The DI Wire
Direct Investment Industry News

Guest Contributor: Mini-Tender Offers - The Good, the Bad and the Ugly

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February 10, 2017

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In the world of non-traded REITs, mini-tender offers get a bad rap, but are they all bad? It depends upon whom you ask.

An issuer or its sponsor will likely answer "yes." The mini-tender offer disrupts the company's operations. It comes at an inconvenient hour of the bidder's choosing. The issuer must deal with it—retain counsel—draft a response letter—convene a board meeting—file documents with the SEC—conduct a mailing to all stockholders—each at a significant cost of time and money.

All the benefits, it would seem, accrue to the bidder. If you ask the bidder, he might answer that mini-tender offers are not bad at all. The bidder, buying shares at a steep discount to NAV, potentially benefits from a great deal. Even sweeter for the bidder, the issuer bears a large proportion, and possibly the majority, of the transaction costs. These include not just management's time and opportunity cost, but direct expenses such as printing and mailing expenses and legal fees, all of which in the aggregate can reach into the six figures. And all that for a mini-tender offer whose magnitude in dollars might only extend into the low six figures! Accordingly, in an indirect way, a successful mini-tender offer represents a wealth transfer from the issuer to the bidder.

This is to say nothing of the costs to the tendering stockholders, who risk not receiving full value for their shares. Some of the conditions that will entice stockholders into surrendering their shares in a mini-tender offer include: (1) an acute need for liquidity, (2) displeasure with management and an intention to "vote with their feet" and (3) not understanding the offer. Even a frequent bidder might describe taking advantage of these conditions as "opportunistic." But doing so can be perfectly legal, provided that the deal is properly executed.

What Is a Mini-Tender Offer?

A mini-tender offer is a tender offer for up to five percent of a company's stock, usually at a discount, rather than a premium, to the stock's market value or NAV per share. Most of the protections afforded by the federal tender offer rules only apply to tender offers for more than five percent of a company's shares. The tender offer rules generally don't apply to mini-tender offers beyond a few provisions doing things like prohibiting fraud, requiring that tender offers remain open for minimum time periods and requiring the prompt payment to investors of the purchase price after the offer closes or the prompt return of securities following a withdrawal of the offer. Some of the significant rules that govern tender offers for more than five percent of the company's shares, but that do not apply to mini-tender offers, include those (1) mandating fulsome disclosures and the filing of offering documents with the SEC and (2) giving investors the rights to (a) equal treatment under the tender offer, (b) have their shares purchased on a pro rata basis in the event of oversubscription and (c) withdraw their tenders within a certain time period if they later regret their decision.

A Lawful Market Practice

First, in case it is not obvious, I am not defending deceptive, manipulative or illegal mini-tender offers. Some tender offerors' methods are high-pressure, their backgrounds questionable and their offering materials rife with hyperbole and half-truths. Issuers should pay no deference to such actors.

All that said, what if observers make a mistake in only looking at the demerits of mini-tender offers? What if mini-tender offers are painted with too broad a brush? For one thing, many of the substantive and procedural laws that apply to tender offers generally do not apply to mini-tender offers, so the rules-compliant bidder has done nothing wrong, at least legally. What is more, a bidder may even have a fiduciary duty to at least consider launching a mini-tender offer. After all, the bidder may not be an individual buying for his own account, but a private equity fund or business development company (sometimes even a reputable one) whose sponsor has a fiduciary duty to preserve and grow its investors' capital.

The bidder owes no fiduciary duty to the target issuer and its stockholders. Given this legal disposition, and the returns potentially achievable for the bidder's investors, one could plausibly argue that a real estate fund manager would violate its fiduciary duties by not including a mini-tender offer strategy in its share-accumulation arsenal. If the legal and regulatory regime creates arguably perverse incentives, encouraging wealth-transferring behaviors, it seems hardly fair to blame an economic actor, acting lawfully, for responding to these incentives.

Rotating the Stockholder Base

Moreover, consider some possible collateral benefits to the issuer. Remember I said that sometimes stockholders will surrender their shares in a mini-tender offer out of displeasure with management. Under this scenario, the bidder will mop up shares held by unhappy investors. In effect, a willing investor steps in, taking the place of a disgruntled stockholder. This fortuitous result saves issuers from some of the pressure to expend valuable cash taking out unhappy investors by conducting share repurchases. A disgruntled investor—imagine someone who bought shares a decade ago, right before the real estate market crash, and has since fallen out with her broker—can effectively agitate against management, convince the business press to write negative articles and otherwise make life difficult for the C-suite. If you ask any management team to name the optimal number of angry investors, the answer should be “zero.”

Recall also that stockholders might tender due to an acute need for liquidity. One could argue that it is better for all involved that they do tender. Non-traded REITs are designed for investors with no immediate need for liquidity. If an investor needs liquidity so badly that a bid significantly below NAV per share seems attractive, then perhaps the relationship has passed its prime, and best that the investor and the REIT go their separate ways. The investor who steps in, by contrast, should have no immediate need for liquidity—although of course the investor will look for an exit at some point, which explains why mini-tender activity tends to focus on REITs that have already announced a liquidity plan. (Also, if an investor tenders his shares as a result of misunderstanding the offering materials, that is not a good result. Any claim of serendipitous benefits assumes that the mini-tender offer was honorably executed and not misleading.)

Possibly the foregoing considerations prove too much—constituting an argument that management should follow through on promises to deliver a liquidity event, or at least should conduct share repurchases or make special distributions as cash becomes available—all things that management should do to the extent feasible. But people who have already made up their minds about mini-tender offers might pause to think about the possible collateral benefits of a third-party bid, and management can do worse than to think of a mini-tender offer as a way (though admittedly inefficient) to rotate the stockholder base.

An Element of Flattery

There is a strange element of flattery as well: when investors weigh the merits of launching a mini-tender offer, generally they target one whose management has assembled a portfolio that the investor finds desirable.

At the very least, the potential bidder does not oppose the general thrust of the issuer's business strategy. So in a way, the stockholders' receipt of a bid, however low, represents a feather in the cap of management—a sign of buy-side pressure. Said another way, I have never heard of a mini-tender player accumulating a position in an issuer that it considers a "sinking ship." Management may find the bid price objectionable, but perhaps counterintuitively, in some cases can view the bidder as a fan and potential ally.

The Future of Mini-Tender Offers

Despite the possible collateral benefits outlined above, on balance, mini-tender offers can erode stockholder wealth. As discussed, by diverting management's attention and causing issuers to incur printing, mailing and legal costs, mini-tender offers harm the non-tendering stockholders pro rata; and the sellers usually sell below the secondary market-clearing price, however thin the secondary market. And it goes without saying that bidders who violate the securities laws deserve every bit of SEC sanction and private lawsuit that they bring on themselves.

Personally, I believe that Congress and the SEC should improve the legal and regulatory regime pertaining to mini-tender offers. This means promoting efficient means for bullish investors to accumulate a position while reducing the costs to issuers and tendering stockholders. The SEC strives to fulfill the dual mandates of investor protection and capital formation. The current legal regime falls short on both fronts by allowing third parties to accumulate a position while outsourcing a substantial portion of the transactional costs to the target instead of bearing all such costs themselves. However, as long as these incentives endure, investors in real estate securities remain entitled to maximize their profits within the bounds of the law, and issuers should expect the mini-tender strategy to persist.

In the meantime, issuers can take certain defensive measures to ward off prospective bidders. Bidders in the meantime can make sure their bids fully comply with the securities laws and the targets' constituent documents, and try as much as possible to make bids that represent win/wins for all stakeholders.

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