

Chapter 2

The Global Real Estate Investment Trust Market: Development and Growth

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2.1 Introduction

Up until the mid-1990s Real Estate Investment Trusts (REITs) were largely confined to the United States and in Australia, where they were known until recently as Listed Property Trusts. Although in both markets a REIT type structure had been in existence for decades, they were, within the perspective of their broader equity markets, relatively small sectors. The last two decades has however seen large scale growth in REITs, not only in the pioneering markets of the USA and Australia but globally through the introduction of REIT regimes in the majority of large capital markets.

Whilst the detailed exact structure of REIT vehicles does differ globally, as will be illustrated in this book, there are broad similarities in the rationale behind the introduction of REITs. REITs are broadly tax transparent closed-end funds. The key difference between REITs and conventional corporate structures is that dividends paid to share holders are exempt from corporation tax, thus providing tax transparency. In contrast conventional property companies pay dividends out of after-tax income like any other corporation. This can in many jurisdictions lead to tax slippage and a perceived relative disadvantage for a tax-exempt institutions of holding real estate indirectly through a property company in comparison to holding private real estate directly. This argument is however dependent on the institution managing their portfolio in such a way that this comparison is assessed. If the indirect real estate holdings are managed as part of their broader equity portfolio then the arguments relevance does reduce substantially. The second tax component is concerned with Contingent Capital Gains Tax. The assets underlying a property company are subject to the relevant Capital Gains Tax in place in that jurisdiction. This means that a conventional corporate vehicle cannot totally realise their

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portfolio in cash terms. These contingent tax liabilities will lead to a property company shares having a built in discount to their Net Asset Value per share. Furthermore, changes in the assessment of capital gains can lead to large changes in the Contingent CGT liability. For example, in the 1988 UK budget the base date for Capital Gains Tax was moved from 1962 to 1982. This effectively made up to 20 years of capital gains tax exempt. It is estimated that the average Contingent CGT liability across the UK property company fell from 17 % of NAV pre-budget to 11.9 % post-budget. The fact that capital gains are also tax transparent in the REIT sector means that REITs will have a tendency to trade at prices closer to their NAV than property companies. It does not however mean that there will not be periods of time when REITs are trading at discounts or premiums relative to the underlying NAV.

While this tax transparency does provide advantages to investors it arguably is the regulations that REITs have to comply with to obtain tax transparency that endows them with their key investment characteristics. The key regulations in place in the US market, from which most global regulations have followed, are that 75 % of the trusts assets and income must be derived from real estate and that a minimum of 90 % of the taxable income must be paid out as dividends. This dividend requirement in particular is commonly felt to be the key distinguishing feature of REITs in comparison to property companies. It provides investors with relatively high dividend yields and in addition, given the nature of the underlying assets and their income flows, the dividends tend to be relatively stable. This means that the dividend payments from REITs are similar in many respects to coupon payments in the bond sector. This can lead to REITs having bond like characteristics in their investment dynamics.

2.2 Growth in the Global REIT Market

While REITs were introduced in the United States in 1960 the next 30 years saw very few other countries adopt the structure. Some markets introduced a REIT type vehicle in the 1990s, such as Belgium (1995), Brazil (1993), Canada (1994) and Spain (1994). However the major period of growth took place post 2000. The major Asian markets such as Japan (2000), Hong Kong (2003) and Singapore (2002) all introduced REITs just after the turn of the millennium, whilst France was the first major European market to launch a REIT vehicle in 2003. Markets such as the UK and Germany launched later in 2007.

The Asian markets and in particular Hong Kong, is a market of particular relevance in any examination of REITs as it highlights a number of issues. Given the size of the Hong Kong private real estate market, its macro-economic importance and the fact that there was in existence a large traded property company sector in existence it is perhaps initially surprising that the REIT market has not developed to the same extent as in other markets. At present the Hong Kong REIT sector has a market capitalisation of around US\$15bn, which remains a small proportion of the

overall listed real estate sector in Hong Kong. The fact that corporate vehicles continue to dominate in Hong Kong highlights a key element in REITs. The original US structure, and those that followed, are designed for investors holding standing investments in real estate. They are not specifically designed as a vehicle for development activity. Furthermore, given the restrictions in place in most countries regarding the distribution of dividends it creates challenges for REITs in retaining earnings for re-investment. The major Hong Kong property companies undertake a large amount of development activity and therefore the REIT vehicle is perhaps not perfectly suited to them. It also in part explains why there still exist Real Estate Operating Companies (REOCs) in the US market and why only nine property companies in the UK converted in January 2007 to REIT status. One interesting exception in this regard is the regime established in Turkey where dividend regulations are far less restrictive and therefore help to facilitate development focused firms from utilising the vehicle structure.

The development of REIT regimes contributed to an extraordinary growth in the size of the global listed real estate sector from the mid-1990s onwards. This was particularly in the post-2000 period, marked by a combination of both the launch of REIT vehicles in the major Asian and European markets but also the strong performance in the US and Australian markets. By year end 2006 the global real estate security market had a total market capitalisation of over US\$850bn. Whilst this was naturally adversely impacted due to the 2007–2008 financial crisis it subsequently rebounded to close to US\$1tr as of the end of 2012 (Fig. 2.1).

Table 2.1 compares some of the regulations in place in a number of different markets. What is perhaps not fully appreciated is that while the broad thrust of the regulations in place is similar; there are subtle but important differences in place. While some of these are of limited importance some are highly important, particularly as the growth in REITs has also been accompanied by an increase in the number of dedicated real estate security funds being launched. The dividend restrictions have a number of consequences, the most obvious one being that it implicitly reduces leverage. This is due to the fact that unlike conventional companies REITs do not have a tax advantage to issuing debt as not only debt repayments but also dividends are exempt from corporation tax. For companies, while dividends are paid out of after tax income, debt repayments are above the line. This means that while some countries, such as the UK, have imposed explicit gearing limits, implicit constraints are structurally in place.

The second issue relating to the dividend restriction refers to what figure the minimum dividend payout refers to. In particular, whether depreciation is accounted for or not. This is related to the broader issue of the accounting regulations in place. Most countries now operate under IFRS (International Financial Reporting Standards). Under IFRS you have the choice as to how to account for investment properties and in the case of all major markets in which IFRS applies, the choice has been made that properties are placed onto the balance sheet at market value. In contrast, in markets such as US, which still operate under their own accounting regulatory structure (US GAAP), REITs place their properties onto the balance sheet at depreciated historic cost. This approach provides no indication

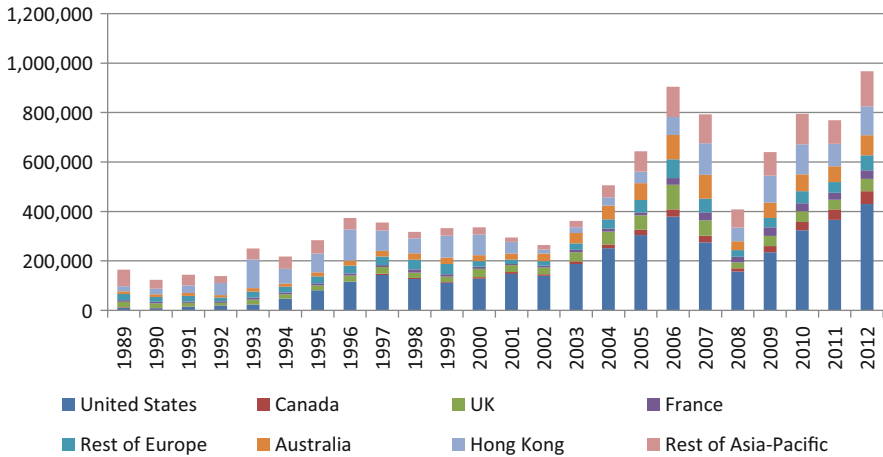


Fig. 2.1 Market capitalisation global listed real estate (US\$m)

of the actual current market value of the underlying portfolio. Whilst the use of market values does provide greater transparency it does have important consequences on the dividend payments. This is because in both systems the change in the asset value, either from a revaluation or depreciated, is accounted for in the income statement.

In the case of say the US this provides REITs with a fairly stable and predictable non-cash outgoing, depreciation, on the income statement. In contrast a firm in, for example, the UK, has a very uncertain non-cash adjustment due to the revaluation of the portfolio. Furthermore, this adjustment may be a deduction, in the case of a negative revaluation, or an addition, when the portfolio is re-valued upwards. If one considers the US dividend rule the implication of this can be clearly seen. US REITs have to distribute a minimum of 90 % of taxable income, a figure from which depreciation has already been deducted. The large and predictable non-cash items gives US REITs far greater flexibility than is initially implied and helps to explain why they regularly payout more than the minimum. Chan et al. (2003) show that between 1980 and 2000 the average REIT payout was 117 % of taxable income. This means that REITs still use dividends as signalling tools in relation to issues such as expectations concerning future corporate performance. Furthermore, as with any listed stock, REIT dividend policy reflects relative growth rates and reinvestment return. Higher growth REITs will tend to pay out lower dividends due to the higher reinvestment returns they are expected to achieve, and vice-versa for REITs operating in lower growth sectors. In contrast, the rules in a market such as the UK have to be more restrictive as REITs operating under IFRS do not have the same flexibility.

2.3 Are REITs Real Estate?

An ongoing debate is concerned with the extent to which REITs reflect the dynamics of the underlying private real estate market. Furthermore, there are ongoing discussions as to whether REITs track the private market closer than the conventional property company sector. While non-listed REITs are allowed in some markets, what we are largely referring to here is the investment characteristics of the listed sector. In this case the key difference between the private and listed real estate sectors is the basis of valuation. The private market together with non-listed private funds, are valued according to valuation estimates. Notwithstanding the recent introduction of transaction based indices, the use of valuations for performance measurement in private real estate is driven by the relative lack of transactions. In contrast, listed securities, such as REITS, are priced on an ongoing transaction based basis. These basis of pricing are fundamentally different and can lead to substantial differences in the pricing, return performance and risk of private and listed assets, even in cases where the same underlying assets are involved.

As is commonly known in the real estate investment literature, the use of valuations, whether in the context of benchmark indices or in the performance reporting of a fund, is subject to a number of problems. The most well known of these, is that smoothing can be introduced into the performance figures. However, in the context of comparative performance, issues with the fundamental valuation approach used in the private market are key. Private real estate valuations are based on discounted cash flows of future income. These rely however on comparable evidence concerning factors such as market rents and yields. This can lead to a backward looking element being introduced into the pricing/valuation process. This can be particularly noticeable during quiet periods in the either the rental or investment market, when recent comparable evidence may be lacking.

In contrast, listed REITs will be priced in a similar fashion to stocks generally, with market expectations playing a key role. The liquidity in the listed capital markets means that investors and traders will not wait until they have confirmation of relevant news. Rather they will trade based on expectations. For example, if a REIT is due shortly to release their financial statements a trader who believes that profits at the firm will rise will not wait until the firm releases the figures, rather they will increase their holdings in the firm prior to that date in the hope that figures are in line with their expectations and that the share price will respond positively on the release of that news. If however, sufficient numbers of other investors have similar expectations then their combined purchases will increase the stock price prior to the release of the financial statements. Therefore, if an investor had waited until confirmation of increased profits they would have missed out on at least some of the upward movement in the share price, thus reducing their return. Expectations concerning a broad range of factors will affect the share price of a listed REIT. These include not only company specific information regarding their financial statements but also changes in their underlying portfolio structure. Broad macro-economic information will also play a key role. Obviously this will include issues

having a direct bearing on the real estate market given the important link between the macro-economic performance and the drivers of occupational demand in the private market. Factors such as GDP growth will provide indications as to possible impacts on future market rental values. Given that expectations can change with far greater frequency and to a greater magnitude than fundamentals, listed vehicles can behave quite differently to the private market. These impacts can particularly be apparent in relation to the volatility of the returns. In context of the Efficient Markets Hypothesis it is important to remember the role of expectations. The semi-strong form of market efficiency is that all publicly available information will be incorporated into prices. This includes expectations and in particular the market consensus. The most important element in the release of news is not how the released data, whether it be company specific or macro-economic, differs from the last released figure, but how it differs from market expectations.

The macro-economic linkages also play a broader role as they affect sentiment across the broad equity markets. A factor that many within the real estate industry often under appreciate is that REITs, just like property companies will be affected by broad stock market sentiment and behaviour. During major market wide movements the likelihood is that listed real estate securities will be affected just as other equity sectors. A related factor, and one that can vary considerably across international markets, is the extent to which REITs are priced in relation to the broad equity markets. The chapter on the US market will discuss this issue in depth as changing investor behaviour has led to a quite dramatic change in the investment dynamics and characteristics of the US REIT sector. However, at this point two key factors will determine broad investment dynamics. The first relates to the investors trading REITs and other real estate securities. If the majority of these investors are effectively real estate investors it may be that the share prices do reflect and track closer the underlying private market fundamentals. If however, the majority of the trading is undertaken by equity fund managers and traders their basis of comparison will not be the underlying private market but with the broader equity markets. As will be discussed in the chapter on the US market, this perhaps explains why the US REIT sector substantially underperformed during the period 1998–2000. This is despite the largest stock market boom in US history, strong economic performance and strong underlying private real estate performance. The reason why REITs underperformed was that in comparison to growth sectors in the equity markets REITs did not provide attractive returns. Likewise, it also in part explains the rebound in REIT share prices in 2000 in the immediate aftermath of the technology crash.

These factors will vary considerably across global markets. The relative maturity of the sector in terms of broader investor awareness will be play a key role in determining the make up of the traders in the sector. Furthermore, the nature and structure of the vehicles will also come into play. In markets such as Singapore a number of REITs have been launched that are effectively single-asset vehicles rather than having a portfolio of underlying assets. The specific nature of the REITs assets will in all likelihood mean a closer relation with underlying performance than with portfolio based trusts.

These issues are of direct relevance when REITs are being introduced. An ongoing debate in the last few years in the UK has centred around to what extent the introduction of REITs will impact upon the investment dynamics of the listed real estate sector and to what degree the performance of converted property companies will alter. While the restrictions imposed on REITs will lead to changes, their pricing mechanism will however be the same. Large, relatively heavily traded listed real estate markets, such as the UK and US also tend to see greater homogeneity in performance within the real estate sector. Barkham and Ward (1999) find that in the UK property company sector firm specific factors explain only around 15 % of the cross-sectional variance of discounts to NAV. They argue that there exists a sector wide sentiment factor that is vital in understanding the discount. This sector wide factor is also influenced by factors that have direct relevance to all listed real estate, including REITs. Barkham and Ward propose that their results are due to noise traders over-estimating the changes in the value of the underlying asset. This leads to a short-term resale price risk being incorporated into the share prices.

Effectively the horizon of the investment decision is a lot shorter in the listed markets due to the liquidity in the market and that an investor can trade a REITs shares numerous times during a single day of trading. In contrast, the private real estate market has a slower heartbeat. Real estate prices will respond slower to new information, meaning that an investor can still profit from the formal release of new information. Furthermore, the heterogeneous nature of returns in the private market is in contrast to the more homogenous behaviour noted in the larger more heavily traded listed markets. While private real estate is priced as such, the key issue in understanding the pricing and therefore the return performance of the listed sector is that while the underlying asset base is real estate they are valued as traded stocks.

A commonly used argument in relation to the behaviour of the listed sector relative to the private real estate market is that during the long-run REITs do provide returns comparable to the underlying asset. A number of studies examining the US have for example found evidence that the private and listed markets are cointegrated, thereby implying a long-term common trend (e.g. Campeau 1994 and Glascock et al. 2000). However, it is important to note that while over an extended horizon REITs may provide similar returns to the private market you are giving up the liquidity benefit from owning a listed security. Furthermore, given the additional volatility in the capital markets, an investor is still vulnerable to short-run movements in the REIT sector unless they have the flexibility regarding the exact timing of the trade.

2.4 What Can REITs Offer?

While at times the investment opportunities in REITs may be oversold there remain a number of important opportunities from the growth of REITs internationally. In particular they have highlighted the possible advantages from a country having a viable tax transparent vehicle. At present the proportion of real estate that is held by

listed firms varies hugely. While the proportions held in markets such as Australia and Singapore may be unrealistic for other countries to attain, the possibilities for markets such as Germany and other continental European markets remain large. As has already been seen in markets such as France, REITs can provide attractive opportunities for governments and corporations in terms of managing their real estate assets.

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