

Johnson/Souza Group, Inc.

THE DOWNREIT STRUCTURE

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July 1998

EXECUTIVE SUMMARY

Goals of the DownREIT structure are:

- Provide a tax efficient (deferral) mechanism for sellers of apartments or land wanting to transfer properties exchangeable into exchange for BRE stock at a future date.
- Provide sellers/investors more flexibility in their estate and tax planning objectives.
- To gain access to good quality apartment product in targeted markets.
- Acquire investments that are accretive to shareholder value.
- Provide liquidity to sellers/shareholders as needed.

Structure of the DownREIT

- A DownREIT structure is an expansion of an existing REIT or UPREIT by forming a new partnership to acquire and own property.
- The term DownREIT refers to a REIT that owns properties directly but holds some of its properties in a partnership having other partners.
- Owners of the DownREIT hold their interests as operating units (OP units) in the partnership until they are redeemed or exchanged for cash or REIT shares.
- In most cases, no tax liability is triggered when the owner/developer contributes properties to the operating partnership. Not until the partnership units are converted into stock or the partnership assets are sold will the owner/developer's units become taxable.
- In a DownREIT structure the REIT becomes the general partner and the economic interests of the other partners are aligned with management and stockholders of the REIT, in most cases distribution to OP unit holders closely track the dividends paid by the REIT to its shareholders.
- Properties held in the DownREIT partnership will benefit from the REIT's management expertise and cash contributions to discharge debt or improve or expand the properties.
- Any DownREIT transaction is complex; partnerships units are securities and their issuance can have securities laws implications. Therefore, competent tax and securities counsel should be consulted.

THE DOWNREIT STRUCTURE

Introduction

This document is intended to assist potential sellers of apartments and brokers specializing in apartment transactions, gain a broader understanding of the DownREIT structure and the use of OP units as a tax strategy.

Goals of the DownREIT structure are:

- Provide a tax efficient (deferral) mechanism for sellers of apartments or land wanting to transfer properties exchangeable into exchange for BRE stock at a future date.
- Provide sellers/investors more flexibility in their estate and tax planning objectives.
- To gain access to good quality apartment product in targeted markets.
- Acquire investments that are accretive to shareholder value.
- Provide liquidity to sellers/shareholders as needed.

Any investor in appreciated real estate who is faced with a number of potential buyers one or more of which is a REIT -- should consider the tax savings that may be achieved by selling to a REIT – through an operating partnership or through the use of the DownREIT vehicle.

Any DownREIT transaction is complex; partnerships units are securities and their issuance can have securities laws implications. Therefore, competent tax and securities counsel should be consulted.

Evolution of the DownREIT Structure

Due to the credit crunch and real estate recession of the early 1990s, owners and developers of real estate were in dire need of investment capital to improve properties, buy down debt and expand their portfolios. Wall Street stepped in and used REITs as the investment vehicle to fill this equity capital need.

The umbrella partnership REIT (UPREIT) was invented to overcome tax difficulties associated with more traditional methods of transferring real estate to REITs.

The UPREIT, first used in the 1992 Taubman Centers IPO, is a structure in which a partnership owns the assets of the company. The partnership in turn is owned by the REIT and existing investors in the company that is going public. The REIT is then owned by its shareholders (largely new public individual and institutional investors). Using the

structure at worst defers and at best eliminates serious tax liabilities for owners of low tax basis properties. An additional reason for using an UPREIT structure is the future possibility of using UPREIT equity interests as currency in tax-deferred acquisitions.

Over the past five years, the UPREIT structure has evolved into many variations, one of them being the newer DownREIT structure.

The significant difference between the DownREIT structure and the UPREIT is that the REIT has formed a partnership with the property contributor only with respect to the contributor's properties. Most of the REIT's real estate investments will be held directly by it or through other partnerships that have no relationship to the DownREIT partnership.

The DownREIT Structure

The DownREIT is formed and functions similarly to any joint venture partnership in which a corporation might enter. The REIT contributes cash and the owners contribute their property, *a conventional non-taxable event*, and the REIT becomes the general partner.

The unique feature of the DownREIT structure for existing owners, however, is the *ability to defer taxable gain* until they swap their Operating Partnership Units (OP units) at some future date for the REIT's stock. Moreover, an individual partner can convert his or her OP units to suit their own estate or financial plans independently of the other partners.

In most cases, no tax liability is triggered when the owner/developer contributes properties to the operating partnership in exchange for OP units. Not until the partnership units are converted into stock or the partnership assets are sold will the owner/developer units become taxable. In a DownREIT, the REIT will probably have to agree to a *standstill or lockout agreement, for the sale of contributed assets*, and for a period of years. This period generally negotiated at the front end.

A DownREIT partnership typically falls into two categories. The first is where the REIT contributes little or no capital, the limited partners receive a preference on distributions of operating cash in an amount equal to the dividends paid on the REIT shares, and any excess cash from operations are distributed to the REIT general partner. The second category is that in which the REIT contributes significant capital to the partnership, typically to pay down debt. The general partner will typically receive a distribution representing a return on capital. Remaining cash from operations will be distributed to the limited partners.

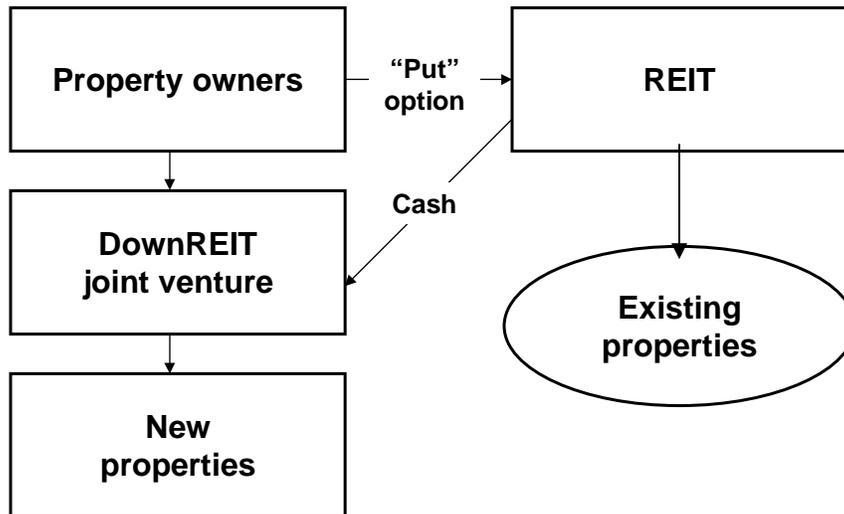
The DownREIT is an excellent tax-planning tool. Sellers do not have to convert their partnership OP units all at the same time; they can do the conversion in segments, spreading out their tax liability over several years.

DownREITs are also valuable for estate planning purposes because the tax laws allow for a step-up in basis upon the death of a spouse. In this case, the surviving spouse will get a step-up in basis which will allow him or her to convert the operating partnership units into REIT shares without incurring taxes. This allows the surviving spouse to obtain cash without waiting for the remaining partners to agree to sell and also lets the remaining partners stay in the DownREIT without incurring a tax liability.

In most instances, holders of partnership units will receive distributions from the operating partnership, effectively giving them the equivalent of dividends.

The exhibit below graphically illustrates a typical DownREIT structure.

Typical DownREIT Structure



Sample DownREIT Transaction

- Size: Portfolio of 3 properties, 1,000 units
- Price: \$85 million
- Cap: 8%
- Existing Debt: \$60 million at 8.5%
- Neg. Cap. Acct: \$15 million
- REIT's Stock: \$27 per share
- REIT's debt: 7.25% interest expense

The analysis assumes that the general and limited partners owning three apartment communities wish to defer their tax liabilities and achieve a price at an 8% cap. The

properties have \$60 million of 8.5% debt, and, collectively, the partners' capital accounts stand at a negative \$15 million.

At closing, the REIT pays off \$45 million of the existing debt and replaces \$15 million, the amount of the negative capital accounts, with lower cost 7.25% debt. Concurrently, 925,925 OP units, assuming a share price of \$27, are issued to the existing partners for their \$25 million in equity.

The REIT would become the managing general partner and relieve the limited partners of any further capital requirements. Quarterly, the limited partners' distribution per OP unit would be equal to the dividend per share distributed to the REIT's public shareholders. The distribution would move in lock step with the dividend and any stock splits or movement in share prices would have a similar impact on the OP units (anti dilutive provision).

Other DownREIT Issues

- **Term:** While a matter of negotiation, some sellers may wish the DownREIT partnership to go on indefinitely to defer their tax liability. They see the OP units as an estate-planning device. While current market transactions have partnership lives averaging around eight years, some REITs are willing to go fifteen years, if warranted. Conversion, however, would be required when 75% of the partners, or OP units, had been converted to stock.
- **Sale of Partnership Assets:** The sale of a partnership asset would trigger an unwanted gain. Typically, Sec. 1031 of the tax code would be employed to overcome this problem for the life of the partnership. Alternatively, however, an asset within the DownREIT partnership could be swapped for one of the REIT's other properties and then sold if need be without a 1031 requirement. The partners' basis would attach to the new asset within the partnership, leaving the old property subject only to the REIT's basis which by selection would create a little profit for the REIT as possible. The caveat, however, is that the REIT must hold the asset for two years outside the partnership before the sale.
- **Debt:** Repayment of debt below the level of the negative capital accounts also is a taxable event to be avoided. Debt may be replaced with lower cost debt and shifted to other assets in the partnership, but it must be kept in place within the partnership until conversion. Another solution is to restructure the asset ownership simultaneously with the partnership transfer. This is done by bifurcating the debt into two separate loans, one collateralized by improvements, and the other encumbered by the fee interest in the land. This type of transfer minimizes the debt associated with the improvements.
- **Tax Treatments and Rulings:** The transaction would be structured to qualify as a tax-free exchange of stock for property (stock or partnership units) under applicable tax

code section. The deal could be structured as a “Triangular” merger with the “seller” receiving the REIT’s stock if the properties are in a LLC or other type of corporate entity. The IRS has not ruled regarding the DownREIT structure, while the UPREIT structure has become accepted. The burden of adverse risk lies with the seller. Nevertheless, the REIT would want to be contractually indemnified.

- Valuation: The OP Unit is valued based upon a mutually agreed price by the REIT and the Seller, which is typically the average closing stock price on the NYSE for five or 10 days prior to the exchange (or other reasonable period). For example, if the Seller has \$32 million in equity in a property and the REIT and the Seller agree that the OP Unit is to be valued at \$32.0 per share, the Seller will receive one million OP Units at the closing of the sale of the property.
- Registration and Lockout Period: DownREIT shares would be fully registered. The REIT is traded on the stock exchange under its own trading symbol. A sample *lockout period* would be 30 days from closing to allow for full disclosure to market and stabilization of stock price.
- Representations, Opinions, Costs and Time: The REIT and the “seller” are required to provide normal representations and opinions as needed, as to security issuance and knowledge. Real estate expenses would be shared as is custom in the area. Securities issuance cost would be those of the REIT. Each party would pay its own legal costs. Ernst & Young estimates that legal costs, depending on the size and complexity of a portfolio, could run to \$50,000 with accounting costs of approximately \$10,000. Unless there are time consuming SEC requirements caused by a large number of limited partners, no extraordinary amounts of time are required.
- Conflict of Interest: Unlike the UpREIT structure, where there is an inherent potential conflict of interest between the public shareholders and the holders of OP Units, the DownREIT is not so tainted because it is a subordinate and relatively minor portion of the REIT’s activity. The shareholders of an UpREIT may be concerned that the principals of the UpREIT who are major holders of OP Units may likely act to preserve their own best interests when dealing with the assets rather than the best interests of the shareholders.

APPENDIX

DownREIT Structures

Example #1:

Fifty years ago, Jack Smith established a business that became highly successful. Over the years, it acquired real estate that has greatly appreciated in value. During the same period of time, Mr. Smith has given ownership interests to 25 family members-his children and grand children and other relatives.

The grandchildren and other younger owners would like to sell and get cash for their interests. But Mr. Smith is reluctant to sell because he would incur a substantial tax liability. So, he prefers to hold off until his estate planning program kicks in.

Obviously, it would be difficult to purchase this property for cash. But a DownREIT would enable each owner to sell at a time of his or her choosing, thereby giving all parties liquidity when they want it and setting around the problem that is posed when all owners are tied together in an investment. The DownREIT is suitable only for select groups of individuals who are concerned with taxes and tax planning.

To find those groups, we talk to established business contacts, contacts of our board members and accountants and lawyers who might know of opportunities to use a DownREIT.

Example #2:

Through a long-standing relationship with a southern California developer, early in 1995, the REIT found an opportunity for doing a DownREIT. Mr. Konwiser headed a consortium of 11 apartment projects in five southern California cities: Covina, West Covina, Diamond Bar, Ontario and San Diego. There were a total of 1,368 units in these properties.

The REIT saw that this would be a complex transaction because the 11 properties were owned by approximately 70 partners in 17 different partnerships. The first transaction took a year to put together. The REIT signed an agreement to acquire all of the properties for about \$72 million. The REIT then formed a new operating partnership (NOP) in which the REIT would own 80 percent and become the general partner with the members of the consortium all becoming limited partners and holding a 20 percent interest.

By mid-August, the REIT announced that escrow had closed on eight of the 11 projects, with a total value of \$63 million. A few days later, the REIT closed escrow on the last three properties, valued at \$9 million.

At these closings, the REIT issued a total of 226,000 limited partnership units. These units are convertible into the REIT's common stock on a one-for-one basis beginning in August 1997.

The REIT invested a total of \$14.5 million in the operating partnership. Of that total, \$13.5 million will be used to pay down and restructure conventional debt on a portion of the portfolio and costs associated with consummating the transaction. The remaining \$1 million will be used to improve the properties over the next year or two.

After the REIT receives a stated fixed return on its investment, the limited partners will receive a cash distribution (to the extent that the partnership has cash to distribute) equal to the REIT's dividend per share for each partnership they hold.

Thus, in a single transaction, the REIT was able to increase its assets to \$280 million, more than double what they were less than two years earlier.

The 11 projects in this DownREIT appealed to the REIT for several reasons. First, the REIT saw great potential for increasing their occupancy and revenues. Second, the portfolio included three projects for active senior citizens.

The REIT views senior housing as a growing market, especially in Southern California, and these projects can be quite profitable and fit into the REIT's long-term business strategy.

Five of the acquired properties are financed by tax-exempt, low-floating rate bonds. The REIT expects to use tax-exempt financing programs in future acquisitions.

This transaction shows that the REIT has the expertise to deal with difficult, complicated situations. Owners of other attractive properties can be confident that the REIT will be able to accommodate them through a DownREIT structure when that appears to be the appropriate method for an acquisition.

Example #3

- Size: Portfolio of 3 properties, 1,000 units
- Price: \$60 million
- Cap: 8.5%
- Existing Debt: \$45 million at 8.5%
- Neg. Cap. Acct: \$15 million
- REIT's Stock: \$25 per share
- REIT's debt: 7.5% interest expense

The sample DownREIT analysis attached as Exhibit I should help to illustrate many of the key issues involved in using the structure. The analysis assumes that the general and limited partners owning three apartment communities wish to defer their tax liabilities and achieve a price at an 8.5% cap rate. The properties have \$45 million of 8.5% debt, and, collectively, the partners' capital accounts stand at a negative \$15 million.

At closing, the REIT pays off \$30 million of the existing debt and replaces \$15 million, the amount of the negative capital accounts, with lower cost 7.5% debt. Concurrently, 600,000 OP units (assuming a share price of \$25) are issued to the existing partners for their \$15 million in equity. The REIT's total cash investment including underwriting, closing costs and some rehab comes to \$30.1 million.

The property has a \$5.1 million NOI, and, after paying the existing debt service, the partners had anticipated a distribution of \$913,000 in the current year. Despite the fact that the REIT will relieve them of any further capital or management responsibilities, they were unwilling to receive less than they had expected under their previous financial structure. So at distribution time, the NOI is reduced by interest on the new debt and the partners' \$913,000 distribution, leaving the REIT with \$3.06 million, a cash on cash return of 10.2%. This is a negotiated arrangement and the enhanced cash flow is a result of the REIT's credit worthiness and ability to obtain lower cost debt.

Finally, there is the issue of dilution of the existing shareholders. Clearly we would want to avoid such a potential. In the example, 600,000 shares would be added to the REIT's approximate 32.9 million existing shares outstanding upon conversion, bringing the total to 33.5 million shares. The property's contribution to FFO following conversion would be \$1.718 million after deductions from its NOI of interest expense and an assumed cost of the REIT's cash investment. The result is accretive. The "new" shares contribute \$2.86 per share of FFO, raising FFO from \$1.82 per share to \$1.84 per share.

Exhibit I
SAMPLE DOWNREIT ANALYSIS

Assumptions:

(\$ in 000s)

Price	\$60,000	
Debt	\$45,000	30 yr. Amort.Mtg.
Seller's Equity	\$15,000	
Interest Rate on Existing Debt	8.5%	
Neg Capital Acct	\$15,000	
NOI	\$5,100	
CAP Rate	8.50%	
Interest Rate on BRE's Debt	7.50%	
REIT's Stock Price at Closing	\$25.00	

Cash Required:

Pay Down Existing Debt	\$30,000
Underwriting & Closing Costs	\$50
Improvements	<u>\$50</u>
Total	\$30,100

Operating Units:

Seller's Equity	\$15,000	
Divided by Stock Price	\$25.0	
Number of OP Units in 000s	600	
Dividend Upon Conversion	\$828	(\$1.38/share)

Distribution Before DownREIT

NOI	\$5,100
Debt Service	<u>\$(4,187)</u>
Net to Partners	913

Dilution Test:

Pre-DownREIT Shares Outstanding	32,900
Pre-DownREIT FFO	\$59,878
Pre-DownREIT FFO/Share	\$1.82

Distribution After DownREIT:

NOI	\$5,100	NOI	\$5,100
Debt Service	\$(1,125)	Debt Service	\$(1,125)
NOI	\$5,100	Cost of REIT's \$10.1 Million	<u>\$(2,258)</u>
Debt Service	\$(1,125)	Contribution to FFO	\$1,718
Distribution to Partners	<u>\$(913)</u>	Pre-DownREIT FFO	\$59,878
Net to BRE	\$3,062	Post-DownREIT FFO	<u>\$61,596</u>

First Yr. Return on Cash Investment 10.2%

Number of New Shares 600

FFO per New Share \$2.86

Post-DownREIT Shares Outstanding 33,500
Post-DownREIT FFO/Share \$1.839

Example #4:

The sample DownREIT analysis attached as Exhibit II should help to illustrate many of the key issues involved in using the structure. The analysis assumes an elderly general partner of a \$20 million Bay Area apartment community is willing to sell if he and his partners, several of whom are friends and relatives, can defer their tax liabilities and achieve a price at an 8% cap. The property is burdened by \$15 million of unattractive 9.25% debt and, collectively, the partners' capital accounts stand at a negative \$5 million.

At closing, the REIT pays off \$10 million of the existing debt and replaces \$5 million, the amount of the negative capital accounts, with lower cost 7.5% debt. Concurrently, 250,000 OP units (assuming a share price of \$20) are issued to the existing partners for their \$5 million in equity. The REIT's total cash investment including underwriting, closing costs and some rehab comes to \$10.1 million.

The property has a \$1.6 million NOI, and, after paying the existing debt service, the partners had anticipated a distribution of \$107,000 in the current year. Despite the fact that the REIT will relieve them of any further capital or management responsibilities, they were unwilling to receive less than they had expected. So at distribution time, the NOI is reduced by interest on the new debt and the partners' \$107,000, leaving the REIT with \$1.1 million, a cash on cash return of 11%.

But what of the value of the OP units? If the OP units are viewed as "cash", the REIT's return declines to 7.4%. Arguably, however, the OP units are not the equivalent of cash unless we intend to acquire shares in the open market when OP unit holders wish to convert them. Otherwise, they would be registered, but unissued, stock which would have some marginal registration cost.

Finally, there is the issue of dilution of the existing shareholders. Clearly we would want to avoid such a potential. In the example, 250,000 shares would be added to the REIT's approximate 32.6 million existing shares outstanding upon conversion, bringing the total to 32.85 million shares. The property's contribution to FFO following conversion would be \$468,000 after deductions from its NOI of interest expense and an assumed cost of the REIT's cash investment. The result is accretive, raising FFO from \$1.62 per share to \$1.622 per share.

Exhibit II
SAMPLE DOWNREIT ANALYSIS

Assumptions:

(\$ in 000s)

Price	\$20,000	
Debt	\$15,000	30 yr. Amort.Mtg.
Seller's Equity	\$5,000	
Interest Rate on Existing Debt	9.25%	
Neg Capital Acct	\$5,000	
NOI	\$1,600	
CAP Rate	8.00%	
Interest Rate on BRE's Debt	7.50%	
REIT's Stock Price at Closing	\$20.00	

Cash Required:

Pay Down Existing Debt	\$10,000
Underwriting & Closing Costs	\$50
Improvements	<u>\$50</u>
Total	\$10,100

Operating Units:

Seller's Equity	\$5,000	
Divided by Stock Price	\$20.0	
Number of OP Units in 000s	250	
Dividend Upon Conversion	\$330	(\$1.32/share)

Distribution Before DownREIT

NOI	\$1,600
Debt Service	<u>\$(1,493)</u>
Net to Partners	107

Dilution Test:

Pre-DownREIT Shares Outstanding	32,600
Pre-DownREIT FFO	\$52,812
Pre-DownREIT FFO/Share	\$1.62

Distribution After DownREIT:

NOI	\$1,600	NOI	\$1,600
Debt Service	\$(375)	Debt Service	\$(375)
NOI	\$1,600	Cost of REIT's \$10.1 Million	<u>\$(758)</u>
Debt Service	\$(375)	Contribution to FFO	\$468
Distribution to Partners	<u>\$(107)</u>	Pre-DownREIT FFO	\$52,812
Net to BRE	\$1,118	Post-DownREIT FFO	<u>\$53,280</u>

First Yr. Return on Cash Investment	11.1%	Post-DownREIT Shares Outstanding	32,850
First Yr. Return on Cash and OP units	7.4%	Post-DownREIT FFO/Share	\$1.622