

OSP Market Information: Real Estate Investment Trust (REIT) marketplace summary

Solutions marketing

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Executive summary

Real estate investment trusts (REITs) are one of the leading centralized property owners for the multi-tenant unit (MTU), multi-dwelling unit (MDU), and multi-hospitality unit (MHU) market segments. To focus on a market opportunity as large as this requires partnering with property owners that are segment-focused and own multiple properties within a given segment. REITs are such an entity, providing the necessary economies of scale required to establish a market-dominant presence. Other property ownership entities tend to have decentralized management structures, making it more difficult to focus on multiple properties within a given segment.

REITs are publicly traded entities that aggressively look for ways to increase their shareholders' value. This differs from other privately held organizations that look to optimize one or two properties and reduce tenant churn. The MDU, MTU, and MHU segments are three of the larger segments in which REITs have investment ownership. The MPC segment is the one market where REITs have not traditionally been a player, focusing more on developed properties from which they collect a rental revenue stream.

Definitions

Master-planned community (MPC)

MPCs are large new home communities that typically feature community entries, parks, recreational areas, schools and community shopping. Within a planned community there are smaller communities offering a variety of home styles and price levels to choose from.

Multi-dwelling unit (MDU)

MDUs include apartment buildings, garden apartments, apartment complexes, and townhouses, regardless of whether they are owned or rented by the occupants.

Multi-tenant unit (MTU)

MTUs are commercial buildings in which several businesses operate. There are several different classifications of buildings housing multi-tenant units; however, office use is the most interesting to telecommunications carriers.

Multi-hospitality unit (MHU)

An MHU is characterized by a transient population that stays an average of three days or less. Proprietors offer a range of telecommunications and entertainment services at no charge or for a fee.

Introduction

One of the keys to success in the MTU, MDU, and MHU market segments is identifying and working with the right property owners. In many instances, office buildings, apartment complexes, and hotels have third-party property managers overseeing day-to-day operations. Although these parties will eventually be critical in any solution deployment, they are not the final decision-makers. The property owner will own the rights of way, physical plant, and wiring.

Table A. Property ownership		
	Private Market	Public Market
DEBT	Mortgages Line of Credit Secured Loans	CMBS Bonds REIT-Mortgages
EQUITY	Sole Proprietorship Partnership LLC/LLP Joint Venture S-Corps Commingled Funds Opportunity Funds	REIT C-Corps Master LTD Partnerships

Property ownership comes in many financial forms and sources. Identifying the best form of property ownership is not always as simple as it may seem (Table A).¹

Of the listed property ownership models, REITs represent the market “sweet spot.” They target ownership of mid- to large-sized apartment complexes, shared tenant office space, and business traveler hotels. Most importantly, REITs represent a centralized management decision-making body. This is not to say that REITs represent the only ownership body worth targeting, rather they are the one providing the fastest access to the most targeted properties.

REITs have been around since the 1960s as a mechanism for ownership of investment properties. Since these beginnings over thirty years ago, REITs have grown to over 203 companies.² They focus on income generation from property ownership and rental revenues. REITs have weathered many financial storms, including the savings and loan bailout of the late 1980s.

As a trust, REITs must follow highly regulated rules of ownership and dividend distribution (Table B).²

Table B. REIT regulatory rules

1. There must be no more than 100 shareholders.
2. The shares must be fully transferable.
3. No fewer than five people can own more than 50 percent of the company.
4. There must be a board of directors.
5. At least 75 percent of a REIT’s assets must be in qualifying investments—these include properties, mortgages, and government securities.
6. At least 75 percent of the gross income must be derived from rents, mortgage interest, or gains from property sales; 9 percent of gross income must meet the 75 percent test plus dividends, interest, and gains from sales of securities.
7. A previous requirement that less than 30 percent of the gross income could be derived from gains on sales of properties held less than four years was repealed in 1997, but a 100 percent excise tax on prohibited transactions remains.
8. A REIT must distribute at least 95 percent of its taxable income to shareholders each year.

Over the past ten years, REITs have seen their market caps increase over tenfold, from \$10B in 1987 to over \$150B in 1997.¹ REITs tend to focus on properties by segments. Several of these segments align well with the definitions of MTU, MDU, and MHU. Focusing on specific property types allows REITs to better understand the specific needs of a given segment. This permits REITs to manage properties

and buildings more efficiently, ensuring better returns on shareholder investments, much in the same way that mutual funds specialize in a single market sector. On the other hand, REITs tend not to focus geographically, instead going where the market is strongest.

¹ NMHC, 1998, *Strategic Management of Apartment Business*, pp 4, 7, and 21.

² Ferris-Baker-Watts, June 2000, *REITs Building Momentum*, pp 3, 6, 30-33, 42, 33, 38-40, and 46.

Market research

As mentioned previously, REITs have become one of the single largest centralized property owners in the MTU, MDU, and MHU segments. As a group, REITs focus primarily on what is referred to as Class A and Class B properties. The classifications listed below are for the MTU market. However, the MDU and MHU use very similar metrics.³

A-Class: New or newer properties, large towers/buildings, high-demand area or structures, cost=\$350 per square foot, rent=>\$70 per square foot.

B-Class: Newer to several years old, smaller buildings, 1 to 2 stories, cost=\$100 per square foot, rent=\$10-20 per square foot.

C-Class: Older buildings.

This type of focused building demographic is well-suited for broadband deployments. It targets higher-end and newer properties with tenants that require high-speed access, voice, and video services.

Market segments

MTUs

Within the MTU segment, REITs favor mid- to large-sized office buildings with greater than 50,000 square feet (Table C).⁴ These types of properties include shared-tenant office space. This is a targeted group because they lack their own IT departments.

Table C. MTU building size by REIT ownership

REIT Ownership in the MTU Market			
Sq-Ft	REIT Owned Office Properties	Total US Office Property Market	REIT %
<50K	839	673,557	0.12%
50K to 100K	1030	18,644	5.52%
100K to 200K	870	8,222	10.58%
200K to 500K	553	3,463	15.97%
>500K	194	1,113	17.43%
<i>Totals</i>	3,486	704,999	

Of the 2.8 percent publicly held MTU office properties, REITs own over 95 percent. This ownership again emphasizes the strength of REITs in the MTU segment. The top six REITs for 1999/2000 are shown in Table D.³

³ Ferris-Baker-Watts, June 2000, *REITs Building Momentum*, pp 3, 6, 30-33, 42, 33, 38-40, and 46.

⁴ Dain-Rauscher-Wessels, June 2000, *Bullish on Broadband*, pp 113, 120.

MTU properties averaged approximately a 10 percent vacancy rate per year, with leases averaging 10 years. Due to the lease terms, REITs are more focused on tenant attraction to fill the 10 percent of vacancies.⁵

Table D. Top MTU REITs		
Segment	REIT	Location
MTU-Office	Boston Properties	Boston, MA
	Brandywine Realty	Newton Square, PA
	Corporate Office Properties	Baltimore, MD
	Great Lakes REIT	Oak Brook, IL
	Parkway Properties	Jackson, MS
	CarrAmerica	Washington, DC

MDUs

The MDU apartment market is the second largest segment for the REITs. They focus on the complexes with more than 50 units per property (Table E).⁶ These complexes tend to be garden-style apartments with ten to twelve units per building, greater than one story. Apartment age is also critical, dictating the access to what wiring standard is in place. Since REITs focus on Class A/B buildings, most of the apartments they own were built with in the last ten years. However, many apartments still have category 3 (CAT3) wiring still in place.

Table E. MDU property ownership by organization vs. property size				
REIT Ownership in the MDU Market				
Ownership	All Properties	2-4 units	5-49 units	50+ units
Individuals	46.9%	84.8%	57.4%	19.2%
Partnerships	20.3%	3.9%	14.9%	32.7%
REITs	2.1%	0.6%	1.1%	3.4%
Real Estate Corps	5.8%	1.0%	4.0%	9.6%
Other Corps	3.4%	0.9%	4.0%	4.6%
Non-profit/Co-Ops	3.7%	0.6%	2.5%	6.0%
Other	4.4%	3.7%	4.6%	4.9%
Not reported	13.4%	4.5%	11.5%	19.6%

⁵ Ferris-Baker-Watts, June 2000, *REITs Building Momentum*, pp 3, 6, 30-33, 42, 33, 38-40, and 46.

⁶ Yankee Group, Nov. 1999, Vol. 16, No. 1,9 *Residential MDUs*, pp 5, 10.

REITs own 7.4 percent of the 11.7 million units that are publicly traded. Only individual owners and partnerships own more. However, they own fewer properties as individuals than are owned by an individual REIT. The top six MDU REITs for 1999/2000 are shown in Table F.⁷

Apartments have held a fairly constant vacancy rate, averaging around 8 percent per year. However, the turnover rates for apartments runs at 75 percent per year. The direct and indirect cost of a tenant moving out is reported to be as much as 2 percent of the value of the unit.⁸ With short-term leases, coupled with high turnover rate, REITs are looking for ways to ensure tenant retention.

MHUs

Although REITs have many holdings within the hospitality industry, direct correlation to a particular REIT is somewhat difficult. Since hotel charges cannot be considered rental income. REITs lease these properties to third-party property management firms who, in turn, rent to the public.

Of all MHU properties, 17.3 percent are publicly traded, of which the REITs have 19 percent. The largest MHU owners are the C-Corps with just over 65 percent.⁹ The top six MHU REITs are shown in Table G.⁷

Table F. Top MDU REITs		
Segment	REIT	Location
MDU-Apartment	Home Properties	Rochester, NY
	Charles E. Smith	Crystal City, VA
	United Dominion	Richmond, VA
	Avalon Bay	Alexandria, VA
	Town and Country	Baltimore, MD
	Grove Properties	Hartford, CT

Table G. Top MHU REITs		
Segment	REIT	Location
MHU-Hotels	Equity Inns	Germantown, TN
	Innkeepers	Palm Beach, FL
	RFS Hotel Investor	Memphis, TN
	LaSalle Hotel	Bethesda, MD
	Humphrey Hospitality	Silver Spring, MD
	Jameson Inns	Atlanta, GA

The MHU segment is very different from the MTU and MDU segments. Here, the lease runs one to two days and the tenant is a business traveler with a PC. Cahners In-Stat's survey of hotels indicated that over 73 percent would deploy broadband access, with

48 percent deploying within the next twelve months.¹⁰ Cahners also found that the top two reasons for deploying broadband were retention and attraction respectively; incremental revenue for the service was third.

⁷ Ferris-Baker-Watts, June 2000, *REITs Building Momentum*, pp 3, 6, 30-33, 42, 33, 38-40, and 46.

⁸ NMHC, <http://www.nmhc.org/media/indust>.

⁹ NMHC, 1998, *Strategic Management of Apartment Business*, pp 4, 7, and 21.

¹⁰ Probe Research, Jan. 2000, *US Competitive Service Markets*, p 7.

Business approach and alliances

REITs do not want a repeat of the early 1970s, when cable TV franchises were given free access to tenants without any share of the revenues. With telecom deregulation in the 1990s, REITs fully understand the value of their rights of way, and hold control over all services and infrastructure providers. Today, REITs will negotiate a base set of services and features for their properties in return for a share of the revenues, which range from 2 percent to 10 percent.^{11, 12, 13} The service provider will pay for the cost and deployment of the infrastructure.

The advantage for service providers is the economy of scale a REIT can offer. One contract can cover several properties; upsell is easier when dealing with a single entity instead of focusing on a specific building. Bell Atlantic reports that 80 percent of their MDU business is conducted with the REITs, 20 percent with independently owned properties.¹²

Global view

Many of the capital sources outlined in Table A apply to the U.S. Much of overseas property ownership is managed through banks.

Conclusions

REITs can provide access to many of the targeted properties within the MTU, MDU, and MHU segments. In addition to access, REITs are also motivated customers looking for ways to attract and retain tenants, while at the same time gaining access to incremental revenues.

Although REITs address many property ownership concerns, they should not be viewed as the sole owners of all MTU, MDU, and MHU properties. Far from it—there are many large properties owned through partnerships, individuals, or corporations. All of these represent significant opportunities to gain and grow market share. REITs should be viewed as a focal point for market entry.

¹¹ Dain-Rauscher-Wessels, June 2000, *Bullish on Broadband*, pp 113, 120.

¹² Yankee Group, Nov. 1999, Vol. 16, No. 1,9 *Residential MDUs*, pp 5, 10.

¹³ Probe Research, Jan. 2000, *US Competitive Service Markets*, p 7.



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56030.25/01-01 • Printed in USA January 2001

Published by:

Nortel Networks

Marketing Publications
Dept. 0526
P.O. Box 13010
RTP, NC 27709