

REIT Economies of Scale: Fact or Fiction?

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Abstract

Growth and consolidation in the real estate industry is generally viewed as a foregone conclusion. However, no systematic study of the benefits of this consolidation exists. Focusing on the multifamily industry, we examine growth in REIT income to determine whether it is due to portfolio acquisitions, better management (control of expenses), active branding strategies, or geographical concentration. The results of this study provide insights into REIT performance and whether consolidation in the industry can be sustained.

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Executive Summary

With the growth in the number and market capitalization of real estate investment trusts (REITs) during the 1990s, many believe that the real estate industry is now in a period of significant consolidation as REITs look for ways to continued growing. One of the industry leaders, Sam Zell, actively promotes the idea that larger REITs have higher earnings growth potential by virtue of their ability to generate economies of scale in rent growth or expense control, or both.

Several factors appear to justify this belief in the efficiency of large REITs. First, economies of scale may result from large REITs ability to control expenses and utilize higher quality/professional management. An essential component to this argument is that larger REITs, with higher quality management, will be better positioned to acquire properties and position them for rent growth. Second, large REITs operating in many markets may be able to achieve higher earning through the creation of brand identities. Third, large REITs may be in a position to capitalize on informational advantages in pricing by geographically diversifying their portfolios.

We test the hypotheses that REIT growth is a function of these factors using a sample of multifamily REITs. We compare each REIT's net operating income (NOI) growth rate to its growth rate in gross number of units and to the NOI growth rate for its 'shadow' portfolio controlling for management ability with respect to market choice. The shadow portfolio mimics the REIT's exposure to each market and captures the change in the 'market' NOI. We calculate the 'market' NOI by subtracting the 'market's' average rent reported by REIS from the it's average operating expense reported by the Institute of Real Estate Managers (IREM). The 'shadow' portfolio method also allows us to segregate growth in NOI into its component parts reflecting 'same store' properties and net new acquisitions. Comparing the REIT NOI growth rate to its shadow portfolio NOI growth rate provides an estimate of management's ability to increase cash flow through efficiency gains, by either increasing rents or controlling expenses, relative to the general change in the market.

Our results indicate that between 1994 and 1997, average actual REIT NOI growth rates declined while growth in 'same store' NOI increased. The implication is that growth through portfolio acquisition, operating cost reduction, and revenue-generating gains has slowed. Analysis of the differences in REIT and shadow portfolio growth rates indicates that REIT gains relative to the market occurred from increasing rental income faster than the market rather than from greater expense controls.

Using regression analysis, we formally test the impact of REIT size and economies of scale, REIT branding strategy and economies of scale, geographic concentration and economies of scale, and finally, changes in REIT NOI growth rates over time. Contrary to the popular large REIT size hypothesis, we do not find evidence that large REITs have higher NOI growth rates. We also find that the ability to generate economies of scale in NOI growth via acquisitions existed early in the consolidation phase, but this ability has declined. With respect to branding ability, we do not find that REITs with an active branding program

having higher NOI growth rates. Finally, the results do not support the existence of economies of scale with respect to geographic concentration.