

## Preface of the Editors

The dissertation of Dr. Nicolai Striewe covers three issues related to the governance of real estate investment trusts (REITs). Each of these issues is dealt with in a separate essay. The essays are empirical in nature and draw on U.S. data. However, the conclusions are relevant not only for the governance of U.S. REITs but for REITs in general, given that REITs in other countries are closely modeled after those in the U.S. Focusing his research on the U.S. is, therefore, a sensible strategy for Dr. Striewe because there is a lot to learn from the American experience, in terms of both positive and negative aspects of REIT governance. Choosing to base the analysis on U.S. data makes all the more sense given that the U.S. REIT market is so far the only well developed REIT market in the world and the only one that has reliable data over many years.

From a policy perspective, the work of Dr. Striewe is highly relevant given the problems of governance we have seen in the wake of the mortgage crisis and, later, the financial and economic crisis. The issue of how to contain or rein in CEOs and other corporate officers for the longer benefit of investors and other stakeholders of public companies is of very significant importance. Arguably, the recent economic crisis is intimately tied to the breakdown of effective corporate governance structures. Yet change has been slow to emerge, if at all. Providing aspiring MBAs with a course in ethics or in social responsibility is unlikely to resolve the issue of governance. What is needed are effective mechanisms to contain CEOs and their fellow managers. In his dissertation Dr. Striewe is looking

at two such mechanisms in the context of REITS: external versus internal management and institutional ownership.

The few studies that cover these topics have potentially serious methodological shortcomings or rely on data that make causal analysis difficult if not impossible. The three essays contained in Dr. Striewe's dissertation advance the literature in both respects. The data are richer, in that panel data are used, and more thoroughly motivated than in the previous work. Hence, they hold the promise for more representative results. The three essays also stand out relative to the published research in that fixed-effects panel data estimators are used. In contrast to the common cross-sectional approach, the results of the papers are more reliable because they can be more easily interpreted as causal and independent of unobserved confounding factors.

The first two chapters provide a very readable overview of the dissertation and the topic of corporate governance, as it related to economic theory on the one hand and the institutional environment of REITs on the other.

The first essay, which makes up chapter 3 of the dissertation, was published in the *Journal of Real Estate Research*. This journal is one of the top three academic journals in the world devoted to research in the field of real estate.

The paper looks into the external advisor structure of REITs and its impact on the capital structure of REITs. For the early REIT era, when REITs received little attention or scrutiny from stock market participants, previous research associated externally advised REITs with an excessive leverage, which translates into a higher bankruptcy risk. Dr. Striewe does a good job explaining the rational

for the high leverage values; in particular how they may follow from the compensation structure of externally advised REITs. In the new REIT era, which is typically thought to have begun around the middle of the 1990s, REITs have moved from being an exotic corporate structure on the sidelines of the stock market to becoming main stream. The question that appears to have not been asked is whether externally advised REITs continue to behave the way they did in the early REIT era, that is, excessively driving up their leverage ratios.

The study makes use of time fixed-effects to account for macroeconomic changes and other effects that are common to all REITs. In addition, fixed-effects are utilized for the different property types that REITs specialize in.

The main result of the paper is opposite to the conventional wisdom, which still relies on studies and results focused on the early REIT era. In particular, the study finds that externally advised REITs choose a lower leverage compared to their internally advised counterparts. This conclusion is fully consistent with the fact that externally advised REITs bear higher costs of debt. It suggests that there is no agency conflict any more for externally advised REITs along the lines suggested in the literature for the early REIT era.

The second essay, chapter 4, was published in the *Journal of Real Estate Portfolio Management*, another highly ranked real estate research journal. The essay analyses the impact that institutional investors have had on the performance on REITs. Institutional investors tend to be more informed about the companies they invest in than individual investors. They also tend to have significantly more influence on corporate policy. Both facts can make institutional investors into a useful countervailing power relative to corporate managers who

are overly interested in serving their own interests.

Similar to the first paper, the study makes use of a panel data set for U.S. REITs. Firm fixed-effects are employed to account for unobserved heterogeneity. The focus is on measuring the impact of both the level and the change in institutional ownership on market performance, as measured by Tobin's  $Q$ , and on accounting performance, as measured by returns on assets. One of the key innovations over the existing literature is the focus on the interactions between the change in institutional ownership and several measures of corporate governance. This appears to be a sensible step forward in the research effort to pin down the performance impact of more institutional monitoring and control.

Particularly noteworthy in the paper is the careful discussion of the estimation results in section 4.4. Numerous robustness checks are presented and alternative explanations of the results are evaluated in a way that lets the reader come away with the impression that the analysis has been conducted in a very thoughtful way.

The third paper, which is single-authored, is an outgrowth of the second paper. If institutional investors can improve the bottom line of REITs, then it may be in the interest of REITs to attract them. Dr. Striewe asks two important practical questions in this context. First, what role do macroeconomic conditions play for institutional investors when they consider investing in REITs? Second, what types of REIT characteristics are favored by institutional investors? An answer to these questions is of immediate policy relevance for REITs.

Although a number of studies have tried to isolate the driving forces behind

the interest of institutional investors in REITs, they suffer from two important problems. First and foremost, they rely on cross-sectional data, which makes it difficult to identify causal effects. Second, macroeconomic factors are not explicitly considered. This is one reason why existing studies are troubled by mixed results, in particular, period-specific factors, that is, the macroeconomic environment, play a significant role.

Of particular note in the paper is its careful attention to detail in the construction of the panel data set. This is very evident, for example, in the way the Livingstone Survey data are incorporated and in how the microeconomic variables are defined. As in papers one and two, excellent use is made of the fixed-effects estimator to check that the chosen macroeconomic factors truly capture the data generating process of institutional ownership of REITs. In terms of methodology, the variance decomposition presented in Table 18 is helpful in sorting out the relative importance of the driving forces behind institutional investment.

We consider all three essays to be excellent studies relative to the published empirical research on governance issues, be they focused on REITs or corporations in general. The essays are well motivated, very timely and of immediate policy relevance. They are based on very detailed data work, display excellent methodological choices, and are very well researched in terms of the existing academic literature. The doctoral thesis more than fulfills the requirements and reflects the state-of-the-art of empirical research on REIT governance issues. It deservedly received a *summa cum laude* evaluation in March 2012.

Wiesbaden, July 30, 2013

A handwritten signature in blue ink, appearing to read 'N. Rottke'.

Prof. Dr. Nico B. Rottke FRICS CRE

Executive Vice-President, EBS Universität für Wirtschaft und Recht

Head of Institute, Real Estate Management Institute, EBS Business School

Aareal Endowed Chair of Real Estate Investment & Finance

&

A handwritten signature in blue ink, appearing to read 'Matthias Thomas'.

Prof. Dr. Matthias Thomas MRICS

Endowed Chair of Real Estate Management, EBS Business School

## Preface of the Author

This dissertation was motivated by the events surrounding the recent global financial crisis that started in 2008 following the subprime mortgage crisis. The financial crisis led to massive government intervention to rescue the economy and compensate for excessive risk-taking by managers.

Why did many executives engage in risky strategies from a behavioral point of view? The reason is that many managers tended to maximize their own benefit rather than shareholder value. This was made possible by the fact that both parties tend to have different incentives.

Incentive structures have changed a great deal in recent decades due to market deregulation and financial innovation. This change, in part, created distorted incentives, which in turn provoked opportunistic managerial behavior. One of the key changes relates to compensation: it has become increasingly performance-linked. The focus has shifted to short-term success at the expense of sustainable performance. Empirical examples of the results are corporate scandals, deceptive accounting and fraudulent managerial actions. And yet, even in the face of failure, CEOs have received golden parachutes and generous bonus payments. Therefore public attention is now focused on the compensation levels of top executives - and this scrutiny appears to be at an all-time high. It is apparent to us that corporate governance has failed in this context.

Corporate governance finds its most cited definition in the article “A Survey of

Corporate Governance” by Shleifer and Vishny, which appeared in the *Journal of Finance* in 1997. Since that article appeared, the topic has expanded greatly and become truly interdisciplinary. Researchers not only from the fields of economics and finance but also from the disciplines of law, management, and accounting now cover the topic. Corporate governance appeared as a keyword in more than a thousand SSRN abstracts in 2011.

Research on corporate governance builds on one major theory: the principle-agent theory. This theory substantiates the need for corporate governance. It describes how managers may consume perks, make selfish risk choices and focus on short-term profits at the expense of long-term gains. Such agency costs can materialize from the conflicts of interests between the principal, namely the shareholder, and the agent, namely the manager.

Hence, my dissertation is about a problem that we all know. But the solution is not clear at all. What is certain is that corporate governance mechanisms are an important piece of the puzzle.

I have always been interested in questions about why people behave as they do, be it in business, in politics or in private life. Rather than viewing an enterprise as a sum of its assets, I prefer to focus on the people within the firm. The reason is that the behavior of firms is a function of the decision-making of individuals who follow their individual incentives. Firms are only maximizing shareholder wealth if the utility functions of the people within the firm are consistent with the shareholder’s wealth maximization objective. The separation of ownership and control in most firms induces agency issues, which stem from conflicts of interest and incentive problems. Resulting opportunistic behavior can

become so serious that it adversely impacts corporate performance.

This dissertation brings forward new evidence on the impact of conflicts of interests in the real estate market and focuses on an important, but less visible corporate governance mechanism, namely institutional monitoring. Institutional monitoring moderates the actions of managers and encourages value-maximizing decisions for the benefit of the shareholder. Institutional investors utilize a wide set of instruments to monitor managerial actions, including direct influence through personal correspondence with the management, leading proxy fights to achieve larger goals or threatening to vote with their feet if they feel dissatisfied with the management.

Corporate governance is essential to all parts of the economy. But why is it so important for the real estate market, in particular the market for REITs? The REIT exhibits characteristics that can become problematic with respect to corporate governance. Here are a few: First, only a few REITs are assessed by rating agencies and covered by analysts. This cancels out two important monitoring institutions. Second, the function of the market for corporate control is weak for REITs, because ownership restrictions in the REIT market act as a take-over defense. Third, leverage policies of REITs in the US are not legally capped at a set threshold level. This leaves the REIT manager with considerable freedom.

The effective study of principal-agent conflicts and institutional monitoring requires a mature REIT market to draw general conclusions that apply for REIT markets all over the world. Only the US market provides an unmatched data quality with a long time series and a large cross-section for REITs. It is the

largest and most efficient securitized real estate market worldwide. This is crucial for applying robust panel data models to obtain reliable causal inferences. The National Association of Real Estate Investment Trusts estimates that the Equity REIT market represents about \$ 544 billion of the North American commercial property market (about \$ 7 trillion) as of 2012. REITs are liquid and investors have no minimum investment requirement. The REIT structure benefits from special tax considerations and is legally required to pay out income. These characteristics make the REIT an ideal subject for a corporate governance study.

The paper of chapter three, “Corporate Governance and the Leverage of REITs: The Impact of the Advisor Structure” was published in the *Journal of Real Estate Research*, Vol. 35, No. 1, 2013. Earlier versions of the paper were presented at the 16th conference of the European Real Estate Society (ERES) in Stockholm, Sweden, in 2009 and at the 26th conference of the American Real Estate Society (ARES) in Naples, Florida, USA, in 2010. A later version of the paper in chapter four was published under the title “The Impact of Institutional Ownership on REIT Performance” in the *Journal of Real Estate Portfolio Management*, Vol. 19, No. 1, 2013. The paper of chapter five, “What Drives Institutions to Invest in REITs?”, was presented at the 28th conference of the ARES in St. Petersburg, Florida, USA. I am grateful for the helpful comments I received from the conference participants and the journals’ reviewers.

In the following I would like to express thanks to important contributors. Sincere thanks to my academic supervisors Professor Dr. Nico B. Rottke FRICS CRE from EBS University, Wiesbaden, and Professor Dr. Joachim Zietz from Middle Tennessee State University, USA, for their unwavering support. They

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My greatest gratitude is reserved for my parents: for believing in me and providing me the freedom and unconditional support to choose my direction in life and pursue my academic preferences, which culminated in my doctoral studies at EBS University.

Wiesbaden, July 30, 2013

A handwritten signature in black ink, reading "Nicolai Striewe". The script is fluid and cursive, with the first name "Nicolai" and last name "Striewe" clearly distinguishable.

Nicolai C. Striewe

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