Issue N° 13
January 2015

Equity Solutions

EQUITY IN A NUTSHELL

LEVEL

Real Estate Investment Trusts (REITs)

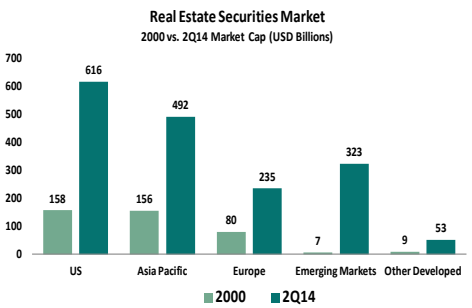
A real estate investment trust (REIT) is a company that owns and operates income-producing real estate or finances real estate properties. An individual investor can invest in REITs by either purchasing shares in a listed REIT or by investing in a mutual fund that specialises in REITs. A REIT allows individual investors to earn steady returns generated through real estate ownership without physically owning the asset. Real estate properties owned by a REIT may include office buildings, shopping malls, residential apartments, hotels, resorts, self-storage facilities and warehouses. Typically, a REIT specialises in a single type of real estate properties. To name a few, there are retail REITs, office REITs, residential REITs, healthcare REITs and industrial REITs.

History

REITs were introduced in the US in the 1960s to provide the average investor with an access to large-scale income-generating real estate. In the next 30 years very few other countries adopted the structure. Later in the 1990s, some markets introduced a REIT-type vehicle, such as Brazil in 1993, Canada in 1994, Spain in 1994 and Belgium in 1995. However, REITs mainly gained traction post 2000. Asian markets such as Japan (2000), Singapore (2002) and Hong Kong (2003) introduced REITs just after the turn of the millennium, while France was the first major European market to launch a REIT vehicle in 2003. Markets such as the UK and Germany launched it later in 2007.

Real Estate Securities Market

As of June 2014, the FTSE ERPA NAREIT Global REIT Index had a total market cap of ~USD 1.7 trn, spread across 456 companies. The US accounted for 35% of the market cap, Asia Pacific represented 28%, while Europe, emerging markets and other regions contributed relatively smaller portions of the market cap. Emerging markets saw the highest growth, now comprising 19% of the global market, up from 2% in 2000. More than three fourth of the companies in the global real estate universe are REITs or REIT-like structures, with the remaining consisting of real estate development companies and non-REIT operators.



Qualification

To qualify as a REIT, a company must have the bulk (at least 75%) of income derived from real estate investments and must distribute 90% of its taxable income to shareholders in the form of dividends. Some of the other key requirements to be classified as a REIT are to:

- Be managed by a board of directors or trustees
- Have shares that are fully transferable i.e. to have shares that can be offered for sale to the general public without any restrictions
- Have a minimum of 100 shareholders after its first year as a REIT
- Have no more than 50 percent of its shares held by five or fewer individuals during the last half of the taxable year
- Invest at least 75% of its total assets in real estate assets and cash

Categories of REITs

There are three categories of REITs - Equity REITs, Mortgage REITs and Hybrid REITs:

Equity REITs purchase and manage income-producing real estate. These REITs are engaged in operations like leasing, maintenance and development of real estate properties and other management services. Equity REITs acquire or develop properties to operate and manage as part of their own portfolio and do not sell them once developed.

- ***Mortgage REITs*** do not purchase or own properties directly but they provide money to real estate owners and operators through debt instruments or indirectly through the purchase of mortgage-backed securities. Mortgage REITs have properties as collaterals and manage their operations using securitised mortgage investments, hedging techniques and other acceptable derivative strategies.
- ***Hybrid REITs*** are companies that use the investment strategies of both equity REITs and mortgage REITs.

Benefits of Investing in REITs

REITs provide investors with competitive long-term returns that complement other asset classes (highlighted on page 2 under Return and Performance section). A REIT is required to pay at least 90% of its taxable income to shareholders annually in the form of dividends.

Investing in REITs enables investors to derive stable income along with capital value appreciation. Liquidity, professional management, regulatory disclosures and transparent capital

valuation are other major benefits of investing in REITs. Investing in REITs reduces the overall risk of a portfolio and also acts as a hedge against inflation.

The need for liquid, securitised and tax-transparent real estate investment vehicles has broadened the horizon for investors. Accessibility to REITs through the secondary capital market, dedicated mutual funds and exchange traded funds has made real estate investment attractive.

Risks of Investing in REITs

REITs that use borrowed capital to hike returns can fail when interest rates rise as their borrowing costs shoot up. Mortgage REITs are usually highly leveraged which makes them more risky. Equity REITs, on the other hand, tend to be less rate-sensitive but are positively correlated to equity markets and may get impacted in downturn period.

Real estate properties are exposed to market risk like insufficient liquidity along with in-frequent fair capital valuation methodology. Geo-political events, fall in credit markets and interest rate fluctuations are other key risks associated with investing in REITs.

Key Terms for Analysing REITs

• **Net Asset Value (NAV) –** is similar to book value and is also called per investment unit. NAV is the marked-to-market value of the company's property investments less liabilities.

• **Funds from Operations (FFO)** – measures a REIT's operating performance. It is net income plus gains (minus losses) from property sale and purchase. Non-cash expenses like depreciation and amortisation are added back because value of real estate tends to rise over time rather than depreciating like other fixed assets and investments. FFO per share is often used in place of earnings per share when analysing REITs.

• **Net Operating Income (NOI)** – measures the cash flow a property generates by subtracting property-level expenses (including real estate taxes) from the property's revenues. It is therefore similar to the corporate measure of EBITDA.

• **Cap Rate (capitalisation rate)** – is an expression of real estate value in terms of yield. A property's current cap rate is the NOI divided by the estimated present value. Cap rate provides a tool for investors that can be used to roughly value a property based on its NOI. For example, if a real estate investment provides USD 160,000 a year in NOI and similar properties have been sold based on 8% cap rates, the subject property can be roughly valued at USD 2,000,000. A comparatively lower cap rate for a property would indicate less risk associated with the investment.

Economic and Business Drivers

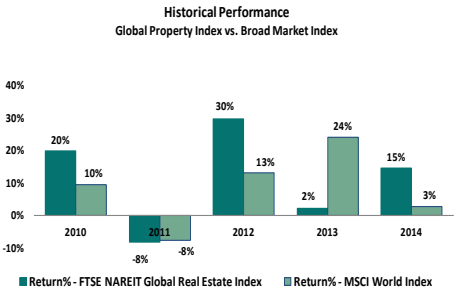
Macroeconomic development, consumer confidence, employment data and corporate activities are the major drivers for REITs.

As global economic activity gathers pace, major commercial global REITs benefit from increased demand and higher occupancy rates for existing assets, new development activity starts building up and market experiences increased supply of property assets. Such activities in the global property market vary from region to region.

REIT-specific fundamentals like strong cash flow growth driven by an environment of improving demand, longer lease duration, limited new property development and relatively low capital costs would enable most REITs to outperform the broader market. Historically, these factors have resulted in income growth and boosted dividend above historical averages.

Healthy balance sheet (loan to value) also enables real estate companies to execute their external growth strategies. The ability to raise capital to fund property acquisitions and developments can be a source of incremental cash-flow growth over time. Accordingly, better credit profiles (usually investment grade) ensure stable cost of debt for a REIT, and many REITs will have an opportunity to refinance their upcoming debt maturities at lower rates even if interest rates rise.

Return and Performance



REITs have provided competitive returns over the long term. In a low interest rate environment, with improving economy and stable inflation, REITs tend to outperform broader market. While interest rates are important, investors should focus on the potential long-term benefits of adding REITs to their portfolio.

REITs should be considered as part of long-term investment strategy with relatively low correlation to traditional equities. Investment in REITs is more of a regular income investment and reduces the overall risk of a portfolio.

Conclusion

For investors, growth of REITs has created better opportunities to access attractive potential returns along with the added benefit of reduced portfolio risk. Investors' search for diversification, regular income and stable return make the real estate investment via REITs a compelling alternative.

The global real estate market is undergoing huge transformation. REIT and REIT-like structures are rapidly gaining popularity, both in the developed and developing foreign markets.