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REIT INTERNALIZATION TRANSACTIONS

REIT Series – Q4 Update

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TODAY'S PANEL

S. GREGORY COPE
PARTNER, CAPITAL MARKETS AND MERGERS & ACQUISITIONS

+1.202.639.6526

gcope@velaw.com

Washington

CHRISTOPHER C. GREEN
PARTNER, CAPITAL MARKETS AND MERGERS & ACQUISITIONS

+1.202.639.6521

cgreen@velaw.com

Washington

CHRISTOPHER MANGIN, JR.
PARTNER, TAX

+1.804.327.6311

cmangin@velaw.com

Richmond

DISCUSSION TOPICS

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DISCUSSION TOPICS (CONT'D)

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WHY ARE EXTERNALLY-MANAGED STRUCTURES USED BY REITS?

- Greater Scale
  - External managers may offer resources, talent and relationships that a new internally-managed REIT may be unable to provide
    - Scaled platform may provide greater access to broad-based deal flow
    - In many cases, the Manager manages multiple funds, REITs or other properties, asset classes or businesses
    - Extensive relationships in financial community, including wide range of dealers, traders, lenders and other market participants
    - Analytics
    - Finance, accounting, legal, etc.
    - Specialists
- Lower overhead
  - Externally-managed structures may provide a lower G&A expense load and greater certainty around expenses for new REIT entrants or less capitalized entities
    - Fitch Ratings analysis between 2010 and 2014 found that the costs associated with managing an internally-managed REIT was 20 bps higher than an externally-managed REIT from a total market value perspective

WHY ARE EXTERNALLY-MANAGED STRUCTURES USED BY REITS? (CONT'D)

- Focused Asset REIT Strategy "Spun Out" from Part of Larger Portfolio
  - Asset manager may desire to separate a single asset focus from an aggregated portfolio of properties
- Leverage the Brand
  - Sizeable asset management platforms may be perceived as more capable of capitalizing on new or complimentary investment opportunities
    - May be more efficient for external manager to add resources/specialists across multiple vehicles
  - Brand recognition and track record of well-known asset manager may aid in ability to raise meaningful initial capital

WHAT FACTORS DRIVE REITS TO INTERNALIZE?

- "Commitment" to internalize at future time upon certain events
  - Typically made in connection with capital raising
- Investor/Market pressures
  - Frequently, concerns center on management fees and expense reimbursements, performance, conflicts, corporate governance and dedication of management time
- Activism campaigns
  - 31% of externally-managed REITs in the U.S. have been subject to an activist campaign (as compared to 13% for internally-managed)*
  - Board control and/or board representation have been areas of focus
- Premiums/Discounts to Market Value
  - Externally-managed vehicles have frequently traded at a discount to their internally-managed peers
- Listing or IPO
- Internal Developments at Manager
  - On-going tension between active and passive investors of the Manager
  - Succession matters

Source: "Internal vs. External Management Structures," Ernst & Young LLP (2017)

PERFORMANCE OF EXTERNAL VS. INTERNAL STRUCTURES

- Internally-managed REITs with greater scale have tended to out-perform externally-managed REITs on the whole*
- Internally-managed REITs have out-performed their externally-managed counterparts by 240 bps per annum (based on total returns over 5 years)*
- However, less capitalized externally-managed REITs (less than $2 Billion) have out-performed their internally-managed peer set*

Source: "Internal vs. External Management Structures," Ernst & Young LLP (2017)

RATIONALE FOR INTERNALIZING

- Economies of scale with growth
  - Through elimination of fees that grow as equity or asset base expands, internally-managed REITs should benefit from lower G&A expenses as scale increases
- Alignment of interests through ownership
  - Where consideration is OP units or REIT stock, increased equity ownership of key executives should further align interests of management and stockholders
  - Equity compensation awards further align interests of management and stockholders
- Mitigation of conflicts
  - Internalization should reduce actual or perceived conflicts inherent to externally-managed structure

RATIONALE FOR INTERNALIZING (CONT'D)

- Expand investor base
  - U.S. institutional REIT investors tend to prefer internalized management structure – may provide access to a greater universe of investors – may improve capital markets execution
  - Expanded investor base may lay foundation for earnings multiple expansion
- Brings asset management platform into the REIT
  - Possibility for additional revenue source at the REIT if the Manager advises other vehicles
  - Gives the Board a larger voice in management's focus
  - Succession planning

STATISTICS ON CERTAIN PUBLIC REIT INTERNALIZATIONS OVER LAST 10 YEARS

- Composition*
  - 44% of these internalizations involved non-traded REITs (NTRs)
  - 78% of these internalizations involved equity REITs
  - 17% of these internalizations involved mortgage REITs

- Terms/Requirements
  - 56% of these internalizations involved some form of equity or stock consideration for termination of management agreement or acquisition or merger
  - 33% of these internalizations were subject to shareholder approval

* Statistics are based on non-exclusive list of 18 public REIT internalization transactions. The non-exclusive list of transactions may not be an exhaustive list of all internalization completed during the subject time period.

NON-EXCLUSIVE LIST OF REIT INTERNALIZATIONS FROM 2008 TO 2018

REIT	DATE	TYPE OF REIT	LISTED/NTR	CONSIDERATION	SHAREHOLDER APPROVAL
American Realty Capital Hospitality Trust, Inc. (Hospitality Investors Trust)	January 2017	Equity	NTR	Cash & REIT stock	No
REITPlus, Inc. (merged w/AmREIT)	May 2009	Equity	NTR	REIT Stock	Yes
Behringer Harvard Multifamily REIT I, Inc. (Monogram)	July 2013	Equity	NTR	Cash & REIT stock	No
Bluerock Residential Growth REIT, Inc.	August 2017	Equity	Listed	OP Units & Special REIT Voting Stock	Yes
CatchMark Timber Trust, Inc.	September 2013	Equity	NTR	Share buyback/ redemption	No
CB Richard Ellis Realty Trust (Chambers Street)	April 2012	Equity	NTR	Cash fees for certain ongoing services	No
Chimera Investment Corporation	August 2015	Mortgage	Listed	Share buyback	No

NON-EXCLUSIVE LIST OF REIT INTERNALIZATIONS FROM 2008 TO 2018 (CONT'D)

REIT	DATE	TYPE OF REIT	LISTED/NTR	CONSIDERATION	SHAREHOLDER APPROVAL
City Office REIT, Inc.	November 2015	Equity	Listed	Cash & REIT stock	No
Cole Credit Property Trust III, Inc.	March 2013	Equity	NTR	Cash & REIT stock	Yes
Colony Financial (Colony Capital)	April 2015	Hybrid	Listed	OP Units & REIT Stock	Yes
CYS Investments, Inc.	September 2011	Mortgage	Listed	Minimal Cash	No
Drive Shack Inc.	December 2017	Equity	Listed	Cash	No
Inland American Real Estate Trust, Inc. (InvenTrust)	March 2014	Equity	NTR	None (minimal transition services fee paid)	No
New York Mortgage Trust, Inc. (RiverBanc)	May 2016	Mortgage	Listed	Cash	No

NON-EXCLUSIVE LIST OF REIT INTERNALIZATIONS FROM 2008 TO 2018 (CONT'D)

REIT	DATE	TYPE OF REIT	LISTED/NTR	CONSIDERATION	SHAREHOLDER APPROVAL
Silver Bay Realty Trust Corp.	August 2014	Equity	Listed	OP Units	Yes
Smart Stop Self Storage, Inc.	September 2014	Equity	NTR	Cash & OP Units	No
Starwood Waypoint Residential Trust (Invitation Homes)	September 2015	Equity	Yes	OP Units	Yes

COMMON DEAL STRUCTURES – FACTORS THAT DRIVE STRUCTURES

- IPO/Initial Capital Raising/Listing Marketing Requirements
- Business of the Manager and its Affiliates (do other businesses need to be spun-off or are there liability concerns related to Manager-entity)
- Contractual provisions in management agreement
- Ownership composition of the Manager
- Consideration mix
- Financing issues
- Tax attributes of the parties
- Consent and shareholder approval requirements

COMMON DEAL STRUCTURES – PRE-NEGOTIATED TRANSACTIONS

- Pre-negotiated process as part of IPO or early-stage capitalization
  - Typically set forth in management agreement or other written agreement
  - Internalization typically triggered by passage of time, listing or liquidity event, or achievement of certain market capitalization or stockholders' equity levels
  - Pre-negotiated structure offer provides for formulaic determination of consideration
  - Consideration may include an "earn-out" component
  - Examples of this approach include American Homes 4 Rent, Jernigan Capital and Bluerock

COMMON DEAL STRUCTURES – ACQUISITION OR MERGER

- Most common structure is contribution agreement approach whereby REIT acquires all of the equity interest in Manager for some form of cash, equity or both
- Some transactions structured as acquisition of assets and assumption of certain limited liabilities
- Cash deals avoid shareholder approval requirements, but may be frowned upon by investors (require owners of manager to have some continued skin in the game) or present funding challenges
- OP Unit/Stock deals likely to require shareholder approval pursuant to NYSE/Nasdaq rules, but likely better received by investors
  - "Earn-out" features more common in these types of deals
  - Tax-deferral provided by OP unit deal may be attractive to owners of Manager
  - Ability to structure to better mitigate dilution
  - Ability to require lock-up agreements
  - Manager may demand registration rights

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COMMON DEAL STRUCTURES – SPECIAL VOTING STOCK

- Managers who received OP Units may request a special class of voting stock as part of their consideration
- Particularly the case where management may own a large percentage of the OP
- OP Units only voted pursuant to matters covered by OP Agreement – which means those votes are not cast in elections of directors and other annual voting matters
- Create special class of stock at REIT-level which provides for voting at the REIT-level that is representative of OP unitholders' ownership interest in the REIT on a diluted basis
- Voting stock provides more votes per share than a single share of common stock
- Voting stock redeemable for cash or common stock and receives dividends similar to common stock

CASE STUDY - JERNIGAN CAPITAL

- Jernigan Capital (NYSE: JCAP) went public in 2015 as an externally-managed REIT that lends to private developers, owners and operators of self-storage facilities
- Management agreement has 5-year term that expires in 2020
- Management agreement provides that:
  - No later than 180 days prior to end of initial term, Manager will offer to contribute to the OP of the REIT all of the assets or equity interests in the Manager
  - Offer price based on the lesser of:
    - Manager’s annualized EBITDA for most recent quarter ended multiplied by the EBITDA Multiple (variable based on total annual return); and
    - REIT’s equity market capitalization multiplied by the Capitalization Percentage
  - EBITDA Multiple and Capitalization Percentage determined as follows:
    - 5.0 and 5.0% if total return less than 8.0%
    - 5.5 and 5.5% if total return between 8.0% and 12.0%
    - 6.0 and 6.0% if total return greater than 12.0%

CASE STUDY - JERNIGAN CAPITAL CONT'D

- Independent Directors can accept offer or submit counter-offer
- Consummation of internalization conditioned on:
  - Receipt of fairness opinion
  - Independent director approval
  - Shareholder approval

CASE STUDY – BLUEROCK RESIDENTIAL GROWTH REIT

- Bluerock internalized in 2017
- Amount of internalization consideration based on formula in Management Agreement at time of IPO (3x sum of TTM Base and Incentive Fees)
  - Paid in OP units, Class C Common Stock and de minimis amount of cash
- Management's ownership of OP units would represent significant indirect economic interest in REIT
- OP units entitled to be voted on various OP matters, but not on annual REIT shareholder matters
- Class C Common Stock created to provide its holders a right to vote at the REIT level that is proportionate to the outstanding non-voting economic interest in the REIT represented by the OP units
  - Class C Common Stock not listed on any exchange
- OP unitholders granted certain registration rights
- 1 year of transition services agreed upon for certain back-office functions
- Subject to shareholder approval

CASE STUDY –COLE CREDIT PROPERTY TRUST III

- Internalized investment/asset management platform in connection with transition from NTR to listing on NYSE in 2013
- Merged the parent company of the advisory subs into Merger Sub, with Merger Sub surviving as wholly-owned sub of REIT
- Consideration included:
  - ~$20 million in cash at closing
  - 10.7 million shares of common stock of REIT at closing
  - Additional 2.1 million shares to be paid upon NYSE listing
  - Potential for payment of additional shares in 2017 as “earn-out” based on (1) acquired business achieving EBITDA above required threshold, and (2) the REIT’s stock performance relative to its peer group
- Merger consummated in advance of NYSE listing – this avoided shareholder voting requirements
- Merger combined REIT that owned more than 1,000 properties with asset manager with more than $12 billion in AUM
  - 3rd-party advisory business provides additional revenue and diversification of revenue streams

CASE STUDY – CITY OFFICE REIT, INC.

- Internalized approximately 22 months after IPO
- Internalization structured as an acquisition of 100% of the equity interests of the Manager
- Consideration comprised of:
  - Issuance of ~297,000 REIT common shares
  - Cash earn-out payments of up to $3.5 million upon achievement by the REIT of certain fully diluted market-cap thresholds
- Entered into administrative services agreement with 3-year term pursuant to which a sub of the REIT would provide various administrative services to funds affiliated with certain officers and directors of the REIT
  - REIT also agreed to make certain executives available to assist the funds with respect to certain matters

TRANSACTION PROCESS – BEST PRACTICES FOR INTERNALIZATION

- Independent directors should control the process
  - Most, if not all, internalization transactions will involve some conflicts of interest between the owners and employees of the Manager and the REIT
  - Identify conflicts early and re-evaluate conflicts throughout the process and transaction
  - Due to conflicts, one or more independent directors must negotiate terms on behalf of REIT
  - Apply constructive skepticism to the transaction and understand the Manager's interests and parameters
  - Availability of business judgment rule depends upon impartial decision-making
- Retain qualified advisors
  - Select qualified advisors capable of rendering independent advice
  - Important to engage legal advisors early in the process to address conflicts
  - Depending on deal structure and consideration, consider retaining financial advisors that can provide the Board with a basis for making an informed decision and provide a fairness opinion

TRANSACTION PROCESS – BEST PRACTICES FOR INTERNALIZATION (CONT’D)

- Devote appropriate time and energy to the process
  - To satisfy duty of care, directors must be reasonably informed
  - Ensure that appropriate time and diligence is devoted to evaluation and negotiation of the internalization transaction
  - Carefully review the terms of the Management Agreement and the various internalization documents
    - Understand the financial and other incentives of the Manager and its principles that could cause them to push for various terms
  - Oversee corporate communications (internal and external) regarding the transaction and its rationale

TRANSACTION PROCESS – BEST PRACTICES FOR INTERNALIZATION (CONT'D)

- Document the process
  - Build a real-time, written record of the Board's consideration of the transaction
  - Ensure that the written record is accurate and complete and that it reflects:
    - Business advice provided by the financial advisor, if any
    - For key decisions, the Board's rationale for its position on the issue and on what advice, if any, it received from third parties on the matter
    - Well-crafted meeting minutes that are consistently detailed and provide clarity around the Board's decision-making process
  - Written record includes meeting minutes, emails and written materials

TRANSACTION PROCESS – SPECIAL COMMITTEES

- Due to inherent conflicts in REIT internalization transactions, Boards should consider establishing a special committee comprised of independent and disinterested directors to negotiate transaction on behalf of REIT
  - At a minimum, conflicted directors must recuse from process
  - Special committee to determine whether it needs separate independent counsel from “everyday” corporate counsel
  - If special committee is formed, ensure that the scope of authority is well defined

TRANSACTION PROCESS – FINANCIAL ADVISORS

- Engagement of financial advisor may provide the Board with reasonable basis for its determination
- Need for financial advisor is fact-dependent
  - Is consideration to be paid strictly based on existing management contract?
  - Is the consideration to be paid material?
- Need to ensure financial advisor is independent and free of conflicts
  - Prior work with REIT or Manager is not by itself disqualifying but committee should carefully deliberate on the issue and document its decision
- While obtaining a fairness opinion provides added protection, it may not be necessary or efficient in every case

TRANSACTION PROCESS – SHAREHOLDER VOTES AND PROXY SOLICITATION

- NYSE Requirements
  - Shareholder approval acquired if:
    - Stock issued exceeds 20% of the voting power or number of shares outstanding before the issuance of the stock
    - Directors or officers receive more than the 1% of outstanding shares or 1% of voting power outstanding before issuance
- NASDAQ Requirements
  - Shareholder approval required if:
    - Stock issued exceeds 20% of the voting power or number of shares outstanding before the issuance of the stock
    - Any director, officer or 5% or greater shareholder has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction(s) and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in an increase in outstanding common stock or voting power of 5% or more
- Stockholder Meeting Necessitates Filing of Proxy Statement with SEC
  - Historical and/or pro forma financial statements of the REIT and the Manager
  - Proxy solicitation process similar to public company M&A process
  - May need to obtain stockholder approval of equity plan – CD&A required in proxy statement

TAX ISSUES

- Tax-Deferred Transaction
  - Requires operating partnership
  - Key issue: ensuring that the transaction is respected as a tax-deferred contribution to REIT's operating partnership vs. a payment for termination of the management contract.
    - Facts & Circumstances inquiry
    - Non-exclusive examples of relevant factors:
      - Contribution of management entity
      - Breadth and depth of management entity assets and business
      - Other business conducted by management entity
      - Employees in management entity
      - Documentation and structuring
- Taxable Transaction
  - Payment of termination fee results in ordinary income to recipients
- Location of Employees Post-Internalization
  - LTIP Units and partner/employee issue
  - Employee/overhead sharing agreement with TRS in certain cases

OPERATIONAL AND INTEGRATION ISSUES

- Employment issues/employment agreements/benefit plans/payroll providers
  - Compensation advisor
  - Benefit providers
- Business integration matters (IP, IT, legal, accounting systems, lease, insurance, other service agreements, etc.)
  - Review agreements to determine if any consents required
- Services/administrative/transition agreements
- Other Matters
  - Revise corporate governance policies and charters
  - Review SOX compliance procedures and internal controls
  - NYSE/NASDAQ requirements
  - CD&A disclosure in proxy statements
  - Update website

THANK YOU

Austin T +1.512.542.8400	**Beijing** T +86.10.6414.5500	**Dallas** T +1.214.220.7700	**Dubai** T +971.4.330.1800	**Hong Kong** T +852.3658.6400	**Houston** T +1.713.758.2222
London T +44.20.7065.6000	**Moscow** T +7.495.544.5800	**New York** T +1.212.237.0000	**Richmond** T +1.804.327.6300	**Riyadh** T +966.11.250.0800	**San Francisco** T +1.415.979.6900
Taipei T +886.2.2176.5388	**Tokyo** T +81.3.3282.0450	**Washington** T +1.202.639.6500			