Market Signals Associated with REIT IPOs

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Abstract

Previous studies have found significant but time-varying valuation effects associated with real estate investment trusts initial public offerings (REIT IPOs). Because REIT IPOs may disclose relevant information about real estate market conditions, they may serve to revalue existing real estate securities. To determine whether REIT IPOs signal information that is impounded into the share prices of other real estate securities, we assess the returns on “rival” portfolios of existing real estate securities upon the issuance of the IPO. On average, the “rival” portfolios experience insignificant effects on the REIT IPO filing date, but negative and significant abnormal returns around the issue date. A cross-sectional analysis of combined effects at the time of the filing date and issue date shows that the negative effects on the “rival” portfolios are more pronounced when (1) the size of the REIT IPO is larger, (2) market conditions are relatively weak, (3) more REIT IPOs come to market, and (4) the IPO is not associated with an umbrella partnership REIT.

Key Words: REIT IPOs, REIT pricing and performance

1. Introduction

Initial public offerings (IPOs) have been widely studied in the academic literature. In general, research has shown that IPOs are underpriced and lead to excess short-run returns. Specifically, for real estate investment trusts (REITs), IPOs are shown to be overpriced in the 1980s (Wang et al., 1992), but underpriced in the 1990s (Ling and Ryngaert, 1997).

The observed variability of returns to IPOs has led to further research seeking an understanding as to whether or not IPOs send signals to investors regarding the quality of the firm involved in the IPO. In this paper, we consider that the short-term performance of a REIT IPO can signal investors as to the performance of other real estate securities. That is, the decision to take a REIT public may emit signals about performance of the real estate
sector and the future price behavior of existing real estate securities. To do this, we consider two scenarios. First, we assume that REITs by definition represent a single economic sector, real estate securities; that is, a REIT competes with and may provide information relevant to other REITs. Next, we recognize that the REIT universe represents a diversity of industrial sectors. Using Standard Industry Classification (SIC)-codes, we tie individual REITs to their specific SIC-matched market niche. For example, we recognize home-builder REITs to be in the home-building industry (SIC 1521) not the REIT ‘industry’ (SIC 6798).

Previous research on IPO signaling effects has focused primarily on the signal an IPO sends with regard to the issuing company. We assess the signal that a REIT IPO sends about other real estate securities that are trading at the time of the IPO issuance. Using an event study methodology, we examine the price effects of a rival portfolio of existing real estate securities around the time of the issue of a REIT IPO. In the aggregate, the results show that REIT IPOs do not signal information on the IPO filing date about the values of existing REITs in aggregate or for REITs trading in specific SIC-identified sectors. However, on the IPO issue date, there is evidence that REIT IPOs signal negative information about the values of other REITs and other real estate securities.

To explain the distribution of IPO effects on rival real estate portfolios, a cross-sectional analysis of the observed rival portfolio returns identifies factors that seemingly influence the returns of the rival real estate portfolio around the time of the IPO. Specifically, the SIC-matched rival portfolios experience a more pronounced negative effect in response to a REIT IPO when the IPO is relatively large, when market conditions prior to the IPO are relatively weak, when a relatively large number of other REITs recently have gone public, and when the REIT involved in the IPO is not structured as an umbrella partnership REIT (UPREIT).

The results imply that REIT IPOs convey information to the market about existing publicly-traded real estate securities, not necessarily REITs. Specifically, the results show that information is conveyed about various real estate sectors, such as homebuilding, commercial developers and hotels, and not REITs in general. This outcome suggests that investors do not assume that all REITs are similar, but consider the specific activity in which the REIT is involved. This result also supports the contention that some REIT indices may not be overly insightful, except in the case of sector investors, because they do not convey information about specific real estate activities. Finally, the results illustrate the usefulness of REIT information in valuing other non-REIT, but related, securities.

2. Related research

There is substantial research on IPOs. Generally, research has shown IPOs to be significantly underpriced with the underpricing attributable to uncertainty surrounding the valuation of the IPO (see Beatty and Ritter, 1986; Ibbotson et al., 1988). The price effects of REIT IPOs have also been studied. Wang et al. (1992) establish that initial returns for REIT IPOs are negative, implying that REITs were overpriced at the time of the IPO. Subsequent research (Below et al., 1995) contends that the overpricing may be a result of