common shares of the REIT on a one-for-one basis at the option of the holder, subject to two important limiting conditions. The first of these is the substantial lock-up imposed prior to conversion. One year is the most popular lock-up period, but the required minimum wait is occasionally shorter, and frequently is much longer. The second condition is that the REIT retains the option of substituting cash for the new REIT shares in an amount equal to the market value of these shares at the time of conversion.

The reason for this second condition is to allow the REIT to control ownership concentrations as required by the IRS rules, particularly the "5-50" rule. This rule prohibits the REIT's five largest owners from controlling more than 50 percent of the REIT's stock. The rule results in so-called "excess share" provisions in the charters of all REITs, effectively preventing any one owner from controlling more than a specified percentage of the REIT's stock, this percentage always being less than 10 percent. The REIT's option to "cash out" a portion of the OP shareholder's position allows it to enforce its own rules at the time of conversion.

It is the REIT's option to redeem the OP units for cash that leads to the use of substantial lock-up periods. REITs involved in transactions that create the potential for large share conversions must not only be certain that they have enough new REIT shares authorized to satisfy the demand; they must also be sure they have enough cash on hand at the time of conversion to adequately protect the firm from violating its ownership concentration rules. REITs have special problems obtaining large amounts of cash because they are required to pay out 100% of accounting earnings in the form of dividends, in order to receive their full corporate tax exemption. The popular one year holding period allows a reasonable length of time for REITs to estimate cash needs, make internal adjustments, and, if necessary, structure public bond or stock offerings.

Although the use of OP units as a medium of exchange in public-private mergers was created for tax reasons, many REIT managers have recognized the potential benefits of these instruments as a way of aligning the interests of new managers with those of the shareholders, allowing REIT acquirers to use the medium of exchange in mergers as an instrument for achieving corporate control. The simple one-to-one exchange ratio directly links the financial interests of the new executives with those of the REIT's existing shareholders. This alignment is not compromised by the REIT's substitution of cash for these shares if it occurs, because the amount of the cash payment is

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and Raman (2001).

determined by the share value at the time of conversion. Extended lock-up periods of a year or more assure shareholders that the motivation implied by the new manager's interest in the convertible shares will remain in place for a substantial period of time. In public-private mergers in the conventional corporate world, SEC regulations require corporate executives to hold new stock issued in the transaction for a minimum of six months. OP units, on the other hand, are almost always locked up for at least a year, and often for much longer periods of time.

4. Institutional Environment of REITs and Hypotheses

Almost all REIT merger activity takes the form of manager-negotiated, "friendly" mergers (See Campbell, Ghosh and Sirmans 2001). The absence of hostile merger activity in the REIT sector is evidence that REIT managers are insulated from the market for corporate control, making control issues very important for investors when REIT mergers occur.

If the acceptance by selling managers of the long lock-ups associated with stock-financed REIT mergers signals their confidence in the future performance of the company, and motivates managers to increase stock value and thereby shareholder wealth, then announcement period returns for the acquirer will reflect that positive evaluation. A related question is whether or not mere participation of sellers in the management of the combined entity constitutes the signal of value, or whether managers must tie their future wealth to the firm’s fortunes through stock ownership. Our hypotheses are:

Hypothesis 1: Returns to acquiring firm shareholders are greater when one or more of the seller's managers are added to the central management of the combined firm.

In approximately 60% of the mergers included in our study, one or more of the selling firm's manager/owners join the central management team of the combined firm. We examine the question of whether or not managerial participation through the restructuring of the acquirer's central management is significantly related to the acquirer's share value.

Hypothesis 2: Returns to acquiring firm shareholders are greater when equity financing is used, and the shares used are locked up for an extended period of time exceeding one year.

Leland and Pyle (1977) develop a theoretical model in which a manager's willingness to invest in his own project signals project quality in the presence of information asymmetries. Building upon this conceptual foundation, Courteau (1995) develops a model related to IPOs to demonstrate that the length of the required holding period accepted by the purchaser of new shares sends a positive signal for value of the underlying asset. In public-private mergers, information asymmetries are a serious problem, since publicly-available information regarding the private target is limited. Therefore we maintain that the theoretical framework developed by Corteau for IPOs will also apply to the case of public-private REIT mergers. In our data, when OP units are used to finance the acquisition, a lock-up period of one year is the mode. However, the lock-up is often longer than that. We posit that revaluation of acquirer stock is a positive function of the lock-up period.

Hypothesis 3: There is a value-creating interaction between the acquisition of new central managers in the merger, and the use of extended lock-up periods for convertible equity offered to them in payment.

When one or more of the target firm's owner-managers joins the central administration of the acquirer, we interpret the use of convertible shares with required lock-ups to constitute a form of corporate control that aligns the new managers' goals with those of the shareholders, and serves as part of a performance-based compensation plan. This being the case, if shareholders value this form of control over new managers, then the interaction between the two variables should be capitalized into a higher share price. At the same time, we believe that the willingness of the new managers to accept the lock-up sends a reliable signal of quality to the market.

5. Data

The full sample consists of 53 public-private mergers from 1995-2001 in which the acquiring firm is a publicly traded Real Estate Investment Trust, and the target is a privately held real estate firm. This sample includes all usable merger events that occur during the period of study. While the N is small compared to most other merger studies in finance, the sample has the major advantage that all events are drawn from the same industry. This circumstance allows us to focus on the variables of interest without explicitly controlling for the multitude of other factors that can influence results in studies that include mergers across industries.

Information about the mergers is obtained from published reports accessed on line through *Dow Jones News Retrieval* using a variety of search routines. The analyses include only those mergers that are subsequently completed. Mergers in which the total acquisition price for the target firm is less than $50 million are omitted. Events are not used if there are other major announcements during the event period. The announcement date is the first date that news of the agreement is published in *The Wall Street Journal,* the *Dow Jones Newswire,* or the *Business Wire,* provided that the announcement appears before 3:30 P.M. on a trading day. For mergers announced on the newswire after that time, the first trading day following the announcement is the announcement day.

The characteristics of the data set are summarized in Table 1. *RSIZE* is the Total Assets of the REIT as presented in the most recent 10K or 10Q SEC filing prior to the announcement, in billions. *DSIZE* is the total cost of the target including all forms of payment, as published in press releases, or obtained from subsequent SEC filings, also in billions. *OP_DS* is OP or LLC units as a percentage of total price. *TOST_DS* is the sum of units and common or preferred stock in the REIT as a percentage of total price. Information regarding the use of units and stock is obtained from press releases, or from subsequent SEC filings, predominantly 8K filings. *HP* is the required holding period in years for units issued, when these are included in the payment package. This information is also obtained from press releases or from subsequent SEC filings. In a few cases, more than one holding period is observed, and in these cases we use the longer one. *HPM1* is an (0,1) indicator variable equal to one if the transaction includes equity payment that is locked up for more than one year. *CNTRL* is an (0,1) indicator variable equal to 1 if at least one of the owners of the selling firm joins the senior management of the combined entity. *REG* is an (0,1) indicator variable equal to 1 if at least one of the owners of the selling firm joins the combined entity as a regional manager, but no seller joins the central administration. In most cases, information regarding managerial arrangements is readily available from press releases; but in some cases the information is obtained from the REIT's 10K SEC filing following the merger.

The average size of the acquirer is $1.5 billion. The average price of a private firm is a little over one third of that amount. The average lock-up period for equity is well over 1 year, and the longest holding period in our data is 6 years. This testifies to the long-term commitment private REIT managers often make to the combined entity's success. In 57 percent of cases, at least one senior manager of the target firm joins the acquiring firm, and in 21 percent of cases, they join regional management only. This confirms that managerial restructuring is often an important element in these transactions.

6. Results and Interpretation

Standard event study methodology following Mikkelson and Partch (1988) is used to measure abnormal returns to shareholders over a three-day event period window (-1, +1) for each firm. To compute the market model estimator for the expected return for each firm, we use an estimation period from day -110 to day -3, a period of approximately five months. The S&P Mid-Cap Index is used as the market proxy.[3]

Table 2 presents acquirer abnormal returns by managerial arrangement, and by method of payment for the 53 events comprising the total sample. The cumulative abnormal return (CAR) over a three-day window (-1, +1) around the event date for the whole sample is 1.52 percent, which is statistically significant. This finding is consistent with Chang's (1998) finding for public-private mergers of conventional firms, and with the results reported by Campbell, Ghosh and Sirmans (2001) for public-private REIT mergers from 1994-1998. Acquirer abnormal returns are highest when target management participates in central management, and lowest in the takeover model, when none of the target's senior management is retained. The "OP Units" column includes all transactions in which convertible units in an operating subsidiary are used; the “REIT stock” column represents transactions where payment to selling firm’s owners includes common or preferred shares of the REIT, but no OP units; the "Cash" column includes all transactions in which no form of equity is used. We note that when central management is restructured, the use of OP units as a form of payment dominates, and there are no cash purchases. Consistent with H1, shareholder returns are higher when central management is restructured. But this is only true when OP units are used. Consistent with H2, average returns for the cases where OP units are used are higher than those for the total sample. This effect is most pronounced when target managers join the central management. This observation is evidence that managerial structure and method of payment interact to influence firm value, as hypothesized in H3.

Table 3 explores this interaction from the perspective of the required lock-up period for units or REIT shares used in the transaction, for the 49 events in which some form of equity is used as a medium of exchange. Consistent with H2, a significantly positive relationship is evident between an extended holding period and shareholder returns. This relationship only applies when central management is restructured, however. This finding is consistent with the notion that the appointment of new executives enhances value when their incentives are aligned with the objectives of the shareholders by the use of equity financing with extended lock-up periods. It is also consistent with the view that when the new executives accept longer lock-ups, it sends a credible signal of quality to the market.

6.1 Regression analysis

In Table 4 we present a more rigorous test of the influence of executive restructuring and the lock-up period using regression analysis with appropriate controls. To focus more clearly on the influence of the holding period, we control for other variables by including only the subsample of 39 mergers in which OP units are included in the payment package. Of course, all of these REITs are UPREITs. The size of the acquirer measured as total assets *(RSIZE)* is included in all models as a control.

Three separate models are estimated. In Model 1, we test the influence of HPM1, the binary variable indicating extended lock-up periods of more than one year, and the percentage of acquisition price paid with OP or LLC units *(OP_DS)*, but do not control for managerial restructuring. *HPM1* is positive and highly significant. *OP_DS* is also positive, and significant at the 10% level. We

[3] The Mid-Cap Index is used rather than the S&P 500 Index because the betas and the F statistics in the Market Model are more significant when the Mid-Cap Index is used. However, the S&P 500 Index and the Morgan-

interpret this result as evidence that the use of convertible shares may send a positive signal to the market even when the lock-up period is not extended beyond one year. The modal lock-up period in the data is one year.

In Model 2, the indicator variables for changes in management are added. *CNTRL* indicates that a target manager is added to the central administration of the combined entity, while *REG* indicates that only regional management changes. Both coefficients are statistically insignificant, indicating that managerial synergies resulting from restructuring, invariably stressed by acquiring firm managers as a source of potential benefit, have little value to shareholders without the use of OP units and the extended lock-up periods that are associated with them.

In Model 3, we test hypothesis 3 regarding the interaction between long lock-ups and managerial restructuring, by introducing *CNTRLCRO*, a interaction variable equal to *HPM1*CNTRL*. The coefficient for the interaction variable is positive and highly significant, and indicates that the use of extended lock-up periods adds nearly 5 percent to shareholder value when convertible equity is acquired by new executives obtained from target firms in private merger.[4] We interpret this result in part as a capitalization of the value of this equity in creating an incentive contract that aligns the personal interests of the new executives with those of shareholders. The higher R-square value for Model 3 as opposed to Model 2 is further evidence of the explanatory power of the interaction variable.

Notably, the *HPM1* variable, which is highly significant in Models 1 and 2, becomes insignificant in Model 3 where the interaction variable is used. This finding implies that the value of longer lock-up periods accrues only when they affect new executives from the private target. On the other hand, *OP_DS*, the percentage of OP units used in the merger payment, continues to be significantly positive in Model 3, implying that the use of OP shares can signal value even when the lock-up period is not extended beyond one year. This finding is consistent with Courteau's (1995) conclusion that required lock-ups can signal value in new issues of equity.

7. Implications for REIT Structure

As the REIT concept has spread across the globe, two distinct approaches have emerged, which we may call the U.S. model, and the Australian Model. In the U.S., REITs as a general rule are self-managed entities; therefore in the U.S. issues of corporate control are very important to shareholders. To date, REITs developed in Europe have followed this U.S. model of self-management. In Australia,

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Stanley REIT Index were both tested as market proxies, and found to produce similar results.

[4] We also examined the usefulness of another interaction variable equal to OP_DS*CNTRL, to test the theory that the value effect may emanate from the quantity of equity accepted, rather than the length of the holding period. The addition of this variable did not change the result for CNTRLCRO; the new variable was insignificant and its inclusion loosened the fit of the model (not shown), allowing us to reject this alternative theory.

Property Trusts generally do not manage their own properties, but hire external managers. Australian Trusts were not permitted to self-manage until the year 2000. REITs developed in Asian countries have generally followed the external management model. When external managers are used, it would appear that issues of corporate control such as those we have discussed in this paper are less important, since the REIT's managers are more passive and are less directly involved in making the decisions that determine the REIT's profitability.

However, the Asian situation is not properly understood as a static condition in which only the status quo matters. Instead, the Asian environment should be regarded as a process in which circumstances are changing and developing. In comparing the two management models it is important to remember that when REITs were first authorized in the U.S., the model was very different from the one that has evolved. When REITs were authorized in the U.S. in 1960, they were required to use external management exclusively. Self-management was not permitted in the U.S. until 1986. As soon as self-management was approved, however, REITs restructured rapidly, and within a decade self-management was dominant.[5] This rapid change is consistent with the position that self-management is inherently more efficient. The literature also supports this view. Clayton and MacKinnon (2000) present evidence that self-managed REITs are more liquid and have lower costs of capital. Cannon and Vogt (1995) compare the performance of self-managed REITs with that of externally managed ones, and find that self-managed REITs outperform "advisor" REITs.

Because of the comparative advantages favoring self-management, we expect to see an evolution toward self-management in Asia that will parallel the U.S. experience. With an increase in self-management will come increased concern regarding the mechanisms for shareholder control. The evidence in this paper is consistent with the notion that the financial instruments associated with the UPREIT structure are useful in aligning the personal interests of new managers with those of shareholders, and in signaling information about firm quality following significant restructuring. Although a duplication of all aspects of the American UPREIT structure is probably not necessary for the efficiency of Asian REITs, our findings support the position that the development of convertible financial instruments with required lock-up periods can motivate managers to greater discipline and effort, and can enhance investor value.

8. Conclusion

We explore the use of financing structure in public-private mergers as a vehicle for aligning the interests of new executives acquired from the private target with those of the public acquirer's shareholders, and as a way of signaling value for the combined entity. Specifically, we examine the use of convertible equity as a medium of exchange in public-private mergers in which the acquirers

[5] Source: NAREIT.

are publicly-traded REITs, when such equity is subject to substantial required holding periods prior to conversion to cash or marketable shares.

Public-private mergers are different from public-public mergers, in that incentive compensation programs for target managers generally are not needed in privately-held firms, and thus do not exist *ex-ante*, creating a need to structure effective incentive contracts as quickly as possible. At the same time, public-private mergers often cause more information problems than public-public mergers do, creating the need for reliable signals of quality in positive-NPV transactions.

We find significant evidence that shareholder value is created when the medium of exchange in these mergers is structured in a way that aligns the interests of new executives with those of shareholders. The primary vehicle used to structure such incentives are units of ownership in subsidiary partnerships or LLCs controlled by Umbrella Partnership REITs, that are convertible to marketable shares of the REIT or to cash of the same value, but only after substantial required holding periods.

Thus our study develops evidence that REIT managers are able to exploit the unique features of the UPREIT structure in the U.S. to reduce agency costs, signal value, and enhance shareholder wealth in public-private combinations.

The findings suggest that the UPREIT structure popular in the U.S. has a usefulness that goes beyond that of being an accommodation to local tax policy. The implication of this evidence is that architects of new REITs in Asia and elsewhere should consider the potential value of organizational forms that provide broad flexibility of financing structure in property acquisitions, even if these structures do not provide local tax benefits similar to those that the UPREIT structure provides to shareholders of U.S. REITs.

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Table 1: Descriptive characteristics of REIT merger

Summary description of data used to analyze 53 merger events 1995-2001, in which the acquirer is a public REIT, and the target is a privately held Real Estate Firm. AR3 is the Cumulative Abnormal Return for the acquirer's shareholders in a three-day window around the announcement date (-1,+1), in percent, computed in accordance with standard event study methodology, using the market model. The S&P Mid-Cap Index proxies for the market portfolio. Indicator variables are all (0,1) Bernoulli variables, equal to 1 under the conditions described below, and zero otherwise. Holding period data applies to the length of time that convertible OP or LLC units tendered by the acquirer as payment in the merger must be held by the owners of the selling firm prior to conversion to the common shares of the REIT.

Definitions for indicator variables:
CNTRL = at least one senior manager of the target firm joins the central management of the combined entity
HPM1 = holding period longer than 1 year
REG = at least one senior manager of the target firm continues as a regional manager in the combined entity, and none of the target firm managers joins the acquirer's central management

Definitions for other explanatory variables:
RSIZE = total assets of the acquirer in billions
DSIZE = total price paid for the target firm in billions
OP_DS = total value of OP or LLC units as percentage of DSIZE
TOST_DS = total value of units and REIT stock, as percentage of DSIZE
HP = required holding period for stock or units accepted as payment, in years

Continuous Variable	**Mean**	**S. D.**	**Low Value**	**High value**
AR3	+1.52	3.21	-5.1	+9.97
RSIZE	1.49	1.67	0.18	8.32
DSIZE	0.56	0.67	0.05	5.78
OP_DS	0.19	0.20	0.00	0.80
TOST_DS	0.29	0.21	0.00	0.85
HP	1.59	0.67	0.00	6.00

Indicator Variable				
CNTRL	0.57	N/A	0	1
HPM1	0.36	N/A	0	1
REG	0.21	N/A	0	1

Table 2: Abnormal returns by managerial arrangement and method of financing in 53 public - private EREIT mergers during 1995-2001

	Cash		REIT stock		OP units		Total	
	AR	Number	AR	Number	AR	Number	AR	Number
Central	-	-	+0.32	5	+1.98	25	+1.71	30
Other	+0.76	4	+1.19	5	+1.44	14	+1.27	23
Regional	+2.11	1	-0.02	2	+1.65	8	+1.39	11
None	+0.31	3	+2.01	3	+1.16	6	+1.16	12
Total	+0.76	4	+0.76	10	+1.79	39	+1.52	53

ARs are percent Abnormal Returns to REIT shareholders in a three-day window around the date of the first public announcement. Announcements must appear in the Wall Street Journal, the Dow Jones Newswire, or the PR Newswire prior to 3:30 PM on a trading day. For announcements made after 3:30 PM, the first trading day following the announcement is used. Standard event study methodology is employed following Mikkelson and Partch (1988). The market proxy is the S&P Mid-Cap Index.

Central = at least one senior manager of the target firm joins the central management of the combined entity
Regional = at least one senior manager of the target firm continues as a regional manager in the combined entity, and none of the target firm managers join the acquirer's central management
None = senior managers of the target firm do not continue as managers of the combined entity
OP Units = Payment to selling firm's owners includes units of interest in a subsidiary partnership or LLC, that are convertible to shares of the REIT after the expiration of the lock-up period.
REIT stock = Payment to selling firm's owners includes common or preferred shares of the REIT, but no OP units
Cash = No form of equity is included in the payment package

Table 3 Abnormal returns in 49 stock-financed public - private EREIT mergers during 1995-2001 by managerial arrangement and required minimum lock-up period for convertible shares issued to the target's private sellers as a form of payment

	Lock-up period ≤ 1 year		**Lock-up period > 1 year**	
	AR	**Number**	**AR**	**Number**
Central	-0.26	15	+3.67	**15**
Other	+1.73	15	+0.07	**4**
All	**+0.73**	**30**	**+2.92**	**19**

ARs are percent Abnormal Returns to REIT shareholders around the date of the first public announcement. Announcements must appear in the *Wall Street Journal*, the *Dow Jones Newswire*, or the *PR Newswire* prior to 3:30 PM on a trading day. For announcements made after 3:30 PM, the first trading day following the announcement is used. Standard event study methodology is employed following Mikkelson and Partch (1988). The market proxy is the S&P Mid-Cap Index.

Central = at least one senior manager of the target firm joins the central management of the combined entity

Table 4: Regressions of abnormal returns for 39 EREIT public-private mergers 1995-2001, in which convertible units in subsidiary partnerships or LLCs are used as a form of payment

Dependent Variable = 3-Day Acquirer CAR
N = 39
*Heteroskedastically-adjusted regressions of event-period Cumulative Abnormal Returns for 39 EREIT acquirers in mergers with privately held targets 1995-2001. Regressand is the Cumulative Abnormal Return in a three-day window around the announcement day (-1,+1). CAR is computed in accordance with standard event study methodology using the Market Model, and the S&P Mid-Cap Index as the proxy for the market. RSIZE is total assets of the acquiring REIT in billions, OP_DS is OP or LLC units as a percentage of total price, HPM1 is an indicator variable signifying a lock-up period >1 year, CNTRL is indicator variable equal to one if at least one target manager is added to senior management of new firm, REG is indicator variable signifying that at least one senior manager of the target firm continues as a regional manager in the combined entity while none join central management, CNTRLCRO is (CNTRL * HPM1). t-statistics are in parentheses.*

Variable	**Model 1**	***t*-stat**	**Model 2**	***t*-stat**	**Model 3**	***t*-stat**
CONSTANT	+0.10	(0.10)	-1.18	(1.11)	-0.77	(0.58)
RSIZE	+0.06	(0.22)	+0.26	(0.99)	+0.28	(1.43)
OP_DS	+2.77	(1.70)	+4.43*	(2.88)	+4.00*	(2.41)
HPM1	+2.29*	(2.58)	+2.62*	(2.71)	-0.40	(0.34)
CNTRL			+0.46	(0.55)	-0.66	(0.49)
REG			+0.05	(0.04)	+0.30	(0.28)
CNTRLCRO					+4.61*	(2.56)
Adj. R-sq	0.156		0.234		0.323	

* Significantly different from zero at 5% level of confidence or better