HOULIHAN LOKEY

Real Estate Management Company Internalizations: Transaction and Valuation Considerations

Real estate management company internalization transactions, when structured effectively and pursuant to an "arm's length" process, can be transformative, value-enhancing events that more effectively align the interests of both management and investors. Below we explore the foundational steps involved in achieving successful outcomes for internalization and real estate management company platform transactions.

External Management Structures and Considerations

For REITs: External management structures have long been used in the context of de novo real estate investment trust (REIT) formation strategies and within the non-traded REIT segment of the real estate market. External structures typically result in a REIT that is not initially overburdened with corporate overhead (and employees) and is instead subject to the terms of a preestablished management agreement with an affiliated third-party entity. Such a structure allows the REIT to grow into its overhead in conjunction with the scaling of its asset base, as management fees are generally driven off of transaction fees and assets under management (AUM) at the REIT. In consideration of the flexibility provided to the REIT, management agreements typically provide the manager with some level of protection, either by way of an evergreen contract or a termination provision that provides compensation to the manager should the REIT be sold or decide to make adjustments to its management structure.

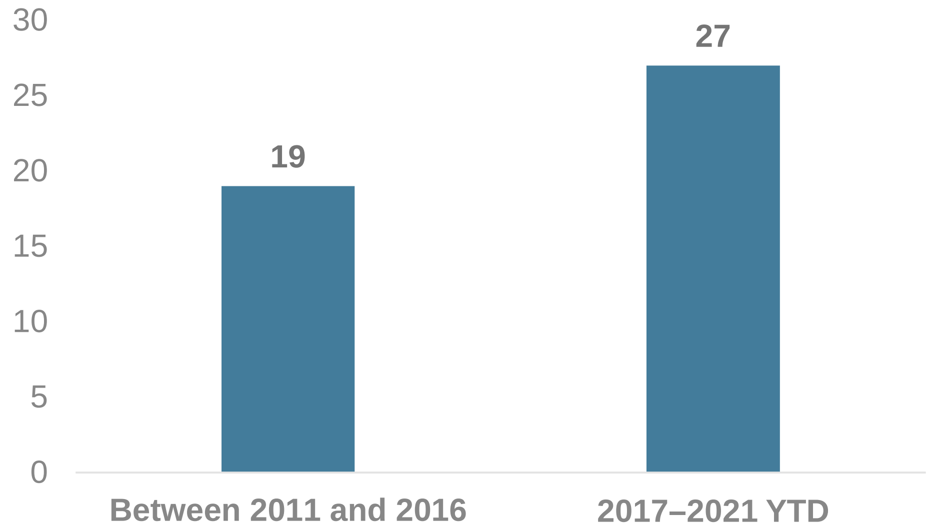
As the REIT achieves a certain level of scale, the fees payable under the management agreement can become more financially burdensome than the costs associated with direct employment of a team to manage the REIT. In these situations, it is often advantageous for the REIT (and also its external manager) to consider the benefits and process involved in internalizing management functions to put it on the path of long-term value maximization.

For Real Estate Private Equity Funds: In recent years, private-equity-driven real estate strategies with more operationally intensive asset classes—logistics, multifamily and single-family residential, hospitality, and data centers, to name a few—have involved management teams and operating platforms that are often owned separately from the real estate assets held within the fund. As liquidity events—including roll-up transactions, IPOs, and outright sales—are pursued by financial sponsor general partners, the assets are often marketed on a holistic and "as-internalized" basis. In these situations, transaction value may need to be ascribed discretely to each of the management company and real estate entities at closing, which can involve many of the same considerations and analyses conducted in REIT internalization transactions, to ensure fair and appropriate value distribution between the sponsor and fund LPs.

What Are Management Company Internalizations and Why Are They Done?

- An internalization is a transaction whereby a REIT or real estate company acquires its external manager and/or certain of the manager's affiliates and employees. Post-internalization, the REIT or real estate company no longer pays management or advisory fees but instead has dedicated staff and increased direct G&A/corporate overhead.
- At sufficient scale, the REIT or real estate company should derive savings through the operational leverage that comes from being internally managed.
- Internalized REITs are generally viewed more favorably by the public markets than those that are externally managed, given the potential for stronger alignment of interests between management (which is often incentivized based on bottom-line performance and/or via stock-based compensation) and investors.
- In private equity transactions, acquiring the manager may be attractive or preferable to a prospective buyer due to the manager's familiarity with the acquired assets and the simplification of the overall process during and post-transaction. Additionally, marketing the real estate assets together with the manager may increase the potential buyer universe with passive investors that may pay a premium for a self-managed portfolio or company.

Management Company Internalization Transaction Volume

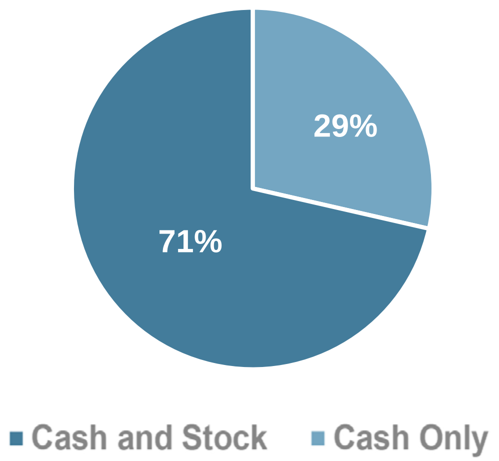


Source: Public filings announced publicly between July 2011 and April 2021.

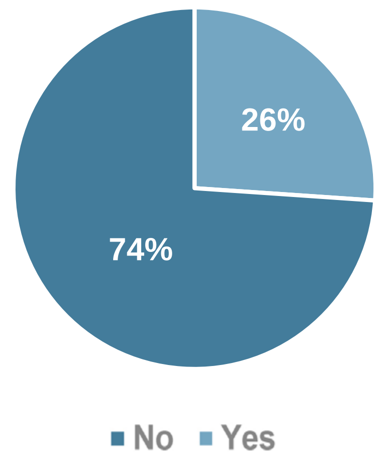
Key Steps to Take When Considering an Internalization Transaction

- ***Form an independent committee empowered to retain its own advisors.*** Due to the inherent potential conflicts of interest between the external manager and the REIT, forming a special committee comprised solely of independent directors is an important first step to establish an appropriate framework to analyze and pursue a potential transaction. The special committee should be empowered with a sufficiently broad mandate and the ability to retain its own independent financial and legal advisors to assist in navigating considerations relevant to its evaluation of a transaction.
    - Financial sponsors may want to consider whether setting up a limited partner advisory committee (LPAC) is advisable.
- ***Review all terms under the existing management agreement.*** Understand the terms and provisions of existing management agreements to determine the current in-place fee stream and the rights of the manager/company under a termination or internalization scenario.
- ***Determine what functions and employees would be internalized.*** Work with advisors and management to establish the post-internalization employee census. This is a critical step to ensure that the would-be internalized assets and employees match up with the practical requirements of operating the company on a post-transaction basis.
- ***Conduct a financial assessment of the internalized entity.*** Develop a pro forma financial forecast that incorporates the prospective benefits of an internalization and review the ultimate savings that would be generated from the transaction by comparing existing fees to the pro forma overhead and cost structure for the company post-transaction.
- ***Decide on the appropriate transaction structure and form of consideration.*** It is important to determine the form and structure of consideration to be paid to the manager in order to optimize alignment post-transaction (e.g., cash, common stock, operating partnership units, preferred stock, earn-out, or other contingent consideration).

Form of Transaction Consideration



Transactions Involving Earn-Outs



What Factors Are Considered in Structuring and Valuing an Internalization or a Transaction Involving a Management Company?

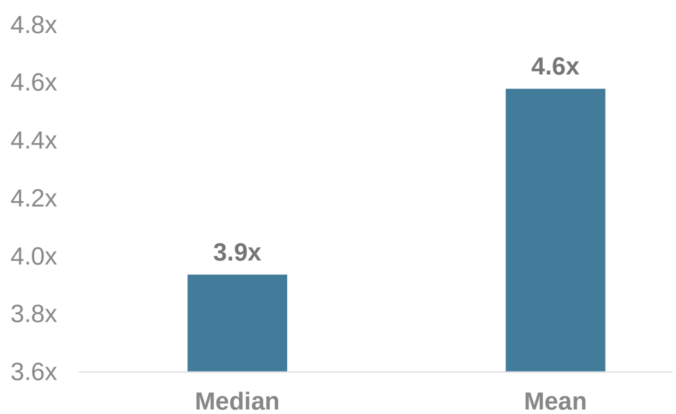
- Unless specified in the management agreement, the economic terms of the transaction typically result directly from negotiation between the independent committee and the management entity's owner or sponsor.
- Common methodologies used in guiding valuation and structuring considerations in internalization transactions include reviewing implied multiples paid from precedent internalization transactions and conducting discounted cash flow analyses of the projected cost savings to the company resulting from the internalization.
- Relevant implied multiples from precedent transactions include Transaction Value / Management Fee Revenue as well as Transaction Value / Total Enterprise Value of the REIT or real estate company.
  - Implied multiples from publicly traded asset management companies are also potentially informative.
- Perform a discounted cash flow analysis of the net realizable cash savings (derived by subtracting pro forma corporate overhead from the discontinued future fees payable under the existing management agreement) utilizing the cost of capital of the REIT or real estate company.

Source: Public filings announced publicly between July 2011 and April 2021.

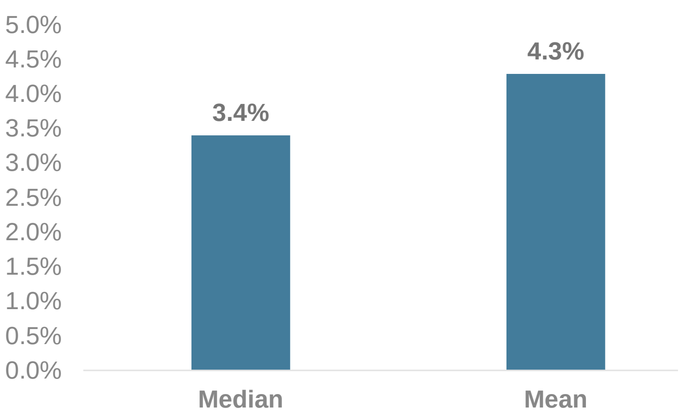
- Pro forma corporate overhead typically consists of employee salary/benefits and other G&A, such as rent, office equipment, software, etc.
- The potential for further AUM growth at the REIT or real estate company is an important aspect to consider, as, all things being equal, increasing AUM at the company will result in higher fees payable to the external manager if not internalized (and greater potential cash savings if internalized).
- Other considerations—such as cash payments related to the financing of the transaction, including incremental interest payments on debt and/or dividends on common or preferred stock—should also be reflected in the pro forma cash flow.
- The terminal growth rate is typically expected to be zero or slightly negative due to inflationary employee compensation expense growth outpacing run-rate discontinued management fees once the real estate portfolio reaches a mature state.

• In a private equity sale transaction or roll-up where the financial sponsor needs to allocate value to a management entity, the above methodologies and approaches to value should also be relevant, depending on the nature and importance of the operations of the management company.

Transaction Value / LTM Management Fees



Transaction Value / REIT Enterprise Value



**Note: The Transaction metrics shown above are based on a review of 46 management company internalization transactions announced between 2011 and 2021 YTD. The Transaction Value / LTM Management Fees multiples range between 1.0x and 15.8x. The Transaction Value / REIT Enterprise Value percentages range between 0.9% and 14.6%.

Source: Public filings announced publicly between July 2011 and April 2021.

Fiduciary Considerations for Boards and Financial Sponsors

Due to the potential conflicts present in affiliate transactions, the success of a management company internalization begins by establishing a deliberate and independent process designed to effectuate strategic goals and withstand potential scrutiny. Given the valuation and structuring complexities of management company internalizations, board members, financial sponsors, and LPACs benefit from the involvement of independent advisors that can assist in satisfying legal, regulatory, and contractual duties, including financial advisors. Fairness opinions and valuation opinions are considered a best practice to support the business judgment of fiduciaries while potentially also being useful in reviewing financial considerations likely to be relevant to investors in the case of sponsor-led transactions.

Houlihan Lokey has decades of experience successfully guiding REITs, boards of directors, funds, and independent committees through the complex process of effectuating transformative and value-enhancing internalizations and management company platform transactions. We welcome the opportunity for further dialogue around the exploration of any potential situation with similar attributes.

Select Recent Houlihan Lokey Representations Involving External Management Companies

Resource Real Estate Opportunity REIT II

has acquired

Resource Real Estate Opportunity REIT, Inc.

and

Resource Apartment REIT III

in separate transactions

Buyside Advisor

PAC Preferred Apartment Communities

has completed a management company internalization

Financial Advisor

Safehold

has received a $250 million equity investment from

iStar

Financial Advisor

Colony Industrial

has been acquired by an affiliate of

Blackstone

Financial Advisor

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