Ramón Sotelo
Stanley McGreal *Editors*

Real Estate Investment Trusts in Europe

Evolution, Regulation, and Opportunities for Growth

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ISBN 978-3-642-36855-4 ISBN 978-3-642-36856-1 (eBook)
DOI 10.1007/978-3-642-36856-1
Springer Heidelberg New York Dordrecht London

Library of Congress Control Number: 2013954988

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Printed on acid-free paper

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Preface

The origin of Real Estate Investment Trusts (REITs) has been coupled with providing a solution to financial distress. This is the case in the mature REIT markets of the USA and Australia. However REITs, as a whole, have proved resilient to financial crises and have in most countries become the industrial standard for indirect real estate investment with sometimes the option and in other cases the obligation of being listed. The history of REITs in Europe is rather recent, although public real estate has had different roots and traditions within European Countries.

Society in general, policy makers in particular as well as economists have in recent years started to cast more doubts on neoclassical assumptions like perfect markets and individuals behaving according to the idea of economic principles. Regulation of financial markets, banks and near-banks are again becoming fashionable as a response to the financial crisis from 2008. In Europe, Alternative Investment Fund Manager Directive (AIFMD) is one of the major regulations affecting substantial parts of real estate investment vehicles, but not REITs.

In highly developed countries, real estate reflects some 80–90 % of capital formation. As long as regulators and market participants remain in neoclassical thinking in which finance is irrelevant, no rules for the optimal construction of real estate investment vehicles can be delivered meaning that good and successful vehicles will only be developed by default. However, once we extend beyond neoclassical thinking, it becomes possible to deliver best practice for the construction of financial vehicles as well as for regulation of tax-transparent real estate investment vehicles.

This book starts with the economic basics on REITs, delivers an overview on the importance and history of REITs, describes and evaluates the mature REIT markets in the USA, Australia and Asia and concludes with country-based chapters on European REITs. The book has an antecessor. In the year 2008, we edited a book called *The Introduction of REITs in Europe – A Global Perspective*. The book you

have in your hands is based on this first book. We thank the publisher of this first book, Andreas Schiller, for facilitating us to publish this second book with Springer.

Weimar, Germany Ramón Sotelo
Belfast, United Kingdom Stanley McGreal
October 2013

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Biography

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In his academic research, Dirk focuses on international public real estate (REITs), and the energy efficiency of housing markets. His research has been published in leading academic journals like: *Financial Management, Journal of Banking and Finance, European Economic Review, Journal of Environmental Economics and Management, the Financial Analyst Journal, Real Estate Economics, the Journal of Real Estate Finance and Economics, the Journal of Real Estate Research, and the Journal of Real Estate Literature*. Besides his research, Dirk Brounen is also active as teacher in several real estate and finance courses at TiasNimbas Business School and in workshops for professionals.

Besides his academic work, Dirk has also been active as advisor for various firms and organizations, like: the pension fund ABP, investment funds Achmea, Amvest, Bouwfonds, and Vesteda, the Dutch Ministries of Housing, Internal Affairs, and Justice, and the European Commission.

Irene Peña Cuenca After finishing my studies on Business management in 2008 at the University of Alicante, I moved to Madrid, where I joined as economist to the Spanish Mortgage Association (AHE), a professional association made up of the financial institutions with major presence in the Spanish mortgage market. As a chief economist, I am responsible for statistics, publications and reports focused on

mortgage and residential market developments and also on funding markets (Covered bonds, RMBS). I represent the AHE in several working groups of the European Mortgage Federation (the representative at EU level of the mortgage loan product). The last 5 years working at the AHE have allowed me to achieve a deep understanding of both the Spanish and European mortgage and real estate markets. In 2010–2011 I reinforced these knowledge studying for a Masters' Degree in Construction and Real Estate management (by the Technical College of Architecture of Madrid) where I focused the final project in the study of REITs as a possible management tool of the real estate assets acquired by financial institutions throughout the crisis.

Bernhard Funk is Professor for Real Estate Investments and Real Estate Finance at HAWK university in Germany. Before becoming an academic, Dr. Funk worked as Managing Director in the US real estate business. His responsibilities included client marketing, fund structuring, and client service for institutional investors and private clients. After graduation from business school, Dr. Funk earned a doctorate and did postgraduate work at the Center of Real Estate of MIT in Boston and at Georgetown University in Washington, D.C.

His research is focused on REITs and US real estate markets. Dr. Funk was speaker, session chair or panelist at numerous events including conferences of the American Real Estate Society, European Real Estate Society, Urban Land Institute and the Real Estate Council of Southern California.

Laura Gabrielli holds a Ph.D. in Property Valuation and Economics at the University of Padua, Italy. She taught Valuation and Economics at the University of Architecture of Venice and at the University of Trento, Faculty of Engineering and University of Bologna, Faculty of Architecture.

She was actively involved in different international networks founded by European Commission. She has also published a numbers of papers and articles in scientific and academic journals in the areas of property valuation and investment, property portfolio construction and risk analysis. She is one of the authors of Italian Property Valuation Standards (2nd ed. Tecnoborsa, 2002).

She was Briefing Editor of Journal of Property Investment and Finance from 2006 to 2008. She is now member of the Editorial Advisor Board of the Journal of Property Investment and Finance and Valori e Valutazioni, a SIEV (Italian Society of Real Estate Valuation) publication.

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Her professional activities concern property valuation, real estate market analysis, feasibility analysis for property development, risk management, PPP valuation, investment analysis in real estate, property funds management and investment.

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Fraser Hughes is Director of Research, Indices & Investor Outreach at European Public Real Estate Association (EPRA). He held a number of investment-related positions in the City of London before relocating to the Netherlands to work for NYSE Euronext. He holds an M.Sc. in Investment Management and a B.A. in Finance. He is a regular speaker at real estate conferences and writes for a broad range of publications.

Ingrid Nappi-Choulet is a Professor at ESSEC Business School and is the founding Director of the ESSEC Real Estate Economics Chair and the RICS Real Estate Track at ESSEC Business School. She received her doctorate in Economics from the University of Paris and completed her post-doctoral stay at Wharton's Real Estate Department at Wharton School of Business. She got an HDR (Habilitation à diriger des recherches- habilitation thesis to supervise research) from the University of Paris-Dauphine and from Sciences Po Paris. Her research interests focus on commercial real estate markets and corporate real estate management. She is the author of several books, the last one being "Les mutations de l'immobilier: de la finance au développement durable" (2009). "L'immobilier d'entreprise, analyse économique des marchés" (2013, 2nd edition). Her blog www.ingridnappichoulet.com and twitter account https://twitter.com/inappichoulet.

Graeme Newell is Professor of Property Investment at the University of Western Sydney. He has been involved in property research and property education for over 30 years. Graeme has strong links to the property industry and is a Fellow of the Australian Property Institute and a Fellow of the Royal Institution of Chartered Surveyors. Graeme has an active property research agenda; he has published widely in the various property research journals in the US, UK and Australia, and regularly speaks at property industry conferences. His main property research interests are in the strategic role of property in a portfolio; this includes property performance analysis, property investment vehicles, the role of property in institutional investor portfolios and assessing the significance of institutional investor allocations to property. He has published widely regarding REITs, both in Australia and internationally.

Dilek Pekdemir is Research Director at Cushman&Wakefield Turkey and also part-time lecturer at academic institutions. She worked as Head of Research at DTZ Pamir&Soyuer for 8 years, after working as research assistant at Gebze Institute of Technology between 1999 and 2005. After completion of her Ph.D., Dr. Pekdemir has started to give lectures, "Real Estate Finance" and "Market Analysis of Real Estate", at İ.T.Ü. Real Estate Development Master Programme since 2010. She is also part-time lecturer at Okan University Real Estate Finance and Valuation Master Programme. Dr. Pekdemir has academic articles in international/national journals and several conference papers in international conferences. She is a member of the board of directors of the European Real Estate Society (ERES), the leading real estate research and education organisation in Europe, since 2011.

Joseph Ooi is an Associate Professor in the Department of Real Estate at the National University of Singapore (NUS). Serving as the Associate Executive Director of the International Real Estate Society, Joseph also sits on the editorial board of nine international real estate journals as well as the board of directors of the Asian Real Estate Society. A distinguished teacher-scholar, Joseph has published more than 40 peer-reviewed research papers in top real estate journals, such as *Real Estate Economics, Journal of Real Estate Finance and Economics, Journal of Real Estate Research, Urban Studies,* and *Journal of Regional Science.* A winner of multiple teaching and research accolades, Joseph's achievements include receiving both the Outstanding Educator Award and the Young Research Award from NUS, as well as an Achievement Award from the International Real Estate Society for outstanding research, education and practice at the international level.

Karen Sieracki has been actively involved in property research and investment management for the past 27 years. She has had over 10 years' fund management experience, during which time she created one of the first institutional property research departments in the UK. Through this work she became closely involved in determining international asset allocation across all investment categories, with particular reference to the role and the future competitive performance of property.

Dr. Sieracki has her own research company for the past 17 years, KASPAR Associates Limited, working with a number of leading institutional clients and the property industry at large. KASPAR's principal areas of business focus are providing analysis of the property investment market in Europe, the US and the Far East, property portfolio investment plans and strategic and tactical business advice to financial service companies.

Dr. Sieracki is Visiting Professor to the Faculty of the Built Environment at the University of Ulster (since 2003).

Ramón Sotelo Immobilienökonom (ebs) and Certified Shopping Center Manager studied business administration at the Free University of Berlin and got his Ph.D. in 2001 at the European Business School (ebs) with a thesis on housing policy, supervised by Prof. Dr. Karl-Werner Schulte. Prof. Sotelo has published more than 80 papers on housing and real estate economic and finance. After working as a developer in Berlin and as General Manager of the German Association of house-owners (Haus&Grund) he was appointed in 2003 assistant professor for Real Estate Economics at Bauhaus University in Weimar and became honorary professor for real estate investment vehicles there in 2009. Professor Sotelo has chaired the Working Committee on Property Investment Vehicles from the German Society of Property Research (gif e.V.) for 7 year, is co-editor of the German Journal of Property Research, member of the editorial advisory board of the Journal of

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Maikel Speelman joined the EPRA research team in December 2008. He is responsible for the management of the FTSE EPRA/NAREIT Global Real Estate Index and publishing industry level research in a wide range of real estate publications. Maikel holds a B.B.A. in Real Estate Management from the Hanzehogeschool Groningen, and a M.A. in European Real Estate from Kingston University London.

Simon Stevenson has been Professor of Real Estate Finance and Investment in the Henley Business School, University of Reading since 2010. He previously held positions at Cass Business School, City University and the Smurfit School of Business, University College Dublin. His primary research interests are in the fields of REITs, real estate investment, housing economics and international finance. He has published over 65 papers in journals such as the *Journal of International Business Studies*, *Real Estate Economics*, *Journal of Real Estate Finance & Economics*, *Journal of Housing Economics*, *Housing Studies*, *European Journal of Finance*, *Emerging Markets Review* and the *Journal of Real Estate Research.*

Paloma Taltavull de La Paz is professor on Applied Economics department at the University of Alicante, Spain. Her research focus is in Housing Markets, Real Estate Markets and Macroeconomics.

She has written more than 28 book chapters and books, around 45 academic articles in Spanish and International journals since 1996, in journals like Journal of Real Estate Research, Journal of European Real Estate Research, International Journal of Housing Market and Analysis, Urban Studies or International Real Estate Review. Economistas or Papeles de Economía Española, are two of the Spanish publications with her articles. She has participated in more than 32 research projects in housing and urban economics refereed to Spanish market since 1992.

Professor Taltavull belongs to different academic Societies committees being active on them, like to European Real Estate Society (ERES) since 1994, American Real Estate Society (ARES) since 1992, International Real Estate Society (IRES) since 1999, Asociación Libre de Economía (ALDE) since 2002, and has been president of ERES during 2002 and IRES during 2010. She won the 1997 Faculty of Economics Ph. D. Award at the University of Alicante, II FICIA President Foundation 1996 Prize for the best Shoe Sector Research, the 2006 I.E. Service Award and both the 2009 and 2013 Award of Excellence Outstanding Reviewer from by Emerald Literary Club.

She was Outstanding Academic Member of the Housing Rent Market Observatory at the Spanish Ministry of Housing (2006–2009), and she led the launch of the Biblioteca Virtual Miguel de Cervantes (Virtual Library ‘Miguel de Cervantes’), the first virtual library in Europe and in Spanish language, in 1999.

Refereing to education projects, she has been the head of the Real Estate Undergraduated (Título Propio en Estudios Inmobiliarios) at the University of Alicante (1996–2013) and responsible of the Curriculum design and coordination. Professor Taltavull organized the I ERES Education Seminars in 2005, 8th ERES Annual Conference and the yearly congress on Applied Economics (1998–2012) at Alicante University.

Dominic Turnbull joined EPRA in March 2008 following a journalistic career at Reed Elsevier and a communications role at Nike's European HQ in The Netherlands. He relocated with EPRA to Brussels. Dominic holds a B.A. degree from Warwick University.

Steven A. Wechsler is president and chief executive officer of NAREIT (the National Association of Real Estate Investment Trusts), the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. He directs all NAREIT programs and services. In this capacity, Mr. Wechsler is a leading advocate of the REIT approach to real estate investment.

NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

Previously, Mr. Wechsler was president and chief executive of the National Realty Committee, now known as The Real Estate Roundtable (RER), which represents the nation's leading real estate owners, advisers, builders, investors, lenders and managers on national policy matters. Earlier, Mr. Wechsler practiced real estate law and served as counsel to a Washington, D.C., consulting firm.

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In 2013 Kamena Valcheva established her own law practice - Valcheva Law Office. Valcheva Law Office is committed to providing top-quality advice in all fields of business law and outstanding service to its clients.

Kamena Valcheva holds a Master's degree in Law from the Faculty of Law of Sofia University, Bulgaria and has also attended post-graduate programs in

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Kamena Valcheva is the author of several publications in the field of REITs, mobile phone payments and banking law.

Part I
Setting the Context

Chapter 1
The Economics of REITs

Ramón Sotelo

1.1 Introduction

Real Estate Investment Trusts (REITs) gained wide acceptance in the United States during the 1990s and have spread internationally, for example Japan, Australia and have gradually being introduced in European countries. For institutional clients in particular, REITs are vehicles that provide indirect real estate investments.

This chapter considers how different real estate investment products as financing vehicles are differentiated from one another. The chapter aims to forward draft criteria for the use of different investment vehicles in particular the optimal design of REITs. The question of the optimal construction of investment vehicles is closely linked to the optimal financial structure of a company. It is argued in this chapter that the neoclassical theory of finance is not able to differentiate between different financing vehicles. While Williamson's (1988) financial theory approach is able to differentiate between debt and equity, it is also not capable of distinguishing between various forms of equity and mezzanine capital. Hence, further development of financial theory towards the concept of latitude is needed, in order to be able to identify real estate investment products and formulate recommendations for their design.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_1, © Springer-Verlag Berlin Heidelberg 2013

1.2 The Neoclassical Theory of Finance and the NIE Approach

From a new institutional economics (NIE) perspective financing can be viewed as a body of rules and regulations that lay down information and co-management rights as well as monetary claims, Alchian and Demsetz (1972). An alternative perspective is that financing can be understood as a series of payments starting with an incoming payment followed by a number of payouts. On the basis of this interpretation, an investment, conversely, is a series of payments beginning with a payout followed by a number of incoming payments, Drukarczyk (2003). This encapsulates the neoclassical theory of finance and forms the basis of both methods of investment appraisal (e.g. DCF) and the quantification and transformation of risk into return in the capital asset pricing model (CAPM), Markowitz (1952).

The question of the optimal financing of an investment, usually treated as a question of the optimal financial structure of a company, is a problem of corporate finance. Under a horizontal financing rule, asset terms should be matched with liability terms. According to the leverage theorem it is possible to optimise capital structure, i.e. to minimise the WACC. This was a fist vertical financing rule based on the assumption of imperfect capital markets. Modigliani and Miller (1958) formulated a second vertical financing rule based on the assumption of perfect capital markets, postulating the irrelevance of capital structure.

The new institutional economics has been gaining acceptability internationally, Richter and Furubotn (2003) and embraces a multitude of theoretical approaches, such as: property rights approach, principal-agent approach, theory of relational contracts, transaction cost economics, new institutional economics of the state. Schneider (1995) in reconstructing institutional economics considered that an institution serves to reduce the insecurity of income and can be distinguished into systems of rules (governance structures) and systems of actions (organisations). A financing institution like credits or shares can be interpreted, in accordance with Schneider's conception, as a form of an institutional manifestation.

Transaction cost economics as part of the new institutional economics was initially developed in parallel to and remained independent from the development of corporate finance. Williamson (1991) is amongst the proponents of transaction cost economics which beginning can be dated to Coase's The Nature of the Firm in 1937. The question that drives the origin and the development of transaction cost economics is the question of the optimal transaction as an alternative between delivery of a service inside a company or via the market Coase (1937).

As illustrated by Fig. 1.1, Williamson (1991) postulates a relationship between the complexity of a transaction and the transaction cost depending on the form of transaction (via market or hierarchy), and in doing so explains the existence of companies as hierarchical organisations. The specificity of an asset means that a player who wishes to offer a factor has a low chance of redeploying this factor for another purpose, so that in a market transaction, especially in the context of the assumption of opportunistic behaviour, there is a high risk of sinking costs, which

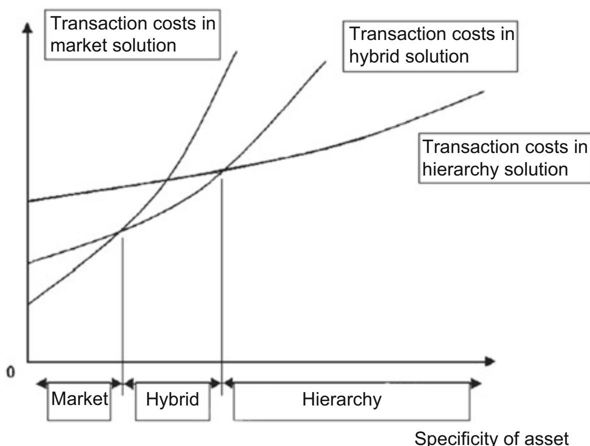

Fig. 1.1 Costs of forms of transaction (Source: Williamson 1991, p. 116)

will be anticipated by the promoter and therefore leads to high transaction costs. Different forms of transactions respond to factor specificity with different levels of transaction costs. In Williamson's 1988 paper Corporate Finance and Corporate Governance, transaction cost economics considerations are transferred to the question of the optimal financing structure, in particular financing with debt and equity, as forms of transactions or forms of governance.

According to Williamson, it is not the risk, measured as the distribution of a company's cash-flow, that determines the debt ratio, but the specificity of the assets (Fig. 1.2).

The case of the equity ratios of the construction industry (ER of 7.9 %) and the pharmaceutical industry (ER of 34.4 %) in Germany in 2004 provides a pertinent example of Williamson's postulate (Deutsche Bundesbank 2006). There are only very few industries that experience such pronounced business cycles as the construction sector and therefore risks in the form of variability of profits. Nevertheless, the construction industry can manage with a very low equity ratio due to the low specificity of the assets. In contrast, the pharmaceutical industry has a relatively steady demand, but due to the high specificity of the assets, its equity ratio is comparatively high. With this postulation on the interrelationship between the specificity of assets to be financed and the question whether these can or cannot be financed with debt, Williamson achieves a plausible explanation for the financing behaviour of companies with respect to the use of debt.

Williamson's approach has far-reaching importance for real estate economics. On the one hand, it addresses the question of lending on real estate investments, but also raises the issue of specificity for property developers and investors, as well as for non-real estate companies as users of real estate. For example, if the lease of property is interpreted as providing real capital in the form of credit from the landlord to the tenant, then Williamson's postulate on financing can help resolve the question whether it is more opportune to buy or to rent an apartment, Sotelo (1996), Sotelo and Hähndel (2009).

Assets		Liabilities
Specific Assets	Equity	
Unspecific Assets	Debt	

Fig. 1.2 Williamson's postulate on financing

Although transaction cost economics can be applied in many ways to real estate economics, this concept however does not describe forms of financing that lie beyond or in between equity and debt. While it may be possible to recognize other forms of financing, such as the broad range of real estate investment products (closed-ended real estate funds, open-ended real estate funds and real estate companies or REITS) as mezzanine forms of financing Williamson's financing approach alone does not deliver explanatory tools to further differentiate or explain these hybrid forms of financing. In literature these hybrid forms of finance are primarily explained based on information economics Rudolph (2004).

1.3 Financing Vehicles as Forms of Governance: Latitude as a Key Concept

Financing can be interpreted as a relationship between the financier (principal) and the management of the entity receiving the financing (agent). What characterises the principal-agent relationship is that information is asymmetrically distributed between the agent and the principal. It is assumed that the principal, while being able to monitor the agent's results, is not able to monitor the agent's input. The relevant literature, Jensen and Meckling (1976) primarily deals with which incentives the principal can use to achieve far-reaching conformity between the interests of the agent and his own, while minimising transaction costs.

Although the principal-agent approach is considered as constituting part of new institutional economics, it goes far beyond Schneider's interpretation of an institution in that the principal-agent approach not only considers the institutions that are suited to reduce income uncertainty in the relationship between principal and agent, but discusses the issue of the hierarchical relationship between the principal and agent itself. In this way, economics becomes a social science of governance relations and not of institutions. Financing can be interpreted as limiting the agent's latitude by the principal. Different financial institutions offer different latitudes of action within the relationship between the principal and the agent. Further regulations of a financing institution, namely those regarding monetary claims, information and co-management rights result from the latitude in this approach. Incentives are combinations of monetary claims, information and co-management rights within certain latitude. By placing latitude in the focus of studying a financing institution, the principal-agent relationship becomes a governance relationship (Fig. 1.3).

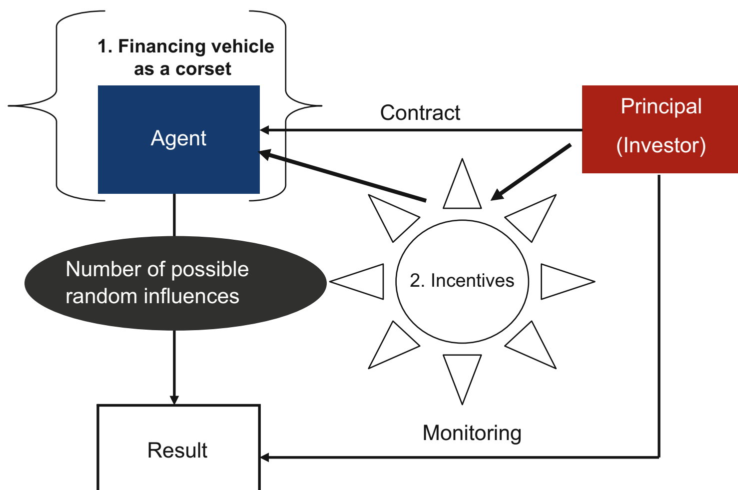

Fig. 1.3 Finance as a principal-agent issue

In essence, the latitude of a financing institution defines the range of possible uses for the financial resources provided by the principal to the agent for fulfilling the tasks. If for example a financier grants a credit to the agent, the latitude is usually very small, as the use of financial funds is clearly regulated in the credit contract. Credit contracts in the real estate industry, for instance in acquisition financing, often include a provision according to which the correct use of funds must be guaranteed by a notary. If an investor subscribes to a closed-ended real estate fund, it is usually known at the time of subscription which property is purchased at which price or which tenant leases it for a certain term, so that the agent has only limited latitude; thus the agent's latitude is already used in full. If an investor subscribes to a German open-ended real estate fund, the German Investment Act (KAGB) regulates which investments are permissible and to what extent. If an investor buys a US REIT, there are also regulations regarding possible investments, for example a high percentage of profits has to be generated from real estate, and also, real estate assets must constitute a certain proportion of total assets. When purchasing a share (stock) in a real estate corporation, in contrast, latitude is considerably larger, as there are virtually no legal restraints regarding the company's investments. Figure 1.4 schematically illustrates the growing latitude of financing institutions:

With different financing vehicles there are different capital costs. Credits can be obtained at the lowest cost; venture capital is the most expensive capital as illustrated by Fig. 1.5.

Figure 1.5 relates capital costs to latitude. Capital costs arise independently from the volatility of the financed asset and if latitude is large, so are capital costs. If the principal allows the agent a wide latitude, under the assumptions of bounded rationality and moral hazard there is a high level of insecurity for the principal.

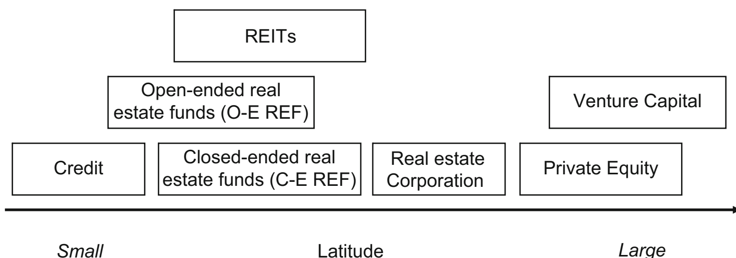

Fig. 1.4 Latitude of different forms of financing

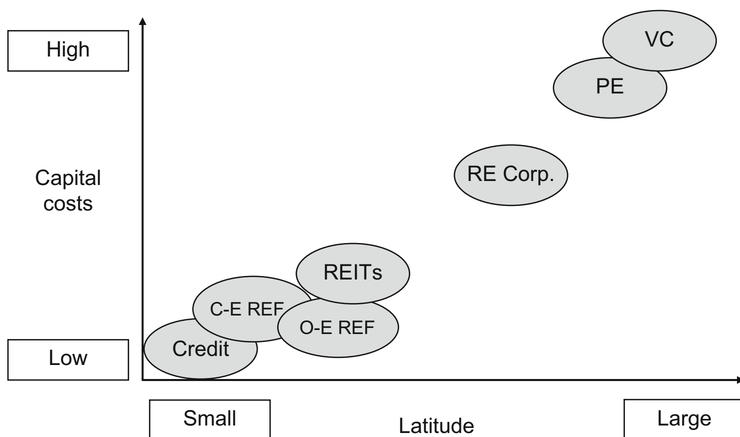

Fig. 1.5 Latitude and capital costs

It is this insecurity resulting from the latitude granted, which is principally independent from the risk measured as the volatility of assets, that leads to higher claims for return on investment of the principal sui generis. The reduction of latitude by means of regulation within a financing vehicle implies a reduction of the principal's insecurity, which he responds to with lower capital costs. Hence, the new postulate on financing is: reduce the latitude of a financing vehicle as much as possible in order to minimise capital costs or put differently the latitude offered by the vehicle shall be fully used by the agent, as it is paid for in any case and separate those business activities that each require a different latitude and keep adjusting latitude to the current necessity over time. Latitude thus explains why equity is more expensive than debt, irrespective of the type of assets financed.

1.4 Applying the New Postulate on Financing: Developing Best Practices for REITs

The postulate on optimal latitude offers a wide variety of applications, particularly in the area of real estate investment products and identifies REITs as a practical vehicle for disinvestment of private equity companies. For example, Fig. 1.6 illustrates, based on the example of a shopping mall, how real estate is optimally financed at the different life cycle stages.

This instrument can also be applied to interpret the increase of investments by private equity funds in housing as witnessed in Germany (Fig. 1.7). In this example, real estate is held by non-real estate companies and by public enterprises. The associated latitude is fundamentally too high for holding a real estate portfolio and is sold to private equity firms who with very high latitude and corresponding capital costs restructure portfolios and disinvest, using a variety of investment vehicles with lower latitude, such as open-ended or closed-ended real estate investment funds and REITs.

The examples in Figs. 1.6 and 1.7 illustrate how from a financial theory perspective, it is possible to make analytical statements regarding the fundamental characteristics of REITs and provide recommendations for the optimal design of REITs. Although REIT regimes in different countries may not be identical, tax transparency and the limitation to real estate activities are common features. However, regarding what exactly are real estate activities, which activities are permitted and which are not, and whether certain activities are only permitted within a limited scope, differences in REIT regimes become apparent. Whether stock-exchange listing is obligatory for REITs or not appears as a further essential characteristic of REITs, as well as the question of internal or external management.

1.4.1 Tax Transparency of REITs

Tax transparency is a fundamental characteristic of REITs, however it is useful to review the economic reasons for the legitimacy of tax transparency and, conversely, the reasons for tax transparency allow conclusions to be drawn regarding the design of REITs. The economic legitimacy of tax transparency of REITs results from the character of debt associated with the reduced latitude of REITs. After all, so far debt – viewed from an international perspective – is usually tax transparent. While the return on equity, company earnings, is usually taxed on a corporate level, interests paid on credits can for the most part be deducted from earnings and paid out in a tax transparent manner to the creditors, who ultimately pay taxes on these at their individual tax rates. Therefore, also for tax reasons, REITs should be limited in their business activities to such an extent that their latitude is considerably reduced, as with debt. Unlimited latitude of REITs would lead to distortion of competition between property developers and real estate service providers and REITs.

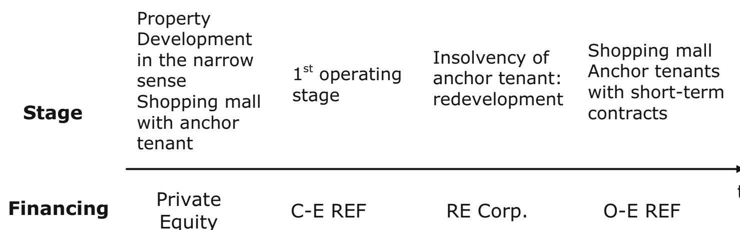

Fig. 1.6 Latitude and capital costs, shopping mall example

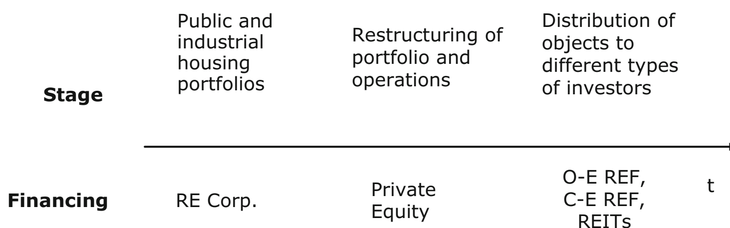

Fig. 1.7 Restructuring of housing portfolios and latitude of financing

1.4.2 Free Float Requirements

When REITs were introduced in the United States in 1961, the product was conceived for retail investors. In order to limit the influence of individual investors, the so-called 5/50 rule laid down that no more than 50 % of capital may be held by no fewer than five investors. However, following recognition that REITs are primarily a product for institutional investors and not for retail investors, this rule was de facto abolished for institutional investors with the Omnibus Reconciliation Act of 1993. Both in the UK and in Germany, a 10 % limit on individual shareholder stakes in REITs has been fixed for tax reasons. The background to this regulation lies in double taxation agreements and EU directives such as the Parents-Subsidiary Directive, the consequence of which is that income from dividends in holdings of over 10 % can be taxed only minimally, if at all, in the country of situs of a real estate.

A free float requirement needs to be rejected as a major part of the investor market would be practically excluded from the market and public housing companies would no longer be able to privatise substantial parts of there shares transforming themselves into REITs first. For going public a liquid market is needed and liquidity can not be imposed by law. In Germany, the legislator has deliberately allowed for the possibility of owning more than 10 % of the capital through subsidiary vehicles, keeping at the same time an obligation for a minimum free flow.

In the future, tax transparency of REITs may become even more important, as a number of industrial countries, such as the United States and Germany, are

increasingly limiting tax transparency of corporate debt. In a tax framework in which debt is tax transparent, but equity is not, international groups in particular are motivated by means of arranging the proportions of debt and equity in foreign subsidiaries in order to minimise corporate income in countries with higher corporate taxes. Thus legislators (e.g. Germany) are wishing to put taxation on a basis that chooses earnings before interests and taxes. In economies with a high degree of tertiarisation, real estate forms the predominant part of the capital stock, for example in Germany, this share is about 88 %. If REITs become the only remaining tax transparent form of financing for real estate the market of REITs may become one of unimagined growth opportunities.

1.4.3 The Rationale of REITs

REITs serve as an asset custodian for real estate whereas non-real estate companies, usually corporations, have a higher latitude than is required for holding a real estate portfolio and the capital costs of the companies are higher than the performance of the real estate they hold. If these companies dispose of their real estate, bound capital is released and can be employed for actual business purposes. Hence, by selling real estate, non-real estate companies can add value. To the extent that REITs generate their performance from real estate trading or development activities, their capital costs can increase and become too high for financing the property assets. A discount between the market capitalisation of the REIT and the net asset value (NAV) of the portfolio can be the result.

REITs as real estate investment products are supposed to reproduce the performance of real estate. Only then are they at all attractive for institutional investors (such as insurance companies), as an alternative to direct real estate investments. Regarding the issue of diversification into real estate related activities (administration, building, brokering), investors can achieve this aim by adding suitable stocks to their portfolio. Direct diversification by the REIT's management constitutes an unnecessary lack of separation of activities that should be financed differently and reduces the possibility of representing the performance of the real estate portfolio hold in the financing vehicle.

As to whether REITs are a separate asset class in terms of performance and therefore offer a suitable means for portfolio diversification has been debated in the literature. Rehkugler et al. (2008) show that, although the performance of REITs correlates more with that of stock markets in the short term, over a 5-year perspective, REITs reflect more the performance of real estate. Over a long-term perspective, REITs are a substitute for direct real estate investment. If REITs are interpreted as an asset class of its own, institutional investors would almost certainly continue to hold real estate in direct or other indirect form in addition to REITs.

Some asset managers consider that, by carrying out real estate trading activities and using real estate cycles, they can increase performance above that of the

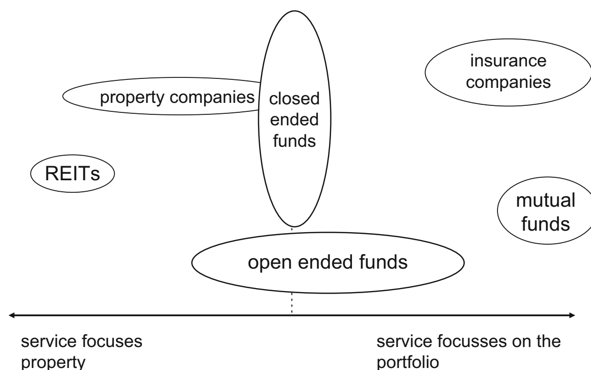

Fig. 1.8 Property investment vehicles and provided service

underlying assets, contradictory to capital market theory. Ling (2005) has shown that expert forecasts regarding the development of real estate markets are systematically no better than random forecasts – a finding that confirms the random-walk hypothesis of efficient capital markets from the neoclassical theory of finance. Thus, REITs should limit themselves to one real estate segment and make this their core competency. Investors are then able to indirectly invest in real estate by means of REITs, use REITs as a means to diversify their portfolios and incorporate considerations of business cycles, as necessary.

The business activities of REITs should therefore be limited to holding and actively managing real estate. Property development activities of a REIT are appropriate and necessary if by this means existing or new property can be optimised for the users. Systematic trading of real estate and trading development, on the other hand, are not suitable activities for REITs, because in this way capital costs are unnecessarily increased and real estate performance is diluted.

Any investment vehicle can be also differentiated according to the service offered to the investor. Some vehicles concentrate on the service on the property itself and some focus on the service on the portfolio. Figure 1.8 shows the spectrum between investment vehicles and offered service.

In mature capital markets investment vehicles focus on either the property service or on the portfolio service. While in Germany open ended funds offer a mixture of both services the market in the US has a clear separation between the property focus of the REITs and the portfolio focus of mutual funds. Table 1.1 shows, that REITs in a mature market are also focused within the property service by concentrating on a usage. Only some 8 % of the US-REITs are diversified. REITs therefore are not bound to work on portfolio selection, but are a suitable vehicle for mutual funds and other institutional investors for their portfolio selection.

Table 1.1 also suggests that REITs are very strong in those property markets, which need the provision of extensive service to the tenant and to the user. This is especially the case in lodging, shopping, and residential.

Table 1.1 Focussed equity- REITs in the mature US-market

No. of REITs	Sector	Equity market cap ($M)	% of total constituents	% of total equity market cap
Industrial/office	30	103.761	20.8 %	16.2 %
Retail	34	165.157	23.6 %	25.8 %
Residential	19	88.415	13.2 %	13.8 %
Diversified	22	53.374	15.3 %	8.3 %
Lodging/resorts	17	37.237	11.8 %	5.8 %
Self storage	4	37.211	2.8 %	5.8 %
Health care	12	87.286	8.3 %	13.6 %
Timber	4	34.090	2.8 %	5.3 %
Infrastructure	2	33.330	1.4 %	5.2 %
Total	144	639.861		

Source: NAREIT, April, 30th 2013

1.4.4 Listing of REITs

Increasing the fungibility of shares by creating a liquid secondary market with a sufficient free flow is an important aim in the implementation of REITs. The US experience has shown that refinancing of REIT markets takes place via the private or the capital market, depending also on the particular cyclical situation of the capital market and the development of REIT markets. Apart from the USA, both the second largest REIT market, Australia, and the fast-growing young market, Japan, have granted freedom of choice regarding stock-market listing for which there are several advantages as briefly listed.

1. Institutional investors such as insurance companies would, at least in a transfer phase, like to be able to hold their investments in non-listed REITs, so that the volatility that is to be expected in the beginning does not directly have an effect on their books.
2. For reasons of capital market discipline, possible delisting is indispensable, as a last and the toughest means of disciplinary action for firms that do not fulfil investors' expectations. A fiscal penalty in the form of the abolition of tax transparency when executing disciplinary action by the capital market would be contra-productive.
3. For a step-by-step transformation of parts of the portfolios of public open-ended real estate funds into REITs, the existence of private REITs would also be of great importance. In a first step, parts of the portfolios could be transformed into non-listed REITs, subsequently a listing with little free flow and price management could be realised in order to reach a large free flow with capital market discipline and reasonable volatility in a mature and liquid market.
4. If the legislator is interested in supervising REITs through an exchange supervisory authority, this could also be required for non-listed REITs.

Table 1.2 Financial classification

	Equity	Mezzanine capital	Debt
Private	Private equity funds	Closed-ended funds, private REITs	Commercial credit
Public	Listed stocks	Listed REITs	MBS, ABS, CDOs, covered bonds, "Pfandbrief"

Neither the obligation nor the prohibition of a stock exchange listing of REITs, on the other hand, seems a suitable measure to reach this aim. From a financial theory perspective, REITs may be considered as mezzanine financing and the classification often found in literature into private and public capital and equity and debt can be extended as outlined in Table 1.2. However, in Europe, listing is obligatory for the young REITs (France, UK, Germany). The reasons for this rule and the developments associated with it are the subject of the country-related Chap. 10.

1.4.5 Management of REITs

In the USA, REITs initially were trusts endowed with an external management. Seemingly the later introduction of an option for an internal management was a factor in the success of US REITs. Indeed, internal management of REITs, often in combination with management shareholdings in the REIT's assets, provides a means to minimise potential conflicts of interest ex ante. With increasing latitude, management is more likely to be internal and from the alternative perspective with reduced latitude, management is more likely to be external. In Demsetz' terminology, financing with equity character have more co-management rights implying internal management. A comparison of the construction of US REITs and Australian REITs on the one hand with Japanese REITs on the other highlights this difference with Japanese REITs, which have the most limited latitude, exclusively having external management.

1.5 Summary and Outlook

The developed new postulate on financing relating to latitude facilitates discrimination between different real estate investment products such as open-ended and closed-ended real estate funds, real estate companies and REITs. Furthermore it lays the foundation for the development of best practice for the design of REITs. According to this postulate, REITs should make theme-oriented investments in real estate assets and avoid commercial supplementary services and increased real estate trading. The obligation for stock exchange listing and the observation of free flow

requirements can be rejected on the basis of financial theory. Tax transparency of REITs can be justified on a financial theory basis, beyond reasons of competition neutrality.

Within Europe, different RIET models have been introduced. France first made no provisions for systematic taxation of foreign investors while the UK and Germany designed their respective REIT regimes to provide for the taxation of foreign investors. While Germany and the UK were still discussing their REIT legislation, the European Court of Justice ruled on September 14, 2006 in the so-called Stauffer case that the location of an entity within the EU cannot be decisive for the question of taxation. If this underlying principle is transferred to European REITs, there is the potential for a EU REIT to invest in other EU states that have REIT structures, without becoming subject to taxation in the country they invest. This would promote competition between European REITs in which case the factors of success for REITs founded on financial theory and discussed in this chapter will be of particular relevance. The development of REITs in Europe should remain an exciting subject.

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Chapter 2
The Global Real Estate Investment Trust Market: Development and Growth

Simon Stevenson

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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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_2, © Springer-Verlag Berlin Heidelberg 2013

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 dominant 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 is 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

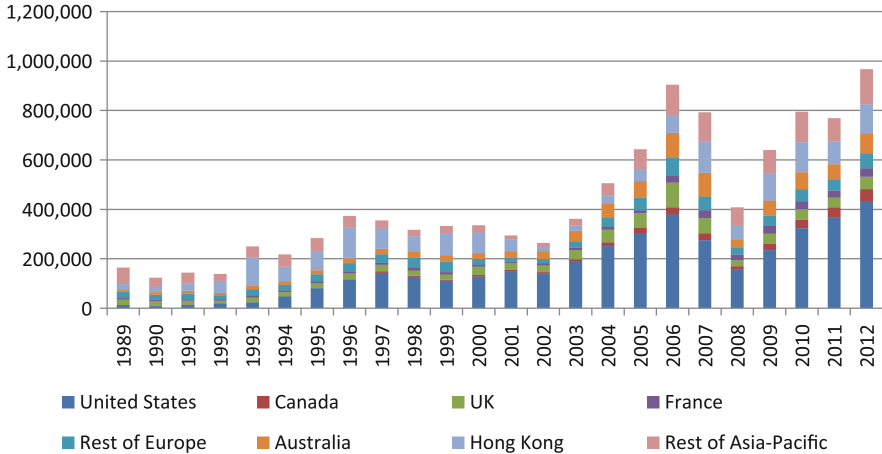

Fig. 2.1 Market capitalisation global listed real estate (US$m)

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.

Table 2.1 Comparison of international REIT structures

	U.S.	Australia	Netherlands	Canada	Belgium	Singapore	Japan	France	UK
Management internal or external	Either	Either	Internal	Internal	Either	External	External	Either	Either
Investment restrictions									
Real estate investments	75 %+	50 %+ of revenue from rent	100 %	80 %+	100 %	70 %+	75 %+	Flexible	75 %+
Overseas investment	OK	OK	OK	OK	Prohibited	OK	OK	OK	OK
Development	OK	OK	Minimal	OK	Minimal	20 % of total assets	OK (but 50 %+ of assets must be income producing)	OK	OK
Gearing limit	None	None	60 % property assets	None	50 % of total assets	35 % total asset	None	None	DSCR 1.25
Payout	90 %+ of taxable income (post deprec.)	100 % of taxable income (post deprec.)	100 % of fiscal earnings	85 % of distributable cash (pre-deprec.)	80 % of taxable income and net debt paydown	100 % of taxable income (no deprec.)	90 %+ of taxable income (post deprec.)	85 % of taxable income from rentals, 50 % of capital gains	90 %+ of taxable income (post deprec.)
Closed ended	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Listed/unlisted	Both	Both	Both	Listed	Listed	Listed	Listed	Listed	Listed
Tax transparency	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes+

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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Chapter 3
The REIT in Europe: History, Opportunities, Challenges

Fraser Hughes, Maikel Speelman, and Dominic Turnbull

With the years ahead promising few certainties, limited growth and challenges from every direction to the investment assumptions of old, commercial real estate is taking on a new relevance. It is has been a constant in the cycles of Europe's economy, finance and society hooked on urban living with a sustainable footprint. But listed real estate has come of age. Within the asset class, REITs and listed property companies have demonstrated over 20 years that public listing and its associated oversight leads to a superior property business in terms of management, assets and investibility.

We will look at the opportunities which REITs and Stock Exchange-listed property offer to the investor, and consider the wide-ranging contribution the sector makes to society and the economy at large.

Real estate, as a general term, describes the built environment, which plays a vital role in every aspect of the European economy, society and environment. Businesses and society cannot function without the services of commercial property, including the provision of offices, shops, factories, housing and many other forms of real estate. The commercial property sector delivers and manages the infrastructure needed for entrepreneurship to thrive. It is therefore a fundamental source of employment and economic growth, and a major contributor in addressing two critical challenges of our time such as providing liveable and functioning cities for a growing urban population and reducing the environmental footprint of the built environment.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_3, © Springer-Verlag Berlin Heidelberg 2013

3.1 Contributing to the Economy and Supporting Jobs

The commercial property sector directly contributed EUR 285 billion to the pan-European economy in 2011 – about 2.5 % of the total economy and more than both the European automotive industry and telecommunications sector.[1] We believe that this figure rose significantly in 2012. The sector directly employs over four million people, which is more than not only the automotive and telecoms sector, but also greater than those employed in banking.

Most employment activity in the commercial property sector is through the construction and the repair and maintenance of buildings. The upkeep, management and care of commercial buildings are also a sizeable activity, undertaken either directly by property owners or on their behalf by a growing number of specialist contractors. All of the above activities are an essential part of maintaining and improving the quality of the accommodation services provided to businesses. Investment, fund and portfolio management is a small but disproportionately high value-added activity.

3.2 Investment: Delivering Infrastructure

Investment in new commercial property buildings and the refurbishment and development of existing buildings on average totals nearly EUR 250 billion each year – representing over 10 % of total investment in the European economy and equivalent to the GDP of Denmark. Investment in other buildings, infrastructure and housing is also substantial, totaling EUR 1 trillion, and when included with commercial property, represents almost 60 % of capital investment in the European economy.[2]

3.3 Commercial Real Estate: A Significant Role in Business, Industry and Social Life

Commercial property, other than residential, encompasses shops and retail outlets, offices, warehousing and light industrial premises, as well as hotels, leisure facilities and other forms of infrastructure. New forms of commercial property are continuously emerging playing a vital role in Europe's business, industry and social life. Its market value in 2011 was approximately EUR 5 trillion. This is comparable to the value of plant and machinery in Europe's businesses and is close

[1] "Stock Exchange Listed Property Companies – Building a Stronger Europe", EPRA 2013.

[2] "Stock Exchange Listed Property Companies – Building a Stronger Europe", EPRA 2013.

to the size of European stock and government bond markets. The total value of residential housing, at EUR 22.5 trillion, far exceeds other property sectors.[3]

Half of all commercial property – with a total market value of EUR 2.5 trillion – is held as an investment. While most families prefer to own their own homes, around half of the EU's commercial property is leased by businesses which prefer the flexibility of renting and are reluctant to commit the capital and management time required of owner-occupation. The commercial property industry meets this need by investing in commercial property and providing accommodation services to these businesses.

Listed property companies and non-listed funds are the biggest single owners, while traditional investors' (insurance companies and pension funds) directly owned share has been declining. However, the situation in Germany is revealing, partly due to the nature of its banking structure which has evolved alongside a cautious investment psychology over five decades. Of the ten largest global property markets (with the exception of Italy at 0.6 %), Germany has the lowest proportion of its underlying real estate held within the listed sector at only 1.5 %. This compares with France at 6 %, the US at 5.8 %, Australia at 16 % and a global average of 5.1 %.[4]

There has been a traditional aversion to risk which has seen German investors favouring what they perceive as safer returns as opposed to higher but riskier ones. It also explains that retail investors find it perfectly normal to immobilise their money in an illiquid investment as the price to pay for this perceived safety. It is commonly viewed that the structural distortion in the real estate investment market in Germany, which has repressed the growth of listed property vehicles in comparison with every other major economy worldwide, has led to lower returns for investors such as German pension funds and insurers and probably reduced the government's take from this major tax-generating sector.

Consequently, as the financial climate adapts to more open, rewarding and liquid listed sector investments, the upside to the German listed sector is significant. Were it to match the European average of **3.5 %**, some EUR **50** billion would be added to the market cap.

3.4 Contributing Towards a Low Carbon Economy

As tenants, investors and regulators all push for a climate-friendly product, the sustainability question of buildings has become a financial as well as political touch-point.

It is no secret that buildings contribute significantly to energy use and greenhouse gas emissions; they directly and indirectly account for 40 % of the EU's

[3] "Stock Exchange Listed Property Companies – Building a Stronger Europe", EPRA 2013.

[4] EPRA figures taken from Monthly Statistical Bulletin April 2013.

consumption and a third of its emissions. Residential housing accounts for the vast majority of this with non-residential buildings – including the public sector – accounting for 12 % of the EU's energy consumption and greenhouse gas emissions.

Residential and, to a lesser extent, commercial and public sector buildings also represent one of the most important untapped potential sources of energy savings. The cost over the decade of meeting this untapped potential for residential and non-residential buildings has been estimated at almost EUR 60 billion per year – a big commitment, which emphasises the importance of Europe's commercial property sector in delivering these important energy efficiency improvements. This drive to meet EU emissions targets will further connect the real estate sector to wider economy activity.

Typically, listed property companies are already leading the way in innovating energy-savings into their assets, responding to investor expectations of green management. In a liquid market, a shareholder can instantly approve or rebuke a listed company by trading their share. This empowerment comes through the visibility of the company's performance combined with analyst research and opinion. Stock Exchange and regulatory requirements for transparent financial reporting, and the increasing adoption of consistent financial measures across the European sector, mean listed companies face constant and informed shareholder action.

The Jones Lang LaSalle Transparency Index 2012[5] reveals that listed property companies are a huge driver of transparency within a country's real estate market. Countries with larger listed sectors, relative to their overall real estate market, scored better in terms of the JLL transparency rankings. One reason for this is the high standard and frequency of reports produced by the listed property companies. This transparency does not only mean that investors are well informed when it comes to the performance of the buildings the own, but also that the management teams are under constant scrutiny from their shareholders.

Similarly, over 100 dedicated equity analysts are actively monitoring the listed property companies in Europe, leaving no 'brick' unturned when it comes to reviewing a company's performance and management decisions. This creates a close alignment between the managers and the shareholders – which ultimately ensures better long-term decision-making and performance.[6]

With accountability comes quality, so is it any wonder that listed property companies have assembled, predominantly, high quality asset portfolios in good locations? Their strategy to own quality assets with the potential to add value through active management has allowed them to enhance returns over the long run.

[5] Jones Lang Lasalle Global Transparency Index is a unique biennial survey covering 97 markets worldwide. It aims to help real estate players understand important differences when transacting, owning and operating in foreign markets.

[6] EPRA monitor the number of analysts covering the FTSE EPRA/NAREIT Global Real Estate Index. As at April 2013, there were 130 analysts covering the 85 companies in the European section of the index.

Such companies possess unique characteristics which make them ideal owners of prime properties. The tax-transparent and efficient structure of the REIT means that income from properties is exempt from tax at the company level. Instead, the dividends paid out to the shareholders are taxed. In order to qualify for REIT status, several important criteria have to be met. One of these criteria is a high pay-out ratio of net income, which guarantees the stable income return to investors and makes the combination of prime assets and REITs the ideal marriage to be embraced by income-seeking investors, including specialist real estate investors as well as general retail investors. The rapidly growing Defined Contribution (DC) pension plan market is a clear beneficiary of this structure.

The listed 'wrapper' also provides significant liquidity benefits to the otherwise illiquid real estate market (including for prime assets) and its investors. The possibility to increase and drop exposure to the real estate market at any given moment allows for unmatched ability to jump at opportunities as soon as they emerge.

On average, a significant proportion of the shares of listed property companies change hands every single year (based on FTSE EPRA/NAREIT Developed Europe Index). This is significantly higher than the liquidity of direct assets, where transactions take much longer to complete as well. On top of that, transaction costs are much lower when acquiring shares as compared to acquiring a direct property.

The quality of the underlying assets in combination with a relative high security of income reduces the risk of Interest Cover Ratio breaches, and as such are the key ingredients in successful real estate financing. New lenders tend only to select the best assets to enter this space in order to minimise risk. The ownership of high quality assets has allowed listed property companies to secure long-term capital from a variety of sources, including equity, corporate bonds and traditional bank debt, facilitating the diversification of their capital structure.

On the public debt market, bond issuances by listed property companies have increased in numbers and size over the past years. The vast majority of issuances have been oversubscribed multiple times and received attractive ratings from the agencies. Demand for this product from investors is strong, as is the long-term trust in the companies and management teams which issue them. Once again, the advantage of being backed by stable and secure income streams generated by high quality assets plays its hand.

As an example, Unibail-Rodamco, Europe's largest listed property company based in France, owning a large portfolio of retail assets across continental Europe, issued a 6-year EUR 750 million bond at a fixed coupon of 2.25 % which was four-times oversubscribed in 2012. At the same time, the 10-year French Government Bond yield stood at 2.28 %. Property companies and REITs' ability to raise debt from multiple sources at low interest rates throughout the cycle suggests inherently strong income fundamentals of the asset class.

3.5 Pension Funds and Long-Term Listed

A recent study into pension fund investment in real estate by Andonov, Eicholtz and Kok of Maastricht University[7] found that larger pension funds are more likely to invest in REITs, whereas smaller funds allocate more assets to fund-of-funds in direct real estate. Investing through fund-of-funds resulted in substantial underperformance compared to other investment approaches. They believe this is at least partly due to multiple layers of fees, but in addition, neither do the fund-of-funds managers seem to have good skills in selecting investment managers, since their gross benchmark-adjusted returns are significantly negative. Smaller pension funds do not seem to recognise that REITs provide exposure to property returns comparable to external managers that invest in direct real estate, and much better than fund-of-funds managers, but with much lower investment costs. Fund-of-funds in direct real estate performed worse than REIT mutual funds and funds investing in hedge funds.

The Andonov et al. paper has some implications for institutional investors investing in real estate. Pension funds should consider the full range of potential investment approaches and avoid extended investment chains. Particularly, smaller funds should consider using more REITs and should re-evaluate their extensive use of fund-of-funds to gain exposure to direct real estate. Smaller pension funds can also implement more passive strategies in REIT investments in order to remain cost-competitive with larger funds.

The long-term cash flows generated from property investment provide an important source of diversified income in the portfolios of European savers and pensioners. Property in its various forms represents EUR 715 billion – over 6 %[8] – of European pension funds and insurance companies' total investments. Direct ownership is their most common form of property investment, but indirect forms of investment – either through non-listed funds or listed property companies and REITs – are becomingly increasingly important. EPRA has work to do to educate this broad group of pension fund investors of the opportunities within the listed real estate sector.

3.6 Blending Direct and Listed: Relative Returns

For a long time now, we have seen the potential role of listed real estate in a blended portfolio. In practical terms, many of Europe's large pension funds such as APG & PGGM have taken this "blended" approach. The fundamental reasons for investing in real estate remian – exposure to quality assets, in quality locations operated and

[7] Value Added from Money Managers in Private Markets – An examination of Pension Fund Investments in Real Estate. Andonov, Eichholtz and Kok, June 2012.

[8] Value Added from Money Managers in Private Markets – An examination of Pension Fund Investments in Real Estate. Andonov, Eichholtz and Kok, June 2012. P. 30.

managed by professional management team with a clear strategy, but there are short-term performance differentials between listed and direct real estate offering numerous arbitrage opportunities for investors to exploit.

Investors have for a while now had many options in which to obtain real estate exposure. However, there are two specific catalysts which have stimulated a surge in interest in combining a more liquid, listed element with direct exposure. Firstly, the inevitable move from Defined Benefit to Defined Contribution Pensions schemes which have a greater liquidity requirement, and require a form of real estate allocation that can provide exposure to the asset class in a more easily tradeable form. Secondly, the redemption issues which many Property Funds faced has led to product developers seeking to capture fund flows by creating a more liquid product.

For example, perhaps the best way of explaining this is to examine the issue of blending real estate vehicles, or the four quadrants, is to select one country and blend just two options initially. We would also emphasis the key point that we are not suggesting that is necessary to combine all four quadrants across all regions to provide effective solutions to specific product liquidity requirements. At its simplest, listed exposure can be added to enhance liquidity of a product to meet investor requirements, or a trading strategy can be developed to arbitrage between the two areas. As a first step, we look at the UK direct market – represented by the IPD All Property Index and the UK listed market – represented by the FTSE EPRA/NAREIT UK Index.

The UK has the longest time series on both the direct and listed side. In addition, the data sets are widely regarded as most representative of each market. Figure 3.1 outlines the straightforward rolling 10-year performance of the UK direct and listed sector, unlagged[9] – both capital and total returns. This provides an initial overview of returns, unadjusted for either risk, management costs, or liquidity. The FTSE EPRA/NAREIT UK Index outperforms IPD UK for a significant period of the analysis – 2000–2010. On the other hand, IPD UK total return outperforms the FTSE EPRA/NAREIT UK total return. The listed sector trades within the boundaries of the direct benchmark.

3.7 Mixing the Blend: A Rules-Based Trading Strategy

While Fig. 3.1 shows the 'raw returns' historically and the stages of the cycle where listed and direct generate superior and inferior performance, the next step is to examine how a simple rules based strategy can arbitrage between the two markets.

[9] Yunus, Hansz and Kennedy (2010) – Short-run analyses also reveal significant causal relationships between private and public markets of all countries under consideration. As expected, it was found that price discovery occurred in the public real estate market in that it leads but is not led by its private real estate market counterpart.

Fig. 3.1 Annualised rolling 10 year performance (Source: IPD, EPRA)

At a strategic level, we use a simple portfolio comprising 50 % direct property and 50 % listed property as starting point. A series of thresholds is calculated around the long term average discount to NAV (−18 %) over the entire period.[10] This can of course be recalibrated throughout the course of the strategy.

An upper and lower threshold is set at two thirds of one standard deviation – approximately 9 %, either side of the long term average discount. The weighting to listed property is adjusted 150 bps for each month that listed property trades below (or above) the thresholds. For example, if the discount to NAV trades at 20 % for a cumulative 5 months period, 7.5 % extra is allocated to the listed allocation. Once discounts to NAV trades within the upper and lower band, weights revert to 50/50.[11]

By combining the direct and listed market over the period and employing the trading strategy,[12] it is possible to outperform both the direct and listed markets by some margin. In Fig. 3.2 we display the results of the strategy, clearly showing that the blended portfolio generates significantly better cumulative total returns than

[10] The long term average NAV discount figure includes data both pre and post REIT introductions in Europe. The current figure is 8 %.

[11] This analysis was first published in issue 34 of the *EPRA Newsletter* – May 2010. The article was written by Martin Allen, now at Deutsche Bank Property Research.

[12] This simulation did not allow for transaction costs, and full allowance for these would reduce the return premium generated. On the other hand, it should also be possible to come up with a more sophisticated algorithm that generates a higher return premium.

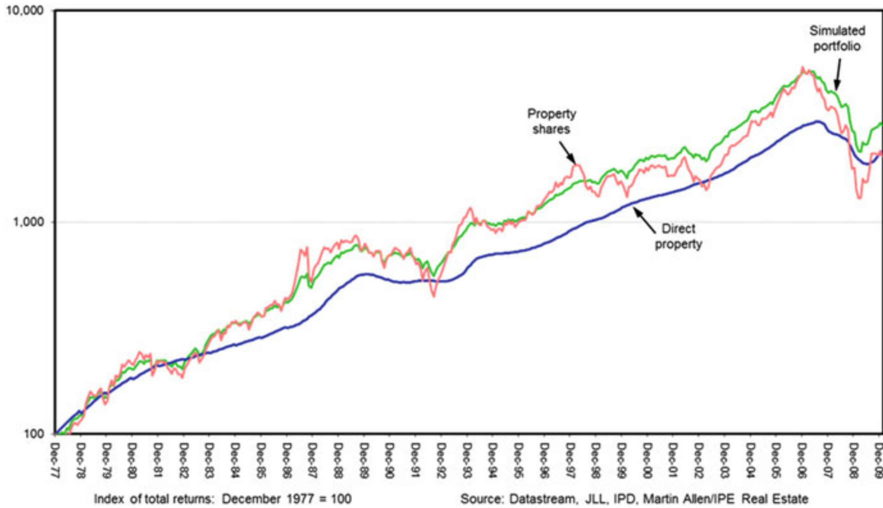

Fig. 3.2 Total returns from simulated portfolio compared with those from direct property and property shares

either direct property or property shares. This approach generates – an average annual return premium of over 100 basis points over that on direct property over this 32-year period.

As might be expected, the volatility of the returns generated by the simulated portfolio sits between that on direct property[13] and that on listed property.[14] Yunus, Hansz and Kennedy (2010) analysed the long-run relationships and short-run linkages between the private and listed real estate markets of Australia, Netherlands, United Kingdom and the United States. Results indicate the existence of long-run relationships between the public and private real estate markets of each of the countries under consideration.

We are now seeing products developed that seek to combine underlying real estate exposure with the investor requirement for liquidity. Given the importance of liquidity in DC schemes and their expected growth, we also believe that attention is firmly focussed on providing a (more) liquid real estate solution for this market, and that the listed sector will play an important role in providing this liquidity.

[13] Volatility using the valuation based methodology – we estimate that 'real volatility' is significantly higher when taking into account significant economic events and low transactions or lack of liquidity.

[14] The market movements experienced by stocks provide an opportunity to buy into property at levels that could never be achieved in the direct market.

3.8 Long-Term Outlook

Good quality real estate can offer long-term capital appreciation and offer attractive cash-flow or income when managed and structured well. So what are the dividend and yield characteristics of listed real estate, and REITs in particular, that give a clear picture of their income-distributing qualities?

The total return on an investment is a factor of both capital return and income returns. Different types of investors have different investment objectives and horizons to which they will try to match their allocations and investment decisions. For example, one investor might need to make regular distributions (e.g. pension funds), whereas others might be more focused on long-term wealth preservation (e.g. sovereign wealth funds).

Real estate offers a distinct set of characteristics when it comes to sourcing income and growing value, which can differ from other asset classes. In combination with the wide variety and heterogeneity of buildings, the right holding structure and management focus can provide attractive returns to investors in terms of income and capital.

3.9 Reliable Income

A distinguishing feature of real estate investment compared against other investments is the way in which income is sourced, generated and secured. Income return on real estate investments is predominately derived from regular rental cash-flow or income. Contractually agreed tenant obligations such as a minimum duration of the term, termination penalties, and rent review structures all lead to a higher level of visibility and predictability of (future) income. These unique features, not often seen in other industries on this scale, are natural to the real estate industry.

To maintain healthy cash flows, and ultimately to distribute income, a stable stream of rental income is required. In order to achieve this, the underlying assets must be of sufficient quality to attract and retain the required levels of rental income. On the whole, the majority of REIT portfolios are composed of good-quality assets in prime locations, you only need to look at the annual reports of largest companies in Europe – Unibail-Rodomco, Land Securities and British Land to see examples of the level of assets they own. It is these assets which attract the better quality (and as such more desirable) tenants, who are less likely to default on their rental payments, particularly when the broader economy is in decline.

Another aspect of REITs which is likely to provide a more stable stream of income is the relatively large size of REIT portfolios. This allows diversification in terms of both assets as well as tenants, and as such delivers more stable occupancy levels by avoiding dependency on a small number of income sources and assuring that lease expiry schedules are well spread over a long time period. These maturity

schedules are transparently featured in most Annual Reports as breakdowns of the percentage of total rental income which could potentially expire in the near future.

Within the real estate sector, the focus on cash flows has increased since the downturn due to the large amount of debt in the market. One of the largest expenses of a real estate investment vehicle will be the cost of debt. When interest rates are increasing, bearing in mind the capital intensive nature of the real estate sector and a relatively high average LTV, it is clear how rising interest costs can threaten otherwise healthy cash flows, dividend returns, and ultimately ICR covenants.

Covenant breaches did not occur however in the listed real estate sector (bar a few exceptions) where average LTV levels were lower (around 50 % in Europe) and cash flows were healthier. The listed real estate companies were able to refinance before debt maturities were reached, not only with equity raisings but also with the banks through renegotiations; meanwhile other vehicles struggled to get access to finance as the debt market virtually locked up.

REITs' ability to do this suggests inherently strong income fundamentals. This solid underpinning is also reflected through the high appetite for bond issues by property companies at relatively low yields, and with good ratings from the well-known rating agencies. The quality of the underlying assets in combination with a relative high security of income reduces the risk of ICR breaches, and as such are the key ingredients in successful real estate financing. Secondary, the vast majority of listed real estate companies' debt has fixed interest rates or is hedged otherwise. In combination with multiple financing options available to listed property companies, a well structured and balanced debt maturity schedule can be achieved. Companies provide a clear picture of interest payment obligations – as well as refinancing needs – to the end-investors by reporting their debt maturity schedules in their Annual Reports.

The income-producing capabilities of REITs will ultimately be reflected in the form of distributed dividends to the end-investor. The next paragraph will look at the dividend distribution levels of REITs.

3.10 Stable Dividends

As indicated previously, one of the key features of real estate investments is their ability to generate a steady stream of income. If managed and structured correctly, this in turn should lead to more stable income returns towards the end-investors. Figure 3.3 displays the long-term dividend growth of European property companies. Annual compounded growth since 1999 stands at 3.8 %, well above the annual compounded inflation of 2.0 % over the same period. As expected, dividend growth will be more volatile when compared to inflation due to lease renegotiations next to agreed annual increases. The data however suggest that over the long-term it will out-perform inflation, illustrating the ability of well managed property companies to offer stable growing income returns to investors.

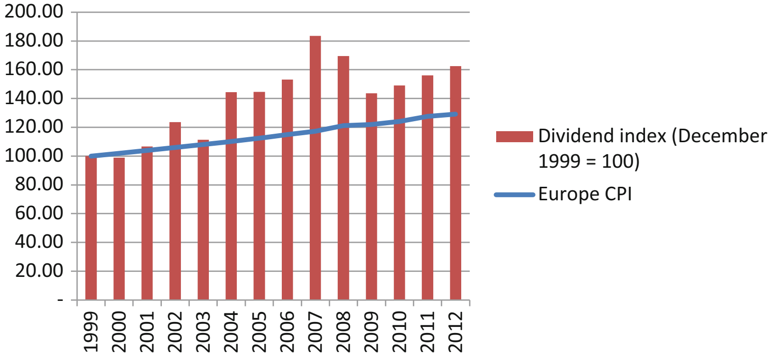

Fig. 3.3 A stable source of income

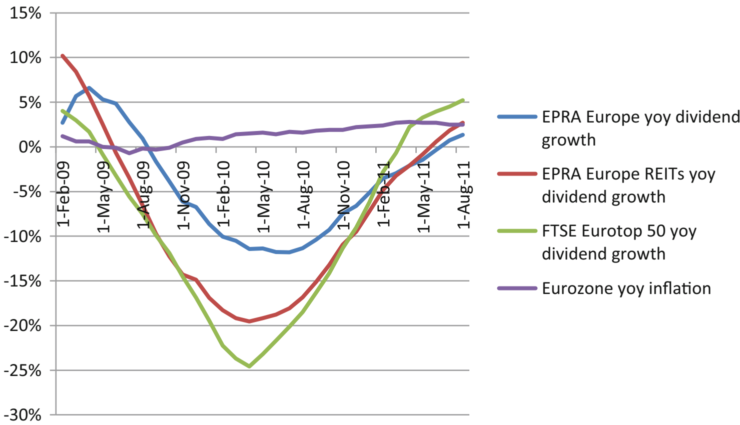

Fig. 3.4 YOY growth

Figure 3.4 illustrates the year-on-year dividend growth for listed property companies and REITs during the recent downturn. Although there was a clear drop in distributed income during 2009, the majority of companies were able to pay out dividends. This indicates the generally healthy cash flows of these companies. The year-on-year drop in dividends paid out by listed property companies bottomed out at around −20.0 %, whereas REITs bottomed out at −11.8 %. In comparison, general equities showed a maximum decline of 25.0 %. As the graph reveals, dividend distributions are growing again, showing the strong long-term income fundamentals of these companies.

In general, REITs pay out higher dividends as compared to non-REITs. Built into European REIT regimes is the obligation to distribute the vast majority (up to 100 %) of their earnings to their shareholders. This is in line with most REITs' income-oriented strategy of offering stable income growth through active asset

management and asset rotation. In some cases this may lower the organic growth potential of the companies as retained earnings are limited. Most companies however possess sufficient levels of firepower due to recent equity raisings, bond issues and available granted credit lines. Likewise, property acquisitions in exchange for shares can be a good way to expand their business. Besides, more countries are starting to allow stock-dividends which do allow REITs to retain earnings.

3.11 Attractive Yields

As indicated above, dividend payouts of REITs are relatively stable when compared to other asset classes. On top of that, REITs tend to trade at higher yields when compared to these other investments. REITs have consistently traded at higher dividend yields when compared to bonds and general equities.

Over a 5-year period, the average dividend yield of European REITs was 5.1 %, whereas European Governments Bonds yielded 3.4 % on average. General equities had an average yield of 4.1 % compared to an average annual inflation of the Eurozone of 1.9 %. Table 3.1[15] highlights the annualised total returns of the main asset classes over a variety of holding periods. Global listed stands out over significant number of periods.

It is however difficult for investors to get access to high quality assets at high yields. This could be seen during the latest downturn when the direct real estate market was basically locked, as the bid/ask spread was too high. Therefore, the number of transactions on the direct real estate market was very limited.

In a way, the expected amount of good-quality assets coming to the market at discounted prices due to distressed selling has not materialised. On the other hand, REITs did offer investors access to prime assets at attractive entry levels. A key feature of REITs in comparison to other real estate investment vehicles is their ability to change hands continuously, even during the downturn, providing exceptional and much desired high levels of liquidity within the real estate market. This meant that investors could obtain exposure to high quality real estate at discounts to NAV coupled with relatively high and attractive yields. These relatively high yields caught the attention of investors, in a low interest rate climate. Similarly, the lower economic growth outlook meant generalist investors re-focussed on income as well.

Real estate, because of its fundamental characteristics, can provide healthy income returns when structured and managed in the right way. REITs have the distinct characteristic that income return, i.e. dividends, are more predictable as compared to some other vehicles due to tenant agreements and standards of reporting. The prime quality assets they tend to own are most likely to offer long-term *reliable income* leading to healthy cash flows.

[15] Source: FTSE EPRA/NAREIT Global Real Estate Index, IPD Global, FTSE World & JP Morgan Global Bonds.

Table 3.1 Global Asset Classes – "Annualised performance over variety of holding periods"

Number of Years–Holding Periods	Listed Real Estate	Global Real Estate	Global Bonds	Globel Equities
1	16.7%		3.4%	12.8%
2	8.3%	4.8%	5.5%	5.9%
3	13.5%	6.3%	4.4%	9.7%
5	2.0%	1.0%	4.4%	2.6%
8	5.5%	5.3%	4.1%	5.3%
10	10.4%	6.0%	3.8%	8.7%
15	7.4%	7.0%	4.6%	4.4%
20	9.3%	7.7%	5.5%	7.3%

Combined with appropriate debt management, *stable dividends* should be achieved when managed correctly. On top of this, the liquid nature of REITs can offer access and exposure to quality real estate at *attractive yields* when other ways of achieving this are blocked. In combination with long-term capital appreciation out-performing inflation and growing dividend distribution, the REIT vehicle can contribute to the stability and return demands of a wide range of investors (Fig. 3.5).

3.12 Market and Research Developments

Investor attitudes have changed over time, for example and has there been relevant recent research looking at blending listed real estate into total portfolio allocations.[16] In addition, impacts of regulatory change at a national and EU level have changed the way we do business in many respects. One of the key developments in the period has been the increased urgency in examining the role of listed real estate securities within defined contribution pension schemes.

3.13 Real Asset Portfolios

In addition to listed real estate as part of the real estate allocation there has been a trend towards looking at real estate as part of a grouping of 'real assets' for pension funds purposes. Russell Investments[17] produced a paper which looked at "real assets for the defined contribution menu", which explored the impact of adding assets such as commodities, real estate and listed infrastructure as a way to help participants achieve their long-term goals. Their conclusions were that target date

[16] "The use of listed real estate securities in asset management" EPRA publication by Alex Moss and Andrew Baum, April 2013.

[17] "Real Assets for the defined contribution menu" Russell Investments by Joshua Cohen and Mark Teborek.

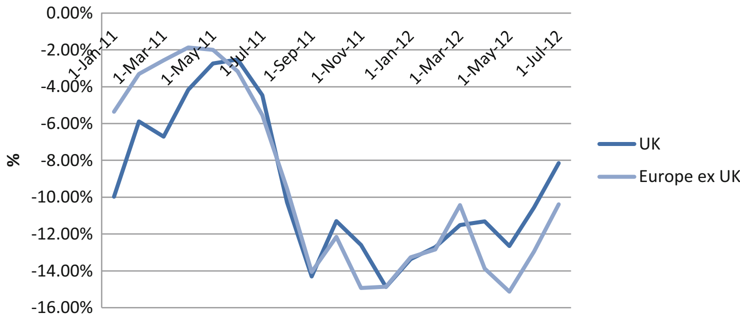

Fig. 3.5 Implied capital value changes (Source: EPRA, Bloomberg, Consilia Capital)

funds should include an allocation to real assets in the early working years, and that real assets provide exposure to compelling long-term global trends.

3.14 Summary

It is clear that listed real estate and REITs are a fundamental part of any serious real estate allocation. We can view this in both practical and theoretical terms. At a practical level, the large Dutch pension funds have been using listed real estate and REITs as a major part of their overall real estate allocation, which in itself trends above the global average of approximately 8 %. APG, the largest Dutch pension fund and the second largest in Europe has held as much as 15 % in real estate, with approximately 50 % of that held in listed real estate or REITs. They have gone on record as stating that their investment strategy 'looks through' investment vehicles and focuses on the asset exposure, quality of management and strategy.

The academic theory makes a strong case to include listed real estate or REITs: the examination of the benefits of diversifaction, risk-adjusted total returns, fees, inflation hedging capabilities, liquidity and transparency all point in a favourable direction. We strongly believe that this environment sets the conditions for expansion and growth in the European listed real estate market over the medium to long-term.

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Chapter 4
The Role of REITs in Strategic Investment Portfolios

Steven A. Wechsler

4.1 Introduction

Over the past 50 years, Real Estate Investment Trusts (REITs) have become an important segment of the U.S. economy and investment markets. The positive experience of the U.S. REIT industry has led more than 25 other countries to adopt the REIT model of investing in commercial real estate.

In this chapter, we explore key investment attributes of stock-exchange listed REITs and the role of publicly traded real estate securities in enhancing long-term investment returns and managing risk for institutional and individual investors. In particular, we focus on how listed REITs mesh with the objectives of many investors seeking diversification, dividend income, inflation protection, and long-term total return performance, as well as the benefits of market liquidity and transparent commercial real estate ownership through REITs, both in the U.S. and globally.

4.2 A Meaningful Economic Force

REITs today play a meaningful role in the U.S. economy, real estate sector and capital markets. At the end of 2012, U.S. REITs owned about $1 trillion in commercial real estate assets, and they directly and indirectly supported some one million U.S. jobs.

Equity REITs are companies that own and generally operate a range of commercial real estate property portfolios, including retail centers, office buildings, apartments, healthcare facilities, hotels and resorts, warehouses, industrial

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_4, © Springer-Verlag Berlin Heidelberg 2013

production sites and data centers, among others, often spread across a number of cities and geographies. Equity REITs generate cash mainly by collecting rents from the tenants of the properties they own and manage, and they are required by law to distribute at least 90 % of their taxable income annually as dividends to their shareholders.

Equity REITs constitute about 90 % of publicly traded U.S. REITs by market capitalization, while U.S. mortgage REITs, which invest in residential and commercial real estate mortgages and mortgage-backed securities, represent the other 10 %. The stock market value of the nearly 200 publicly traded U.S. REIT companies rose to $603 billion at the end of 2012, and the FTSE NAREIT All REIT Index delivered a total return of 20.14 % for the year. REITs distributed $29 billion in dividends to shareholders in 2012, representing a dividend yield of 4.38 % on average for the companies included in the FTSE NAREIT All REIT Index.

The long-term financial performance of REITs has also been strong – they have provided competitive returns for almost every period in the last 40 years. Let's take two examples. An investment of $10,000 in the FTSE NAREIT All Equity REITs Index from the beginning of the "modern" REIT era in 1990–2012 would have grown to $109,152 (including share price appreciation plus dividends), nearly double the $66,009 to which the same $10,000 would have grown had it been invested in the S&P 500 Index of large-cap US stocks. For the 5 years from 2008 to 2012, U.S. equity REITs delivered an average annual total return of 9.24 % compared to 4.53 % for the S&P 500 Index, demonstrating the resilience of REITs in recovering from sharp declines in equity values during the 2008–2009 global financial market crisis.

4.3 REIT Structure and History

In order for a company to qualify as a REIT in the U.S., it must comply with certain ground rules specified in the Internal Revenue Code. These include investing at least 75 % of total assets in real estate; deriving at least 75 % of gross income as rents from real property or interest from mortgages on real property; and distributing annually at least 90 % of taxable income to shareholders in the form of dividends.

The U.S. Congress passed legislation paving the way for the creation of REITs in 1960, as a way to make investment in large-scale, income-producing real estate accessible to all investors. Previously, only large institutions and wealthy individuals had the financial capability to own a share of commercial real estate.

In the early years, the U.S. REIT industry was dominated by mortgage REITs. The market's interest in equity REITs was limited until the passage of the Tax Reform Act of 1986, which lifted restrictions on REITs' ability to both own and manage their properties as fully vertically integrated companies. This helped set the stage for the modern REIT era, sparked by a wave of equity REIT IPOs in the mid-1990s following the real estate depression of the late 1980s and early 1990s.

The importance of REITs to the U.S. economy and capital markets was formally recognized in 2001, when Standard & Poor's admitted REITs to its primary benchmarks of U.S. equities, including the S&P 500 Index.

4.4 REIT Alignment with Investor Objectives

REITs are widely owned by U.S. investors. At the end of 2012, direct ownership by individual investors constituted 18 % of U.S. REIT stocks; mutual funds and exchange-traded funds often used by individual investors owned 38 % and 8 % respectively; and institutional investor and pension fund ownership totaled 26 %. REIT managements and other investors account for the remaining 10 %.

Commercial real estate, including REITs, has been widely recognized by leading pension investment professionals, academics and economists as a core asset in a diversified and well-balanced strategic investment portfolio. Decades of market data and portfolio models demonstrate that portfolios with an allocation to REITs and real estate investment have better long-term returns and lower risk of losses and volatility than portfolios without REIT exposure. Major institutional investors as well as corporate and public employee retirement systems – the bulk of the traditional defined benefit pension fund market – commonly allocate a portion of their portfolios to real estate and REITs.

More recently, that message has spread to a broader audience of individual investors who must increasingly plan for their retirement years on their own or with the help of a financial advisor. A survey of U.S. financial advisors commissioned by the National Association of Real Estate Investment Trusts (NAREIT) in 2011 found that a majority (57 %) recommended REITs to their clients. In addition to buying and selling shares of REITs on U.S. stock exchanges, retail investors can access some 300 mutual funds and exchange traded funds dedicated to REITs and real estate securities.

This includes the 50 million Americans who can now invest in a REIT fund option through their employer-sponsored 401(k) defined contribution retirement savings plans. Many of these employees increasingly choose to invest their 401 (k) portfolios in a target date fund where asset allocations are determined by professional managers and regularly rebalanced based on the remaining number of years to retirement. Today, 75 % of target date funds now include REIT exposure.

In the following section, we examine four key investment attributes of REITs in more detail, including diversification, dividend income, inflation protection, and long-term total return performance. In addition, we review other portfolio benefits including market liquidity and transparency of publicly traded REITs, and global developments as more countries and investors embrace REITs.

4.5 Diversification

REITs provide important diversification benefits for investors due to their relatively low correlation to other assets, including other stocks and bonds. Diversification with REITs can help investors to reduce the risk of overall portfolio losses in volatile markets and increase the potential for long-term gains in value.

True diversification aims to mitigate portfolio volatility, the risk that investors will see strong up-and-down cycles in the value of their holdings. Sensible investors may seek to reduce that volatility by diversifying, for instance by splitting the portfolio between small-cap growth stocks and large-cap value stocks. The problem is that dividing a portfolio between different parts of the same asset class does not achieve the real benefit of diversification.

The most common way of overcoming the diversification challenge is therefore to look at the correlation between asset classes. REITs, for example, have less of a tendency to move in tandem with other equities when stocks go up or down. Over the 20-year period from the end of 1992 to year-end 2012, REITs showed low to moderate correlation with large-cap, small-cap and international stocks, as well as U.S. and international bonds. Large-cap and small-cap equities were 80 % correlated, while large-cap equities and equity REITs were only 56 % correlated. So, diversifying a large-cap portfolio with REITs is more effective than diversifying it with small-cap stocks.

A key portfolio benefit of diversification is the potential to increase long-term returns without taking on additional risk. Figure 4.1 illustrates how reallocating 10 % of a diversified 60 % stock/40 % bond portfolio to equity REITs would have improved annual returns by 0.4 % per year on average from 1992 to 2012. That could add up to thousands of dollars of additional gains over 20 years without any additional risk.

4.6 Dividend Income

The high dividend payout requirement for REITs means that a larger share of REIT investment returns comes from dividends when compared with other stocks. For this reason, many financial advisors consider REITs to be well suited for investors seeking income as well as for long-term investors seeking both income plus capital appreciation.

As discussed, equity REITs generate a consistent stream of cash mainly by collecting rents from the multiple tenants occupying the properties they own and manage, and by law, they must pay out at least 90 % of their taxable income annually as dividends to shareholders. REIT dividend yields have historically been higher than the average yield of the S&P 500 Index. In fact, over the long-term, nearly two thirds of REIT total returns have come from dividends.

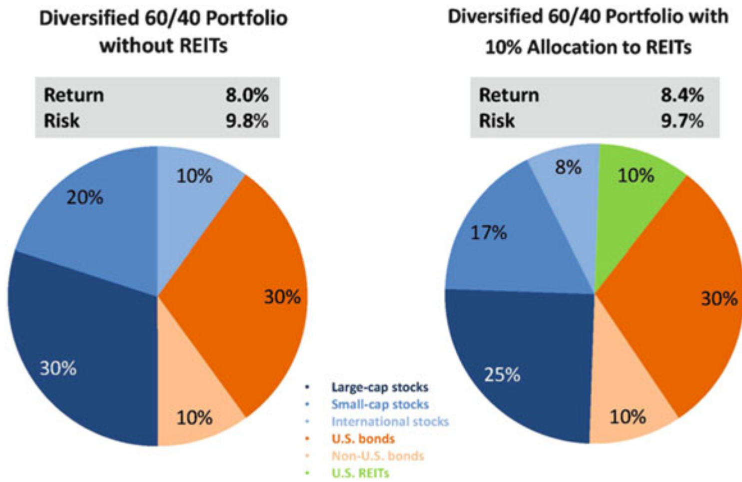

Fig. 4.1 Diversification with equity REITs – the potential to increase returns without increasing risk (Source: NAREIT)

For investors with a longer time horizon to retirement, dividends can be reinvested to generate future returns, while in later years they can provide a steady income stream to help meet expenses in retirement. An original $10,000 investment in REITs at the end of 1991 would have grown to $82,928 by the end of 2012 if dividends had been reinvested. If dividends had been taken as income, the original $10,000 investment would have paid out $18,661 in dividends and delivered another $26,435 in growth, for a total value of $45,096 (Fig. 4.2).

4.7 Inflation Protection

Demographics present a huge dilemma for retirement systems, pension funds and individual investors. People are simply living longer, and a key concern for many investors is how to ensure enough income for a retirement period that could last for decades, or to match long-term pension asset growth with future liabilities.

Even in a low-inflation environment, the cumulative effects of inflation over long periods can erode portfolio values. The dilemma for retirees is that it can be tough to stay ahead of inflation with fixed income securities, while equities – the traditional inflation hedge – are usually trimmed back to minimize investment risk. This is especially true in a period when interest rates are historically low.

REITs provide, in part, a natural hedge against inflation in ways that match up well with investors' needs. Commercial real estate rents and values tend to increase when prices do, which supports REIT dividend growth, providing retirement investors with reliable income even during inflationary periods.

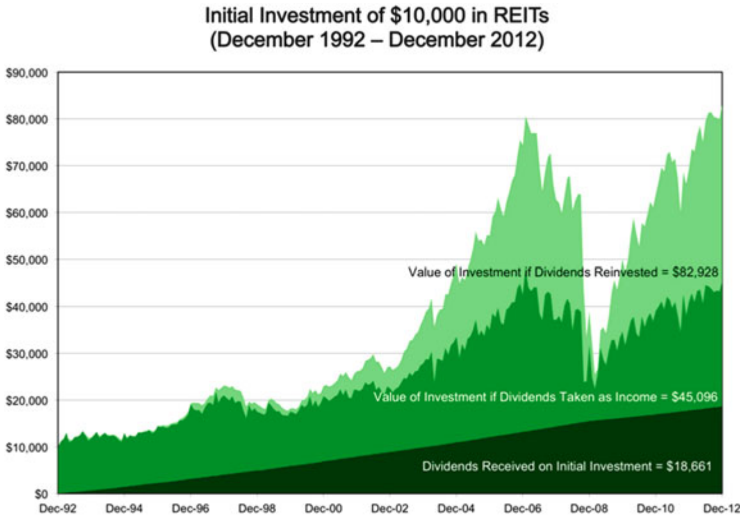

Fig. 4.2 REIT dividends and investment returns (Source: NAREIT)

A practical way of measuring the inflation protection provided by REIT dividends is to directly compare REIT dividend growth with inflation. In all but two of the last 20 years, the annual growth rate of U.S. REITs' dividends has outpaced inflation as measured by the Consumer Price Index (Fig. 4.3).

4.8 Total Return Performance

Publicly listed U.S. equity REITs have provided competitive total returns compared to other assets for almost every period in the last 40 years through their consistently strong dividend payouts and long-term capital appreciation. U.S. REIT total return performance over the past 20 years has outstripped the performance of the S&P 500 Index, the Barclays U.S. Aggregate Bond Index and other major equity and fixed income indices – as well as the rate of inflation (Fig. 4.4).

This pattern of outperformance also holds up globally over most investment horizons. It is notable that both the FTSE NAREIT U.S. All Equity REIT Index and the FTSE EPRA/NAREIT Global REITs and Real Estate Index have delivered total returns that were superior to those of their respective broader equity benchmarks, the U.S. S&P 500 Index and the international MSCI EAFE Index, for almost every period in the past 20 years – or even 40 years in the case of U.S. REITs for which a longer investment record is available (Table 4.1).

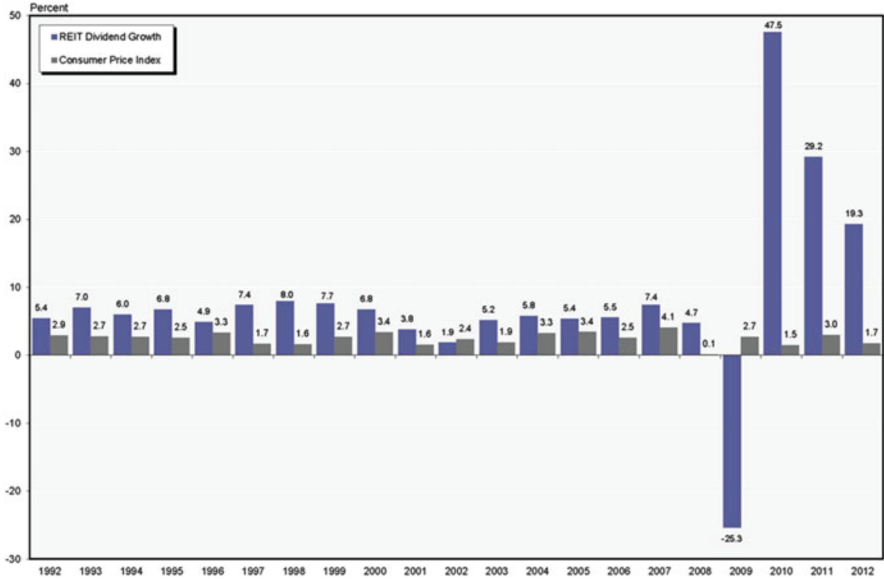

Fig. 4.3 REIT dividend growth versus consumer price inflation (Source: NAREIT, SNL Financial)

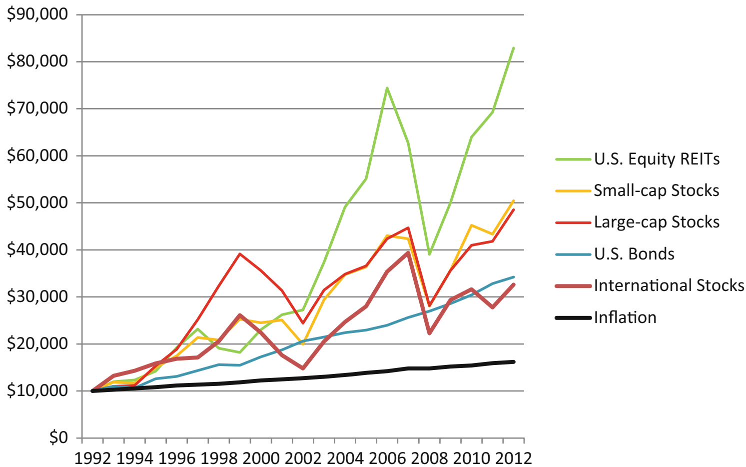

Fig. 4.4 REIT total returns compared to other assets 1992–2012 (Source: Large-cap stocks – Standard & Poor's 500®; Small-cap stocks – Russell 2000; International stocks – Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index; U.S. bonds – Barclays U.S. Aggregate Bond Index; Non-U.S. bonds – Citigroup Non-USD World GBI; U.S. REITs – FTSE NAREIT All Equity REIT Index, Inflation – Consumer Price Index)

Table 4.1 U.S. and global REITs competitive long-term performance

	FTSE NAREIT U.S. Equity REITs	FTSE EPRA/NAREIT Global REITs and Real Estate	S&P 500	MSCI EAFE	Barclays Capital U.S. Aggregate Bond	Barclays Capital Global Aggregate Bond
1-Year	19.70	28.65	16.00	17.32	4.22	4.32
3-Year	18.37	13.42	10.87	3.56	6.19	5.17
5-Year	5.74	1.07	1.66	-3.69	5.95	5.44
10-Year	11.78	12.08	7.10	8.21	5.18	5.98
15-Year	8.88	8.75	4.47	4.38	5.96	5.87
20-Year	11.16	10.65	8.22	6.09	6.34	6.33
25-Year	10.97	NA	9.71	5.12	7.24	NA
30-Year	11.89	NA	10.81	9.51	8.10	NA
35-Year	12.91	NA	11.27	9.62	8.14	NA
40-Year	12.21	NA	9.76	8.56	NA	NA

Sources: NAREIT analysis of data from IDC accessed through FactSet

Data as of December 31, 2012

4.9 Other Portfolio Benefits: Liquidity and Transparency

Listed REITs and real estate equities have become the most efficient way for individual investors and professional investment managers to gain exposure to commercial real estate; an effective way for professional investment managers to manage their investment exposure to real estate; and a meaningful way to reduce the risk of illiquidity.

For many years, investors considered real estate the ultimate immovable, illiquid asset. However, the liquidity of publicly traded REITs listed on major stock exchanges makes real estate investing fast, easy and efficient. REITs provide market transparency for investors with real-time pricing and valuations. As with other stocks, investors can get in and out of their investments to optimize their exposure to REITs and real estate. Listed REITs in the U.S. are also registered and regulated by the Securities and Exchange Commission ensuring adherence to SEC standards of corporate governance, financial reporting and information disclosure. As the investor base for listed real estate has grown over the past decades, average daily dollar trading volume in the U.S. has soared – from about $100 million in 1994 to more than $ 4.1 billion in 2012.

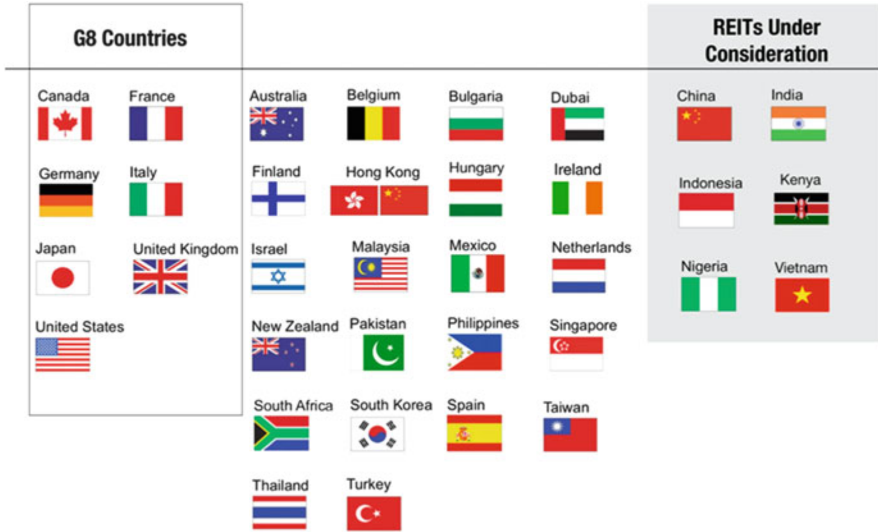

Fig. 4.5 REITs around the globe – 2013 (Source: NAREIT)

4.10 REITs as a Global Brand

The global opportunity in REITs will continue to grow as REIT legislation is adopted in more countries around the world. Currently, more than 25 countries (Fig. 4.5) predominantly in Europe and Asia-Pacific, have adopted REIT legislation, and other nations including China and India are actively considering REITs.

As a result, REITs around the world are beginning to look and function very much the same. The growing global uniformity and resulting acceptance of REITs is driving investment institutions to add commercial real estate allocations through REIT investment to their portfolios. In addition, more and more investment companies are adding actively-managed and indexed REIT funds as well as exchange-traded funds to their product lineups, including investment products linked to one of several global indexes.

The global growth of REITs will create the basis for new financial products for institutional investors, wealth managers and other financial services providers around the world. The FTSE EPRA/NAREIT Global Real Estate Index series created by NAREIT and its partners, the FTSE Group and the European Public Real Estate Association, provides benchmarks for a new generation of investment products aimed at improving and enhancing real estate investment opportunities around the world. The global index at year-end 2012 encompassed 423 companies representing $1.5 trillion in equity market capitalization, and investors can also choose from regional sub-indexes.

The globalization of real estate allocations could accelerate as the REIT approach to real estate investment continues to spread. To support that growth,

NAREIT is continuing to work with policy-makers, regulators and executives around the world to achieve a harmonization of REIT rules that will foster the growth of a global REIT "brand" and encourage cross-border investment.

4.11 Conclusions

REITs are a major force in commercial real estate markets, in the economy and in our capital markets. The REIT approach to real estate investment has a long and sustained track record of success and shareholder value creation.

The benefits of REITs have been recognized by policymakers and investors alike in the U.S. and increasingly around the world. Market data demonstrate that a diversified portfolio that includes REITs can reduce the risk of volatility and losses and enhance long-term returns. In addition to diversification, other investment attributes of REITs, including dividend income, inflation protection and long-term total return performance, are well suited to the priorities of many investors.

Part II
The Experience of Mature REIT Markets

Chapter 5
The Development and Maturing of the US REIT Sector

Simon Stevenson

5.1 Introduction

The US Real Estate Investment Trust (REIT) market is the oldest and most established REIT market in the world. While REITs were formally created by Congress in 1960 their history actually goes back to the nineteenth century and Massachusetts. Massachusetts State law in the mid nineteenth century effectively precluded the use of a corporate structure in real estate investment. This was because corporations were prohibited from owning real estate if it was not an integral component of the business of the firm. In response to these state laws what became known as the Massachusetts Trust was created to provide an effective vehicle through which real estate investment activity could be carried out. These trusts, as would REITs a century later, provided a tax transparent investment vehicle. The tax status of these structures was however removed in 1935 by the US Supreme Court. Ironically, only 5 years later the 1940 Investment Company Act introduced similar tax transparency vehicles for equity investment in the form of mutual funds. However, it took a further 20 years of lobbying on the part of the real estate industry before a similar vehicle was introduced in the context of the real estate market.

The restrictions under which US REITs operate have changed only slightly over the last half century. The two main restrictions are that 75 % of assets and income must be derived from real estate activities and that the REIT is legally obliged to pay out 90 % of its taxable income in dividends. Other restrictions relate to the ownership structure of the REIT. At present no more than 50 % of the REIT shares can be held directly or indirectly by any group of five or fewer investors. As long as these restrictions are complied with then the REIT may deduct dividends from its corporation tax liability. US REITs do however differ from those in most other

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_5, © Springer-Verlag Berlin Heidelberg 2013

jurisdictions in that they are not limited to the private real estate market, rather they can also invest in real estate based debt. In any analysis of the US sector this distinction is important due to the quite different characteristics of the two main sectors. Mortgage REITs frequently move in line with bank stocks due to their underlying asset base. The distinction is also important in that while Equity REITs dominate the listed REIT sector today both in terms of the number and market capitalisation, this was not true in the 1960s and 1970s when they generally made up less than 50 % of the sectors market capitalisation.

An ongoing issue with the US REIT sector is that while legislation was introduced in 1960, with the first REIT being introduced the following year, it is really only since the early 1990s that the market has developed and grown both in terms of trading volumes and also market capitalisation. Two key problems limited the development of the sector during the first 20 years of the sector. REITs were constrained as they were only permitted to own real estate and could not operate or manage it. This meant that REITs were required to find third parties and that the trusts did not have direct control of the portfolio investment decisions undertaken, with the possibility of agency conflicts arising. Furthermore, provisions of the US tax code also distorted the real estate market by making real estate investment tax shelter orientated. A taxpayer using high debt levels and aggressive depression schedules could take interest and depreciation deductions that significantly reduced their taxable income. In many cases these deductions led to ‘paper losses’ that were used to shelter a taxpayer’s other income. As Congress designed REITs specifically to create a taxable income on a regular basis the structure did not permit REITs to pass losses through to shareholders. These two issues were effectively addressed by the 1986 Tax Reform Act. This piece of legislation changed the real estate investment landscape in two respects. It reduced the potential for real estate investment to generate tax shelter opportunities by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of ‘passive losses’. Furthermore, the legislation permitted REITs to operate and manage most types of income producing commercial properties.

However, despite the changes in the tax code, the late 1980s did not see a major expansion in the REIT sector. In part this was due to the fact that strong market conditions financing and investment from domestic and international institutions remained strong. Therefore, the need for new sources of capital in the form of REITs remained subdued. However, in common with a number of real estate markets across the globe many US markets witnessed severe downturns in the early 1990s with falls in real estate values of over 30 % observed in some markets. While in common with other markets this downturn was due in part to over-supply in many markets and worsening economic conditions impacting occupational demand, the US also had the problem of the Savings & Loan crisis. The combination of poor underlying market conditions together with the drying up of traditional sources of capital meant that many participants in the US real estate market were forced to look for alternatives.

The other major factor behind the growth of US REITs in the early 1990s was the development of the UPREIT (Umbrella Partnership REIT) structure. The UPREIT

structure effectively comprises of two vehicles; a REIT and an operating partnership. The rationale behind this structure is that it allows those investors who properties are being placed into the REIT, to obtain units in the operating partnership on a tax deferred basis. Only if the units in the partnership are swapped for REIT shares are they subject to tax. Therefore, existing investors can effectively defer capital gains tax liabilities. The actual underlying properties are owned by the operating partnership, in which the REIT owns units. Therefore, the REIT only indirectly owns the properties in its portfolio.

The Omnibus Budget Reconciliation Act 1993 also played a major role in the growth of the sector and increased the attractiveness of the sector to Pension Funds. The legislation allowed greater flexibility concerning the 5/50 ownership rule. As long as the REIT had a minimum of 100 shareholders then pension funds could treat each contributor to the fund as an individual investor in the REIT. Two further key changes occurred in the late 1990s with the REIT Simplification Act of 1997 and the 1999 REIT Modernisation Act. The first piece of legislation contained a number of changes to the rules regulating REITs, including the elimination of the rule that required REITs not to earn more than 30 % of gross income on the sale of assets not held as long-term investments. The major change that occurred with the 1999 Act was that the minimum dividend payout was reduced from 95 % to 90 %. This came into effect in 2001.

The growth in the sector following the early 1990s crash and the introduction of the UPREIT structure can be can be clearly seen in Figs. 5.1, 5.2, 5.3, and 5.4. Figure 5.1 details the number of REIT Initial Public Offerings (IPOs). In 1993 and 1994 alone 95 REIT IPOs took place. As Fig. 5.2 illustrates the majority of these IPOs were Equity REITs, resulting in a structural shift in the sector, with the majority of listed REITs now being Equity vehicles not Mortgage or Hybrid REITs. This dramatic increase in the number of listed REITs alone accounted for much of the increase in the overall market capitalisation of the sector shown in Fig. 5.3, which also demonstrates how small the sector was prior to the early 1990s and Fig. 5.4 demonstrates the changing composition of the sector in percentage terms. This is a highly important factor in the analysis of the US REIT sector and will be returned to later in the chapter. The reduction in the number of listed REITs in recent years is primarily due to consolidation within the industry, with a large amount of M&A activity taking place.

5.2 Investment Dynamics

The performance of the US REIT sector in recent years has attracted a large amount of attention. As can be seen from Table 5.1 REITs substantially out-performed the overall Equity market from 2000 through to the onset of the financial crisis, with an average quarterly return in excess of 5 % in comparison to 0.63 %, in addition to a lower risk measure. However, as will be addressed in the following section, there are a number of factors that occurred during this specific period that affected these

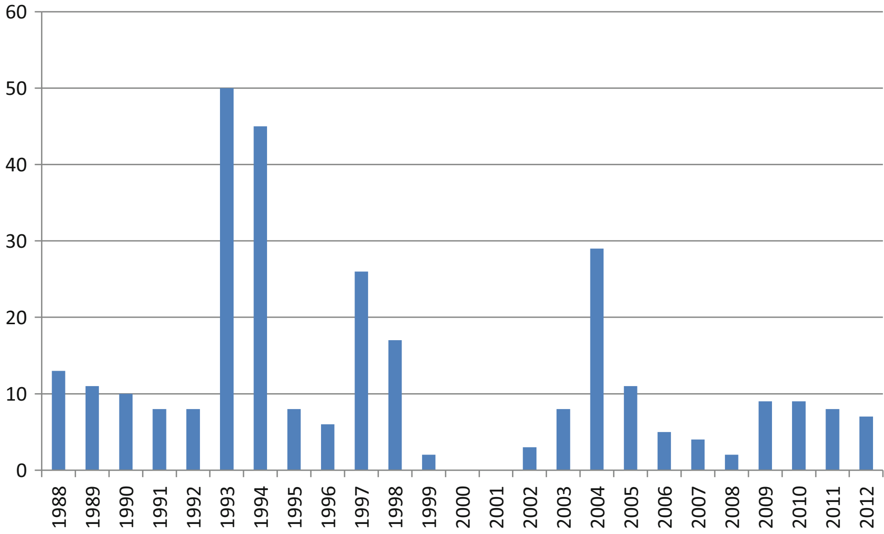

Fig. 5.1 Number of US REIT IPOs

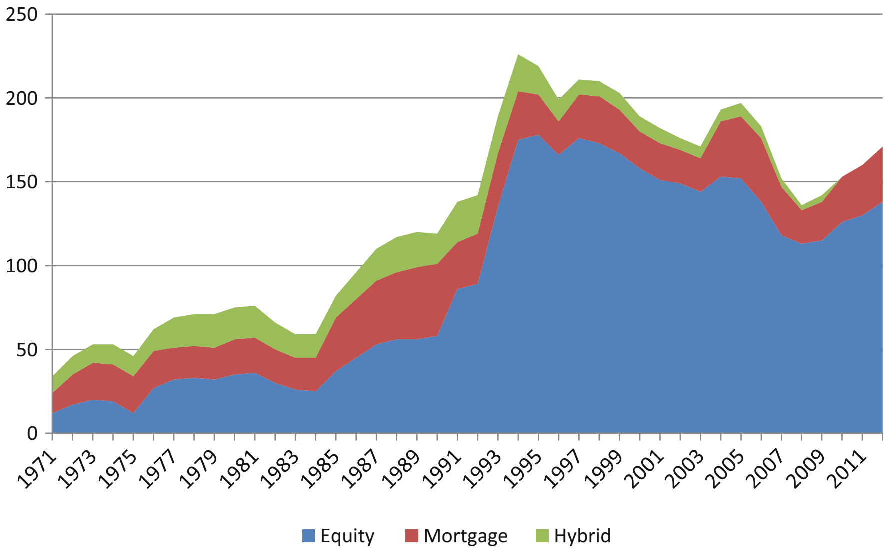

Fig. 5.2 Number of US traded REITs

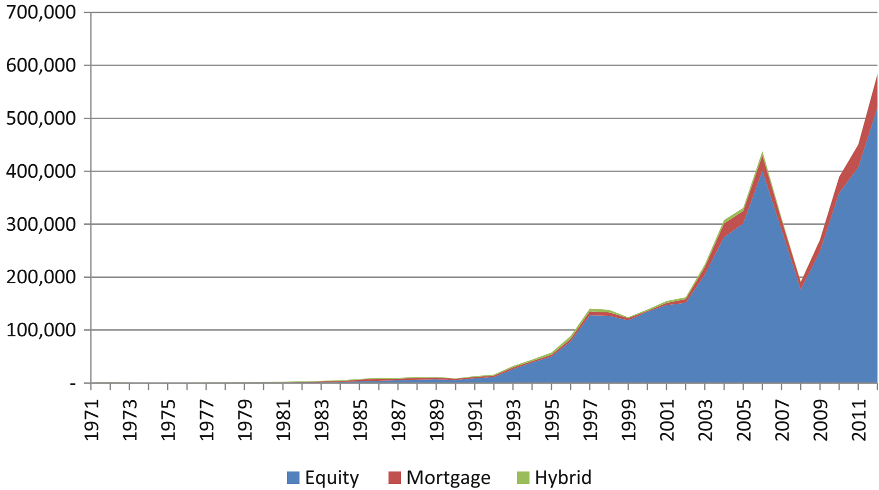

Fig. 5.3 Market capitalisation of US REIT sector (US $m)

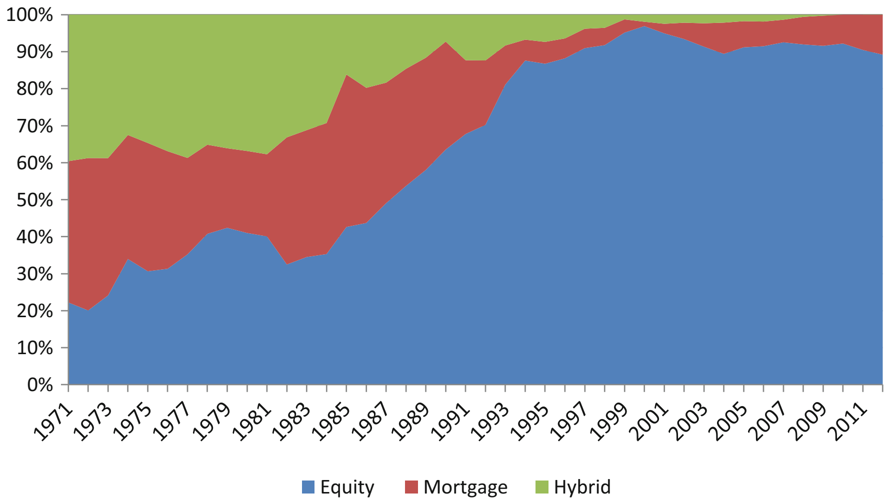

Fig. 5.4 Percentage composition of US traded REITs by market capitalisation

figures. In addition, as can be seen from Table 5.1 the relative performance and the correlations between the three assets are not stable. To a large extent some of these shifts are due to the structural changes that have occurred within the REIT sector.

One of the main arguments in relation to REITs relates to their perceived diversification benefits. These benefits can be viewed from both real estate and capital market portfolio perspectives. A number of recent papers have shown that

Table 5.1 REIT performance

	Panel A: Risk and return			
	REITs	Stocks	Bonds	Private real estate
1980–1990				
Average return	6.29 %	4.48 %	3.38 %	2.78 %
Standard deviation	12.95 %	8.22 %	8.17 %	1.13 %
1990–2000				
Average return	2.76 %	4.84 %	2.18 %	1.42 %
Standard deviation	11.00 %	7.49 %	4.63 %	1.97 %
2000–2006				
Average return	5.29 %	0.63 %	2.14 %	2.94 %
Standard deviation	6.29 %	8.02 %	4.41 %	1.21 %
2007–2012				
Average return	−0.33 %	−0.33 %	2.55 %	−0.09 %
Standard deviation	18.70 %	10.35 %	6.78 %	4.24 %

	Panel B: Correlations		
	ρ REITs-stocks	ρ REITs-bond	ρ REITs-real estate
1980–2012	0.6985	0.1173	0.1133

REITs still provide sufficient diversification opportunities to mixed-asset portfolios that already contain an allocation in the private real estate market. Feldman (2003) finds that both public and private real estate have a place in a mixed-asset framework. Mueller and Mueller (2003) extend the analysis of Feldman (2003) to examine the impact of private and public real estate on the mixed-asset portfolio for various holding periods for the last 5–25 years up to 2002. The authors find that for the full sample period the inclusion of private real estate as measured by the NCREIF index, either appraisal based or de-smoothed, led to improvements in the performance of the efficient frontier at the lower risk levels, while REITs provided improvements to the entire frontier.

These are findings supported by those of Lee and Stevenson (2005), who examine the consistency of REITs within a mixed-asset framework. The results show that the benefits that REITs provide tend to increase as the investment horizon is extended, indicating that REITs may be more attractive to investors with longer holding periods. This increased attractiveness over longer holding periods may also be due to the linkages between REITs and the private real estate market increasing with the use of longer horizons. Therefore, over these longer investment periods, REITs may be displaying more of the diversification qualities of the direct market, further enhancing their diversification qualities. In addition, the diversification benefits of REITs appear to come from both its return enhancement and risk reduction benefits. In the low risk/return portfolios the allocations obtained in the return enhancement tests are larger than those when examining risk reduction. This trend however, reverses as one along the efficient frontier. This would indicate that as an investor moves along the frontier the rationale behind the inclusion of REITs alters, with increasing emphasis being placed on the assets risk reduction qualities

rather than its return enhancing capabilities. This trend is in part probably due to the low correlations relative to both asset classes. While REITs have lower correlations with the general equity indices examined, this is not at the expense of increased coefficients with regard to bonds. REITs therefore effectively sit between the broad equity and fixed-income sectors, with both risk and return measures in-between stocks and bonds. This enables REITs to appear return enhancing to bonds, without the same degree of increased risk that would be seen with stocks, and also risk reducing to stocks. In the case of stocks they provide diversification benefits due to their relative low risk measures and correlation coefficients, without the same level of return sacrifice that would occur if funds were switched into the fixed-income market. It can be argued that perhaps much of these benefits result from the mandatory high dividend payout that gives REITs fixed-income like characteristics.

Any analysis of performance in the US REIT sector has to take into account the structural changes in the market. The combination of those factors detailed in the previous section concerning the 1986 Tax Reform Act, the impact of the early 1990s cycle and the introduction of the UPREIT heralded a new era for the REIT sector. Many empirical studies have shown that the characteristics of the sector changed quite substantially in subsequent years. For example, Glascock et al. (2000) found that that from 1972 to 1991, REITs were segmented from the broader equity market, but were integrated from 1992. In addition, the authors find that prior to 1992 the returns of both Equity and Mortgage REITs behaved in a fashion more similar to the fixed income market, but that the Equity REIT sector acted more like stocks post 1992. Clayton and MacKinnon (2001) note that the correlation of REIT returns with stocks and bonds underwent a structural change in the 1990s, with the sensitivity of REIT returns to large-cap stocks declining over time, while that with small-cap stocks increased. In addition, recent papers such as Cotter and Stevenson (2006) and Case et al. (2012) have highlighted the general instability and time-varying nature in the relationship between REITs and the broader equity markets.

5.3 Market Maturity

While REITs were established in 1960 the main growth has been since the early to mid-1990s. Not only has this obviously affected the size of the sector but it has also led to changes in the investment dynamics of REITs. Clayton and MacKinnon (2001) argue that their finding relating to the changing relationships with the broader equity markets can at least in part be attributed to the growing maturity of the REIT sector. This growing maturity can be illustrated by the level of trading in REIT shares. In 1993 SNL Financial estimates that the average daily aggregate volume in the sector was three million shares. By 2005 this figure had increased to over 40 million. A well observed phenomenon in the financial economic literature is that volume is a key determinant of volatility. As can be seen from Fig. 5.5 daily volatility in Equity REITs has increased substantially over the last decade. Of

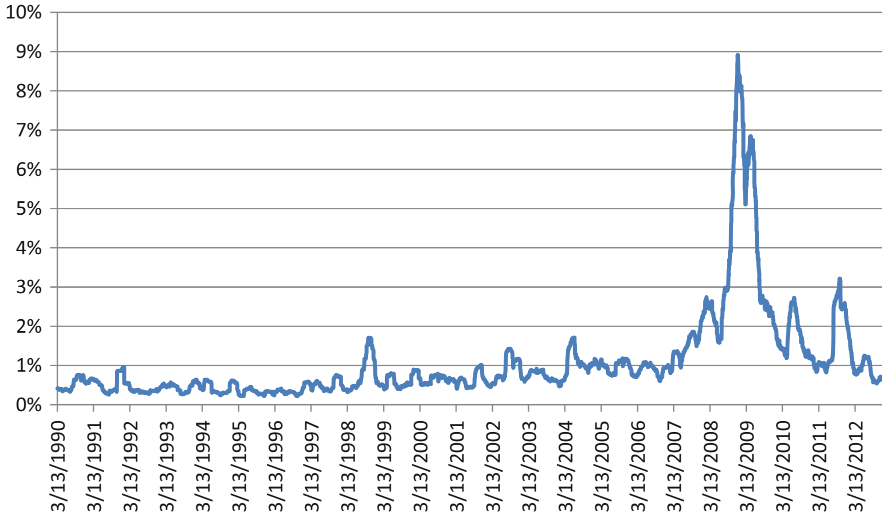

Fig. 5.5 Rolling fifty day standard deviation

interest however are results from a working paper by Cotter and Stevenson (2008) that shows that while volume is a significant determinant of REIT volatility, the sector is half as sensitive to changes in volume as the stock market generally.

From the mid-1990s onwards there has been a marked increase in investor awareness. As Chan et al. (1998) note, institutional investment increased substantially in the 1990s. This had a very quick impact in relation to the number of analysts following the sector (Wang et al. 1995) and a reduction in the bid-ask spread of REIT shares (Below et al. 1996; Bhasin et al. 1997). In addition, a number of studies have highlighted the positive relationship between the increase in institutional share ownership and REIT performance (e.g. Wang et al. 1995; Chan et al. 1998; Downs 1998; Ling and Naranjo 2003). Ling and Naranjo (2006) specifically consider flows from dedicated REIT mutual funds, finding evidence of REIT performance significantly impacting upon future capital flows. This finding would also be supportive of the momentum profits observed in studies such as Chui et al. (2003) and Hung and Glascock (2008, 2010). Whilst the process of increased ownership started in the early 1990s, it continued subsequently and the inclusion of REITs in the mainstream Standard & Poor's indices in 2001 was a further step in increased investor acceptance of the sector. Indeed this increased mainstream equity market investment may, in what can appear initially a counter intuitive argument, have contributed to the changing relationship between REITs and large-cap stocks. It is frequently cited that REITs have had a lower correlation with equities in recent years, as the figures in Table 5.1 support. However, it may be that while the headline relationship has fallen, the influence of the broader stock market is actually greater than at any other time.

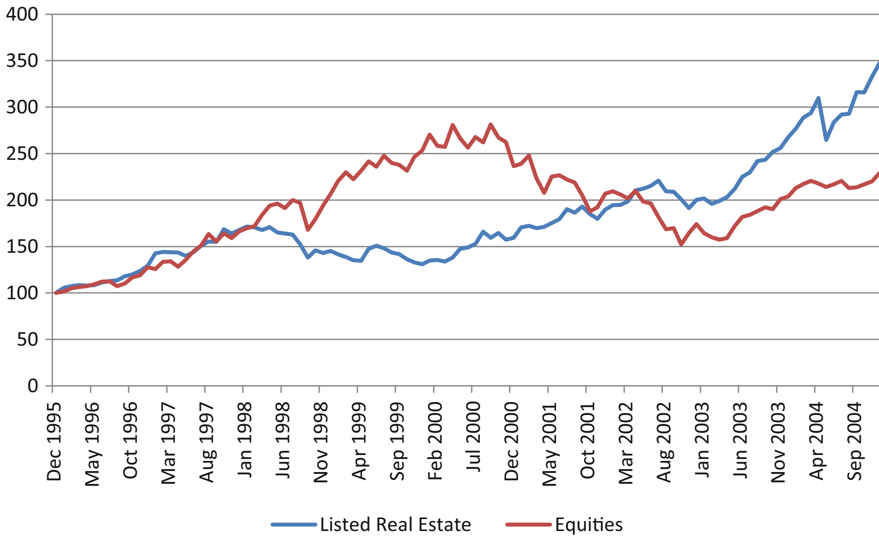

Fig. 5.6 US capital market performance: 1995–2004

As Fig. 5.6 illustrates in the period 1998–2000 while the general stock market was rapidly rising during the technology/dot.com boom, REITs not only underperformed, but they fell in value. This was despite strong underlying economic conditions and robust performance in the private real estate market. Furthermore, operationally REITs were reporting impressive results. In 1998 and 1999 Funds from Operations for listed REITs rose by 14.70 % and 9.50 % respectively. In contrast REIT returns were –18.82 % and –7.38 %. Since 2000 REIT performance has been vastly improved. In the 3 years from January 2000 Equity REITs produced a total return in excess of 50 %, at the same time the stock market fell in value. Furthermore, the operational performance of REITs was subdued. In 2001 REIT dividends only rose by 3.80 % while Funds from Operations fell by 2.20 %. It would appear that certainly for the period 1998–2003 REITs effectively acted as a defensive counter cyclical equity sector. They were highly unattractive in the late 1990s boom in comparison to high growth tech stocks. However, following the technology crash in 2000 REITs became seen as a highly attractive sector. Their high level of asset backing, high dividends and following 2 years of underperformance relatively cheap pricing made them attractive for equity managers looking for income driven sectors. The strong performance since 2000, together with factors such as the inclusion in the S&P indices, has further encouraged increased investment due to investor momentum and herding behaviour. The result is increased flow of funds into the sector, leading to demand driven price pressure.

This impact can also be observed if one examines the relative investment behaviour of the REIT sub-sectors. US REITs are generally highly focused as Figs. 5.7 and 5.8 illustrate. Most REITs have underlying portfolios concentrated

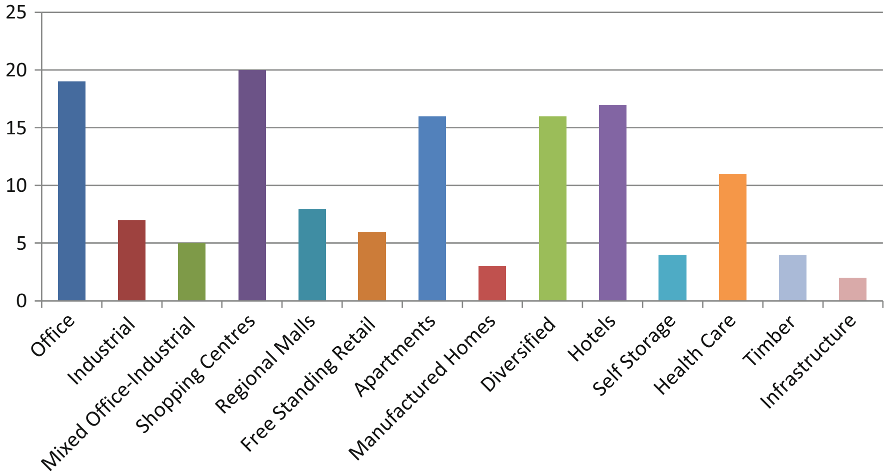

Fig. 5.7 Specialisation of US equity REITs (November 2012)

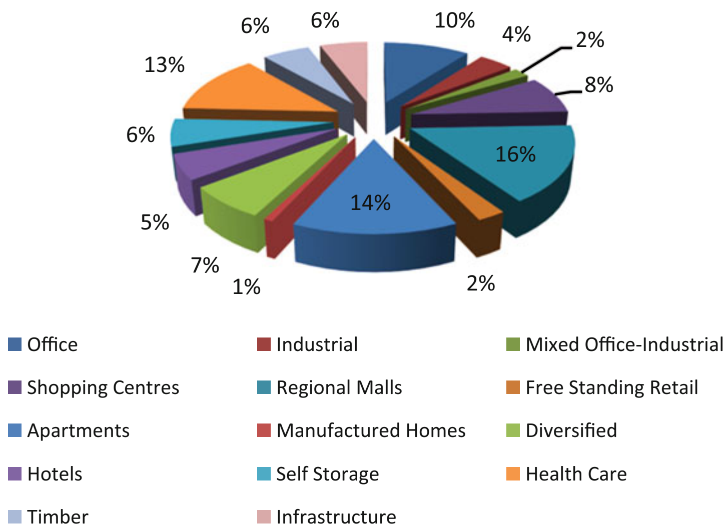

Fig. 5.8 Composition of US equity REITs by market capitalisation

in a single property type. Furthermore, many REITs are also geographically focused, with few having national portfolios. The arguments in favour of a focused strategy are that firstly the portfolio managers should have a better understanding and knowledge of specialist markets and sectors. This is of particular relevance in the context of such a large market as the US as it reduces the number of markets for

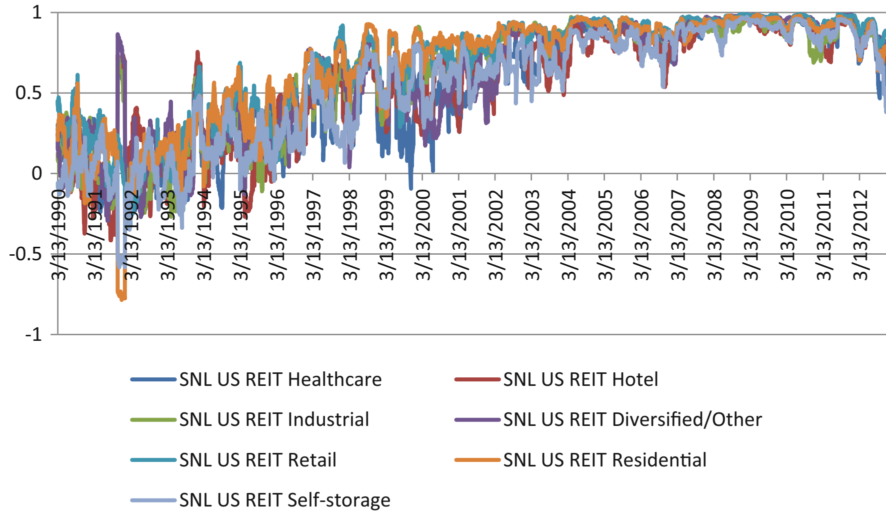

Fig. 5.9 Fifty day rolling correlations: office REITs

which information and market analysis is required.[1] In addition, standard financial theory would argue that firms shouldn't diversify, but rather allow investors to do it for themselves. While this normally refers to conglomerates the same argument can be advanced for firms such as REITs. However, this second argument is dependent on sub-sectors behaving different and effectively tracking their underlying markets. While earlier studies such as Mueller and Laposa (1996) and Chen and Peiser (1999) show strong relationships between focused REITs and the underlying specialist market segment, other papers have found diverging results. Young (2000), for example, shows that the correlations between sector focused REITs has tended to increase. Recent work by Chong et al. (2012) also illustrates this using a Dynamic Conditional Correlation framework. This can be illustrated in Fig. 5.9 which shows simple rolling correlations between Office REITs and other sectors. There is a clear trend that shows that over the last decade the sub-sectors have converged in terms of their return behaviour. This would indicate that the markets are increasingly viewing REITs more as an overall sector and that less attention is placed on the characteristics of individual REITs or sectors.

[1] See Benefield et al. (2009) and Ro and Ziobrowski (2011) for recent evidence on relative performance of diversified versus focused REITs.

5.4 Conclusion

The development of the US REIT market has been a major factor in the growth of the sector globally. However, it is vital in any analysis of the US market to appreciate the changing investment dynamics of the sector and its continued growing maturity. The market has developed significantly in the last decade and a half and this has resulted in the asset becoming more of a mainstream investment sector. This has had the consequence that the dynamics and investment characteristics have also altered.

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Chapter 6
REITs in Australia: Moving forward from the GFC

Graeme Newell

6.1 Introduction

REITs in Australia (A-REITs) have been a successful property investment vehicle in Australia over the last 40 years. This chapter reviews the development of A-REITs, profiles their status and highlights key strategic issues that are impacting on the further development of A-REITs. Particular attention is given to the impact of the GFC and how A-REITs recovered from the GFC.

Initially established as listed property trusts (LPTs), they were re-badged in 2007 as A-REITs to reflect the international nomenclature for this type of listed property investment vehicle. A-REITs have become a mature, sophisticated, highly successful indirect property investment vehicle, with a strong track-record and significant commercial property assets, being available to both general investors and institutional investors. Importantly, A-REITs offer features not available with direct property, including high liquidity, high divisibility, low entry and exit costs, tax transparency and high yields, as well as providing access to trophy property assets, access to quality sector-specific and diversified portfolios, and high quality professional property management skills and expertise.

This has seen A-REITs become the 2nd largest REIT market globally (EPRA 2013), as well as being the largest property investment sector in Australia, accounting for approximately 50 % of property funds' assets under management in Australia (PIR 2012). The features of A-REITs have seen them perform as a different property investment vehicle to direct property, with an important role in mixed-asset portfolios.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_6, © Springer-Verlag Berlin Heidelberg 2013

6.2 Profile and Current Status of A-REITs

6.2.1 A-REIT Regulatory Framework

A-REITs are a property investment vehicle listed on the Australian stock market, which invest in income-producing properties (e.g.: office, retail, industrial) with the goal of obtaining rental income as their main income source. The standard Australian stock market and Managed Investment Scheme regulations apply and provide the regulatory environment for A-REITs. Full details of the A-REIT regulatory environment in Australia, compared to other REIT environments, are given in EPRA (2012). Overall, the regulatory support for A-REITs is seen as the second most supported REIT market in the Asia-Pacific; only exceeded by Singapore (Trust 2011).

A-REITs are tax transparent and do not pay income tax if they distribute 100 % of their taxable income (post depreciation) to the A-REIT share-holders; this typically generates attractive yields by A-REITs. There are no limits on gearing, with international property investments acceptable. Whilst the traditional A-REIT structure was for external managers, prior to the GFC, many A-REITs moved to an internal management model, via stapled securities, to allow for non-property investment activities, such as property development. Since the GFC, this has seen several A-REITs de-staple, setting up purer property products focused on property investment or property development activities. This is discussed more fully in subsequent sections of this chapter on A-REITs.

6.2.2 A-REIT Profile

At June 2012, the A-REIT sector had total assets of over US$140 billion, comprising over 2,000 institutional-grade properties in diversified and sector-specific portfolios (Property Investment Research 2012). There are over 494,000 A-REIT investors (PIR 2012). At February 2013, A-REITs accounted for over US$98 billion in market capitalisation, being the sixth largest sector on the stock market and now represent 7 % of the total Australian stock market capitalisation (UBS 2013). Amongst the 23 countries with REIT markets, this sees A-REITs as the 2nd largest REIT market globally (11 % market share), only exceeded by US REITs (61 %; #1), and exceeding Japan REITs (6 %; #3) (EPRA 2013).

With over $140 billion in total assets, A-REITs are the largest property investment sector in Australia, accounting for 50 % of total property fund assets under management, clearly exceeding unlisted wholesale property funds (29 % market share; #2 sector). A-REITs have consistently represented 50 % of total property fund assets under management in Australia since 2000 (PIR 2012). This sees A-REITs as the main source of listed property exposure in Australia, accounting for over 90 % of listed property exposure. A-REITs have been a popular property

investment vehicle with pension funds in Australia, typically accounting for 2 % of their total assets (in a balanced fund). This contrasts with 8 % for their unlisted property exposure (APRA 2013).

The A-REIT market has grown significantly over the last 20 years. This saw the A-REIT market capitalisation grow from only AU$7 billion in 1992 to over AU $140 billion by 2007. The GFC saw the A-REIT market cap drop by over 50 %, with a slow recovery from the GFC seeing the market cap at February 2013 being over $90 billion (UBS 2013). Stronger A-REIT recovery was seen in 2012. Full details of the impact of the GFC on A-REITs are given in a subsequent section of this chapter. The popularity and success of A-REITs has been a key factor in Australia being seen as one of the most transparent property markets globally (JLL 2012).

At February 2013, there were a range of A-REITs, including diversified A-REITs (33 % of A-REIT sector market cap), office A-REITs (6 %), retail A-REITs (48 %) and industrial A-REITs (11 %) (APREA 2013). Unlike US REITs, A-REITs do not have residential property in their portfolios.

Table 6.1 represents an overall profile of the leading diversified and sector-specific A-REITs in the A-REIT sector at February 2013. There are 20 A-REITs in the top 300 companies on the Australian stock market, with over 35 A-REITs in total at February 2013 (UBS 2013). The largest A-REITs include Westfield, Westfield Retail, Stockland, Goodman, GPT and CFS Retail, with several of these A-REITs amongst the largest REITs globally. Several A-REIT fund managers have more than one A-REIT; often with property portfolio values exceeding $5 billion. Whilst the A-REIT focus has been office, retail and industrial property, some smaller specialty A-REITs have focused on pubs, community living and childcare facilities.

Average A-REIT yields are currently 6.46 %, compared to 3.34 % for 10-year bonds; giving an A-REIT risk premium of 3.12 % (APREA 2013). Debt levels have reduced significantly post-GFC; being approximately 29 % (PIR 2012). High levels of liquidity are also evident in A-REIT trading on the stock market. Performance-based annual fees are typically used by A-REITs.

Overall, A-REITs have been seen to be a high calibre indirect property investment vehicle, offering a range of attractive investment features and access to high quality commercial property portfolios for both institutional and general investors. Whilst adversely impacted by the GFC, A-REITs showed a major recovery in 2012–2013, with features of this recovery discussed in subsequent sections of this chapter.

6.3 A-REIT Performance Analysis

Over the longer-term of 1985–2011, A-REITs and stock market performance has been correlated ($r = 0.62$), with A-REIT and direct property performance showing less correlation ($r = 0.15$), reflecting diversification benefits for both A-REITs and

Table 6.1 Leading A-REITs: February 2013

A-REIT	Assets under management (AU$)	Number of properties	Market cap (AU$)	Rank (by market cap)
Diversified				
Stockland	$14.6B	219	$8.3B	3
GPT	$9.3B	43	$7.0B	5
Mirvac	$8.4B	67	$5.6B	7
Dexus Property	$8.1B	173	$5.3B	8
Retail				
Westfield	$36.9B	119	$25.2B	1
Westfield Retail	$12.8B	54	$9.7B	2
CFS Retail	$8.7B	29	$5.9B	6
Federation Centres	$3.8B	43	$3.5B	9
Charter Hall Retail	$2.0B	90	$1.3B	14
Office				
Commonwealth Property Office	$3.5B	25	$2.6B	10
Investa Office	$2.6B	22	$1.9B	12
Industrial				
Goodman	$5.2B	43	$7.9B	4

Sources: PIR (2012), UBS (2013)

direct property in a portfolio (IPD/PCA 2013). Over this longer period, A-REIT risk (18.0 %) was also below stock market risk (20.8 %). These features changed significantly in the GFC.

Further evidence of the investment stature of A-REITs is shown in Table 6.2, with the risk-adjusted investment performance of A-REITs compared to the other major asset classes (UBS 2013). The recovery of the A-REIT market over the last 1 year and 3 year periods is evident, with A-REITs outperforming shares. The depth of the impact of the GFC is clearly evident in the lesser returns for A-REITs over the 5 year and 10 year periods; with A-REITs being outperformed by stocks. A-REITs are now seen to have higher levels of risk than the overall stock market; i.e. 21.0 % versus 15.0 %. This contrasts to the pre-GFC feature of A-REITs having attractive defensive characteristics relative to the stock market. On a risk-adjusted basis, A-REITs have outperformed stocks in the last 3 years; i.e. Sharpe ratio of 0.46 versus 0.34; with this evident for all A-REIT sectors except for diversified A-REITs.

Table 6.2 A-REIT performance: February 2013[a]

Asset class	Average annual total return (%)				Risk (%)	Sharpe ratio
	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)		
A-REITs	33.4	12.7	−3.1	3.6	21.0	0.46
Office	23.0	15.0	−3.1	3.1	25.4	0.47
Retail	33.2	12.3	2.1	6.3	18.4	0.50
Industrial	41.3	22.6	−18.7	−3.3	51.7	0.38
Diversified	34.2	10.8	−8.0	1.0	28.6	0.27
Shares	24.2	8.0	2.9	11.0	15.0	0.34
Bonds	6.6	7.5	7.6	6.0	4.0	1.12

Source: UBS (2013)

[a]Risk and Sharpe ratio are calculated using 3 year monthly returns

6.4 Previous A-REIT Research

A considerable body of research is available concerning A-REITs. This has involved:

- Performance analysis (Lee et al. 2007, 2008; Newell 2006; Newell and Peng 2006; Newell and Tan 2003, 2004; Peng 2004; Tan 2004a, b; Ratcliffe and Dimovski 2007)
- IPO/financing issues (Dimovski and Brooks 2006a, b, 2007)
- A-REIT futures (Newell 2010; Newell and Tan 2004)
- Market integration (Wilson and Okunev 1996, 1999; Wilson et al. 1998)
- Impact of the GFC (Newell 2010; Newell and Peng 2009).

All of this research has highlighted the potential contribution and added-value benefits of A-REITs in a mixed-asset portfolio. However, most of this research was focused on the pre-GFC performance of A-REITs. The following section highlights the impact of the GFC on A-REITs and their ongoing strategic development in the post-GFC period.

6.5 Impact of the GFC on A-REITs

The traditional rental income-focused A-REIT structure involving prime commercial properties changed considerably in the years prior to the GFC, as A-REITs adopted more aggressive growth strategies. These growth strategies included increased levels of debt, significantly increased levels of international property (e.g.: several 100 % international property A-REITs were established), the use of a stapled securities structure to incorporate property development activities and other fund management activities, and investing in the emerging property sectors (e.g.: retirement, healthcare, leisure, childcare) (Newell 2006).

Whilst these A-REIT growth strategies were initially successful (Newell 2006), the global financial crisis had a significant impact on the performance of A-REITs over 2007–2009, as well as highlighting the ongoing potential structural deficiencies of A-REITs as an effective indirect property investment vehicle. This saw the A-REIT market cap drop from $140 billion to $50 billion during the GFC; a decrease of over 50 %. The A-REIT market cap recovered to $80 billion by December 2009, but then showed no major growth until 2012, with A-REITs recovering strongly in 2012–2013.

As well as poor investment returns during the GFC, A-REITs also saw their risk levels increase from 11 % to 24 % compared to the stock market risk levels only increasing from 9 % to 16 %. The GFC also saw the correlation between A-REITs and shares increase from $r = 0.37$ to $r = 0.75$; reflecting significant loss in diversification benefits by A-REITs. Overall, this represented poor performance by A-REITs in the GFC across all of the key investment performance parameters.

The GFC saw A-REITs trading at a significant discount to NTA, after many years of trading at a significant premium. Difficulties in accessing debt financing and refinancing were evident; particularly with the major debt financing sources via commercial mortgage backed securities (CMBS) and syndicated debt facilities being unavailable or too expensive. This was compounded by many A-REITs having significant debt expiry schedules over 2009–2010.

With many A-REITs potentially breaching their debt covenants (and possibly forced to sell properties), reducing debt levels was a top priority for A-REITs. As A-REITs have minimal retained earnings, this saw many A-REITs undertake major capital raisings via private placements and rights issues; often at significant discounts (up to 50 % discount), with the resultant diluting of shareholder interests from significant reductions in NTA per share. This saw A-REITs aggressively reduce their debt levels from 50 % in 2009 to 29 % in 2012. A-REITs also significantly downgraded their distribution forecasts, as well as having significant write-downs in the value of their property portfolios in a softening commercial property market.

6.6 A-REITs in a Post-GFC Environment

A-REITs took considerable time to recover from the GFC, with 2012 seeing important recovery and market growth. This saw a reassessment of the A-REIT product and the need for a simpler, less financially complex product with a focus on property fundamentals. Significant changes that have occurred for A-REITs post-GFC include:

- A movement towards a "purer" A-REIT product, focused on property investment, not on property development. This was demanded by investors. For example, this has seen the largest A-REIT, Westfield A-REIT, split into

Westfield Group and Westfield Retail REIT in 2011 to separate the development and investment functions respectively

- A reduction in the level of international property in A-REIT portfolios to see a stronger domestic property focus. This has seen several A-REITs significantly reduce their international exposure; e.g.: Charter Hall, Centro; with these international (largely US) portfolios often acquired by private equity players; e.g.: Blackstone
- Some recovery of A-REIT investment features; e.g.: enhanced returns, and risk levels reduced from 24.0 % in 2008 to 21.0 % in 2013
- Transfer of A-REIT management rights; e.g.: management of Macquarie A-REITs transferred to Charter Hall, Ardent; management of ING Office REIT transferred to Investa Office Fund
- De-listing of several A-REITs into privatised, unlisted "club deal" structures. This includes the ING Industrial A-REIT being acquired and privatised by Goodman, China Investment Corporation, Canada Pension Plan Investment Board and APG in a "club deal"; Charter Hall Office A-REIT was also privatised in 2012 by a group of major property investors including GIC, the Singapore sovereign wealth fund
- Reorganisation of A-REIT structure and mandate; e.g.: Centro Properties reworked and rebadged as Federation Centres
- Focus on retail property strategies, given the high level of retail A-REITs (48 %) and the ongoing impact of on-line retailing on retail property
- Major changes at the senior executive management levels.

6.7 Summary

A-REITs are an important property investment vehicle in Australia, offering features such as liquidity, transparency, high yield and access to high quality commercial property assets. This sees A-REITs accounting for 50 % of total property assets under management in Australia, and being supported by both general and institutional investors. This also sees A-REITs as the second largest REIT market globally.

While A-REITs were significantly impacted by the GFC, A-REITs showed a strong recovery in 2012, with major structural changes having occurred for A-REITs post-GFC; this has been supported by strong economic fundamentals in Australia. With several other important REIT markets also recovering (e.g.: US REITs, Singapore REITs), A-REITs are well-placed to continue to play a significant role as a major property investment vehicle in Australia; offering high quality commercial property exposure in a liquid format for investors.

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Chapter 7
Asian REITS: Growing into Maturity

Joseph T.L. Ooi and Woei-Chyuan Wong

7.1 Overview

The Asian REIT markets have grown substantially over the past decade, partly due to a boom in the number of REIT IPOs and partly due to the newly listed REITs expanding aggressively by acquiring many properties within a short time period, often funded by cheap debt. Investors' appetite is boosted by the positive risk-adjusted returns registered in the four major REIT markets in Asia, namely Japan, Singapore, Hong Kong and Malaysia.

The onset of the global financial crisis (GFC), however, stalled the growth momentum. Faced with falling property values, shrinking market capitalization, overleveraging and refinancing risk, several REITs in Asia were delisted or needed bailing out. The GFC experience underscores the vulnerability of REITs to tight credit markets because they do not hold any financial reserves as well as the importance of maintaining a prudent balance sheet and a proactive debt capital management strategy.

In addition to addressing the above issues, this chapter introduces an initiative by the Asia Pacific Real Estate Association (APREA) to create a corporate governance scoring framework for externally managed REITs in Asia. In terms of corporate governance, Asian REITs are somewhat green fields due to the fact that almost all the REITs listed in Asia are externally managed. This, coupled with the fact that they are often tightly held by their sponsors, generates a myriad of agency problems, among which fees and related party transactions are paramount.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_7, © Springer-Verlag Berlin Heidelberg 2013

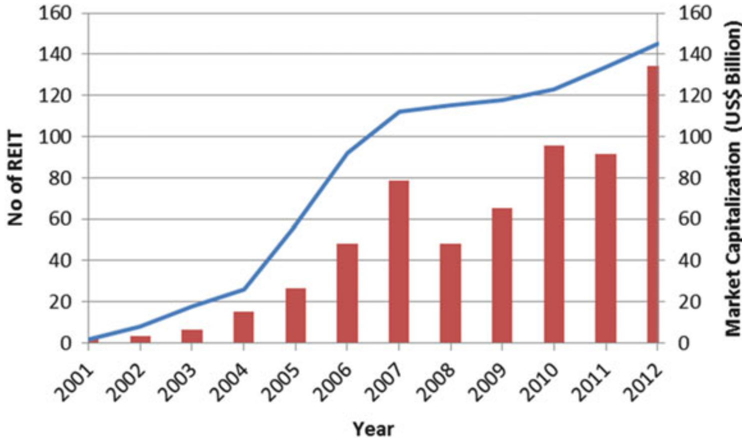

Fig. 7.1 Growth of REITs listed in Asia. The *blue line* tracks the number of listed REITs in Asia from 2001 to 2012, while the *vertical bars* mark their total market capitalization in corresponding period

7.2 Background

Modern real estate investment trusts (REITs) emerged in Asia with two REITs launched simultaneously in Japan in September 2001. Soon after, South Korea and Singapore saw their maiden REITs in 2002. Hong Kong, Malaysia, Taiwan and Thailand subsequently joined the REIT bandwagon in Asia.[1] Figure 7.1 tracks the dramatic growth of the REIT market in Asia between 2001 and 2012. During the 12-year period, total market capitalization of Asian REITs grew from US$1.7 billion to US$134.5 billion. Correspondingly, the number of Asian REITs grew from 2 to 145.

As of December 2012, there were 145 REITs listed in Asia. Table 7.1 provides a snapshot of the relative size of the respective markets. The four largest markets in Asia are Japan, Singapore, Hong Kong and Malaysia. Together, the REITs in these four markets account for 93 % of market capitalization of all Asia REITs. Japan has 37 listed REITs with a combined market capitalization of US$52.2 billion. This is followed by Singapore, which has 28 listed REITs with a total market capitalization of US$43.2 billion. The REIT sector in Hong Kong (HK_REIT) is still underdeveloped as compared to those in Singapore and Japan. It accounted for less than 6 % of total listed property market capitalization in Hong Kong (CBRE 2011). Nevertheless, the potential of REITs in Hong Kong is huge given its role as an offshore center for real estate owners from mainland China. In Malaysia, the increasing appetite for the securitized property investments has led many property owners to

[1] See Ooi et al. (2006) for a discussion on the major driving forces in the growth and development of REIT markets in Asia.

Table 7.1 REIT markets in Asia

Market	Listing date of maiden REIT	Number of REITs	Market capitalization (US$) @ Dec 2012
Japan	Sep 2001	**37**	**52.2**
Singapore	Jul 2002	**28**	**43.2**
Hong Kong	Nov 2005	**9**	**22.2**
Malaysia	Aug 2005	**16**	**8.0**
Thailand	Oct 2003	**41**	**6.1**
Taiwan	Mar 2005	**6**	**2.6**
South Korea	Jan 2002	**8**	**0.2**
Total		**145**	**134.5**

join the REIT bandwagon. Recent listing of IPOs such as Sunway REITs (2010), CapitaMall Malaysia Trusts (2010), Pavilion REIT (2011) and IGB REIT (2012), each with asset base of more than US$1 billion, have escalated the market capitalization of Malaysia REITs (M-REITs).

Due to their restrictive guidelines, the REIT markets in Taiwan, Thailand and South Korea have not grown as much. In particular, the growth prospects of Taiwan REITs are restricted because they are not allowed to offer secondary offerings even if they have good investment opportunities. Similarly, REITs in Thailand have limited growth opportunities because REITs here are passively managed with rigid gearing limit (not more 10 % of their net asset value). Not much vibrancy is found in South Korean market because the REIT market here is populated by corporate restructuring REITs (CR-REITs) which are recession centric instruments that allow investors to participate in real estate held by corporate and financial institutions for a finite holding period.

In contrast, Singapore has developed into a REIT hub in Asia due to its openness and its progressive REIT regime. While most REIT markets in Asia focused on domestic properties, a distinguishing factor of the Singapore REIT market is that many of the Singapore REITs (S-REITs) invest and own cross-border properties. As documented by J. P Morgan (2012), 29 % of the asset under management (AUM) of S-REITs is in overseas assets. This figure could increase to 40 % in the long run. Currently, nine S-REITs are holding pure overseas properties. For example, Fortune REIT, Perennial REIT, CapitalRetail China Trust and Mapletree Greater China Commercial Trust own and operate shopping centres and commercial properties in Hong Kong and China, but they are listed in Singapore. Similarly, First REIT and Lippo Mapletree Indonesia Retail Trust own healthcare properties and shopping malls, respectively in Indonesia, while Ascendas India Trust and Indiabulls Properties Investment Trust own properties in India. Other examples include: Saizen REIT which owns properties in Japan, Keppel REIT owns three commercial properties in Australia, Parkway Life owns healthcare properties in Malaysia and Japan, and Ascott Residence Trust owns properties in Asia Pacific, Europe and the United Kingdom.

In addition, a few S-REITs which started off as purely domestic focused have broadened their investment scope to include overseas properties. For example, Ascendas REIT which focused primarily on industrial premises in Singapore

acquired its first overseas property in Shanghai in 2011. In contrast, none of the Japan REITs (J-REITs) have yet to pursue a similar strategy despite being eligible to acquire assets outside Japan since 2008. According to C. B. Richard Ellis (2012), J-REITs' lack of activity abroad is due partly to the fact that requirements on the appraisal of overseas properties owned by J-REITs are ambiguous.

The phenomenal growth experience in Asia can be attributed to a boom in the number of new REITs being listed, as shown by the increased in the number of listed REITs in Fig. 7.1, as well as the aggressive acquisition strategy adopted by the newly listed REITs. Motivated by a management fee structure that is tied to the size of the AUM and an additional incentive fee for acquisition of new assets, the managers grew their REITs by aggressively acquiring many properties within a short time period. Examining 228 acquisitions by J-REITs and S-REITs, Ooi et al. (2011) find that the aggressive growth strategy adopted by Asian REITs is not detrimental to shareholder wealth. Analyzing the acquisition sequence of serial acquirers, they find that the stock returns are marginally higher for the first deal announced by individual firms. They also observe that smaller-sized REITs generate positive abnormal returns from their acquisitions. On the whole, the results suggest that REITs will find it harder to earn abnormal returns from acquisitions over time.

Between 2002 and 2006, 284 deals involving US$20.5 billion worth of properties were acquired by J-REITs and S-REITs, which accounted for more than a third of the combined market capitalization of the REITs (Ong et al. 2011). Since REITs have to disburse almost all their earnings to their shareholders, these acquisitions had to be financed through external funding, either in the form of debt, or new equity issues, or both. It should be noted S-REITs face a tighter constraint in their ability to raise debt; in general, they are not allowed to have a debt ratio exceeding 35 % of their total assets, but the debt limit can be raised to 60 % if the S-REIT is rated. J-REITs, on the other hand, do not have any debt limit.

7.3 Refinancing Risk

Table 7.2 reports the risk-adjusted performance of the four main REIT markets in Asia, namely Japan (J-REIT), Singapore (S-REIT), Hong Kong (HK-REIT) and Malaysia (M-REIT). Jensen's alpha (α) measures the average return of the respective REIT markets over and above the return of their corresponding stock markets, after adjusting for risk.[2] In addition reporting to their performance over the full

[2] Jensen's alpha (α) is the estimated intercept from $R_{p,t} - R_{f,t} = \alpha + \beta(R_{m,t} - R_{f,t}) + \varepsilon_p$ where $R_{p,t}$ indicates the monthly return on a portfolio of REIT stocks, $R_{f,t}$ is the monthly return on the risk-free three month Treasury bill, and $R_{m,t}$ is the monthly return on the market portfolio. To explore the performance of REIT stocks in Asia, a value-weighted portfolio of all the REIT stocks in each market is first created.

Table 7.2 Risk-adjusted performance of Asian REITs

	Full periods	Pre-crisis	Crisis	Post-crisis
	(Jan03–Dec12)	(Jan03–Jun07)	(Jul07–Dec08)	(Jan09–Dec12)
J-REIT	0.25 %	1.47 %**	0.20 %	0.38 %
S-REIT	0.87 %*	2.00 %***	−2.06 %	1.77 %**
M-REIT	0.10 %	−0.96 %	−1.44 %**	0.78 %**
HK-REIT	0.68 %	0.77 %	−1.62 %	2.08 %***
Overall	0.47 %*	1.23 %***	−1.50 %*	1.18 %***

***, **, and * indicates significance at the 1 %, 5 %, and 10 % level respectively

period, the performance is decomposed over different sub-periods, primarily to highlight the susceptibility of Asian REITs to the global credit crisis in 2007–2008.

Over the full period, all the four REIT markets registered positive risk-adjusted returns with the best performers being S-REITs and HK-REITs. In other words, REIT stocks performed better than common stocks in their respective markets, after adjusting for risk. Comparing their performance over different periods, Table 7.2 shows that the performance of Asian REITs dropped significantly during the credit crisis, which was indeed a tough period for the REITs. As a result of falling property values and shrinking market capitalization, which reduced by 38.6 % from US $78.72 billion to US$48.37 billion, the gearing of Asian REITs increased from 0.38 to 0.42. In a February 2009 report, the Asian Public Real Estate Association (APREA), a body that represents the listed real estate sector in Asia, estimated that listed property firms and REITs had to refinance an estimated US$12 billion in debt. Even if the REITs could refinance the maturing debts, they would have to pay a higher cost as credit spreads widened significantly during the crisis period. J. P. Morgan (2012) noted that many REITs consequently had to sell assets and or raise new equity capital in order to meet their debt obligations and to deleverage.

REITs that could not raise money to repay their debts had to file for bankruptcy. In October 2008, New City Residence Investment Corporation, which was listed in Japan, filed for court protection from its creditors due to difficulty in raising money to repay its debts. It was not the only J-REIT that got into financial difficulties. Indeed, saddled with overleveraging and refinancing risk, nine J-REITs were eventually delisted (or merged) between 2008 and 2010. They include LCP Investment Corporation, Nippon Residential Investment Corporation, Advance Residence Investment Corporation, LaSalle Japan REIT, New City Residence Investment Corporation, Prospect REIT Investment Corporation, Japan Single-Residence REITs, Nippon Commercial Investment Corporation, and Ichigo Real Estate Investment. Consequently, the total number of J-REITs decreased from 42 in June 2008 to 36 in October 2010 (CFA Institute 2011). Meanwhile, in Singapore, Saizen REIT defaulted on a 7.3 billion yen (US$80.26 million) commercial mortgage backed securities loan on 4 November 2009, while another S-REIT, MacarthurCook Industrial REIT, which was subsequently renamed as AMP Capita Industrial REIT, needed to be bailed out.

The GFC experience underscores the importance of maintaining a healthy balance sheet, not only to provide sufficient headroom for growth, but to reduce refinancing risk. REITs are especially vulnerable to tight credit markets because they do not retain any financial reserves. Thus, a major concern of REITs during the recent credit crunch was the ability to access capital to maintain adequate liquidity and to refinance maturing loans.[3] Moreover, the short-term nature of bank borrowings, which is the primary form of lending in Asia, presents an additional challenge for REITs to manage the asset-liability mismatch. Learning to adopt a more prudent capital management policy, REIT managers now recognize the importance of proactively managing their capital, especially the need to lengthen and spread their debt maturity structure by tapping into alternative sources of funding. Although strengthening banking relationships and securing credit lines could insulate the firms against a credit crisis, such protection may not be available to REITs with low credit rating in the first place (Ooi et al. 2012).[4] The GFC experience also shows that support from a strong sponsor is crucial to weather a financial storm. For instance, sponsors such as Keppel Land and CapitaLand subscribed to new shares issued by their sponsored S-REITs when the credit market dried up.

7.4 Governance of Externally Managed REITs

Asian REITs are somewhat green fields in terms of corporate governance, in part due to the fact that REIT regimes are still relatively new in Asia but also because of their structural idiosyncrasies. With the exception of Link REIT in Hong Kong, all the REITs listed in Asia are externally managed. Figure 7.2 shows the classic structure of an externally managed REIT, taking the legal form of a Trust involving a Sponsor, generally a large real estate company, a Trustee, a Trust Manager and a Property Manager. The externally managed model adopted by Asian REITs generates a myriad of agency problems, among which fees and related party transactions (RPT) are paramount (LeComte and Ooi 2013).

More often than not, the Manager is wholly owned by the Sponsor, who also retains a significant stake in the newly listed REIT. Examining 78 initial public

[3] While many scholars have studies the economic gains associated with new debt issues, the effects of debt refinancing is generally ignored because they do not have any effect on a firm's capital structure. Nevertheless, in a tight credit market, the REIT's ability to secure refinancing conveys a credible signal on its credit worthiness. Examining a sample of 340 debt announcements by J-REITs between 2002 and 2011, Tang et al. (2013) confirm the impact of the credit crisis on debt announcement effects.

[4] In a study on 275 REITs listed in the US between 1992 and 2007, Ooi et al. (2012) find that although bank lines of credit may in theory insulate REITs from credit rationing at both the broad market level as well as the firm level, such protection does not work in practice for REITs with low credit rating.

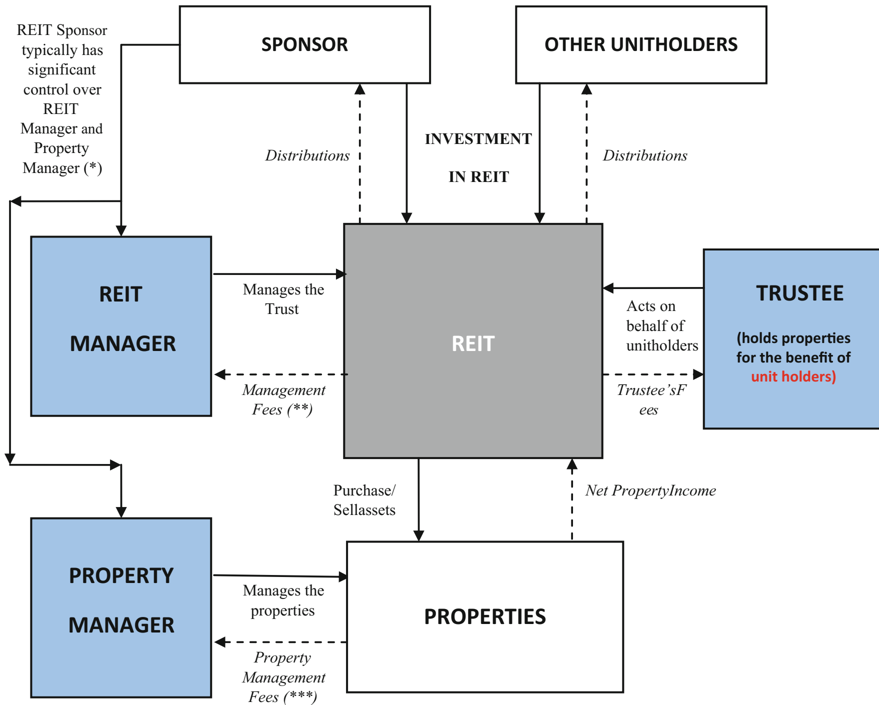

Fig. 7.2 Generic structure of an externally managed-REIT (Source: LeComte and Ooi 2013). (*) The Sponsor has a significant holding in the REIT and usually owns the asset management and property management firms. (**) Management fees include base fee, performance fees and acquisition/divestment fees. (***) Property management fees might include leasing commissions

offerings (IPOs) of Asian REITs between 2001 and 2008, Wong et al. (2013) observe that the sponsors, on average, retained 19 % of the IPO shares. The externally-managed model coupled with the entrenched position of the REIT manager creates a captive situation where minority shareholders' interests are heavily controlled by the sponsor, who also continues to sell its assets and management services to the listed REITs while running its own parallel real estate businesses. This gives rise to potential conflict of interests in terms of staff devotion, favorable treatment of sponsor properties over REIT properties, overpricing of services by the managers as well as cherry picking of properties by the sponsor (RiskMetrics Group 2009).

On average, RPTs amount to 5.4 % of a REIT's total assets. This is nearly double the 2.8 % rate observed for US industrial firms. Figure 7.3 shows that the three main channels of RPTs are: real estate asset acquisitions from related parties (57.4 %), income earned from related parties (22.2 %), and management fees paid to related parties (14.8 %). Other recurring RPTs (3.3 %) include expenses related to shared-services, such as accounting and services and various consultancy fees including debt advisory and arrangement fees, while other non-recurring RPTs (2.3 %)

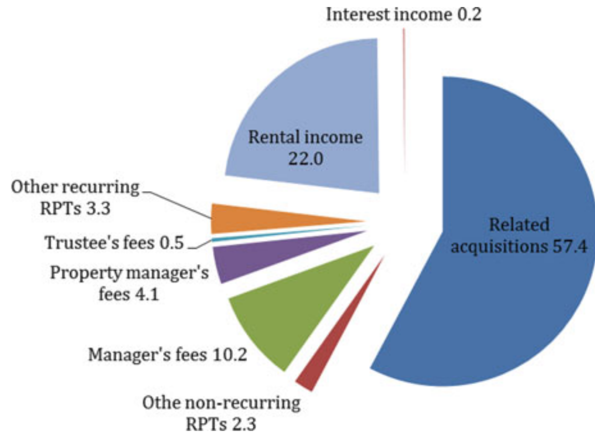

Fig. 7.3 RPTs by Asian REITs (% of total assets) (Source: Ooi et al. 2013)

include interest income, fees related to issuance of securities, banker guarantees and interests paid on loans granted by the sponsor.

With the aim of providing a balanced, contextual view of Asian REITs, APREA designed a corporate governance scoring framework for externally managed REITs in Asia in 2010. Essentially, the scoring framework encompasses 27 governance factors spanning 8 categories of both external and internal corporate governance. Four of the categories are more specific to externally managed REITs, namely REIT Organization, Fees, RPTs and Gearing. The index range is [−11; +88] with a median of 38.5.[5] The framework has been applied by APREA to score corporate governance of S-REITs,[6] and subsequently adapted to other REIT regimes in Asia, such as Malaysia, Hong Kong and Japan. LeComte and Ooi (2013) find a positive correlation between the corporate governance scores and REIT stock price performance. Table 7.3 shows that S-REITs that are ranked above the median score registered 1.6 % points better than those that are ranked below the median score. This implies that corporate governance has a significant impact on REIT stock performance. However, they fail to find any relationship between corporate governance and operating performance of S-REITs. Further analyses carried out by the authors hint that the improved market performance can be attributed to a reduction in information asymmetry enjoyed by better governed S-REITs.

Decomposing the aggregated scores into their components, LeComte and Ooi (2013) find that a positive relationship persists between the respective corporate governance scores and stock returns. Interestingly, the only component that shows

[5] For more details on the scoring framework, see LeComte and Ooi (2013).

[6] Looking at the 8 categories individually, the three best areas are Audit Committee, Board Matters, and Gearing whereas Remuneration, Fees, and RPTs are laggards. Noticeably, Fees is the sub-score with the largest standard deviation, indicating a great diversity of practices related to fees among S-REITs. Remuneration ranks consistently low as many REITs do not provide any information.

Table 7.3 Stock performance of S-REITs (partitioned by corporate governance scores)

Year	No of REITs	Median CG scores	Returns (Portfolio > CG median score)	Returns (Portfolio < GC median score)	Return differences
2004	3	22.50	0.368	0.150	0.217
2005	7	22.50	0.021	−0.102	0.123
2006	12	22.00	0.131	0.027	0.103
2007	17	23.00	−0.151	−0.215	0.179
2008	21	24.25	−0.076	−0.091	0.015
All	64	22.50	−0.043	−0.060	0.016

Source: LeComte and Ooi (2013)

an inverse relationship is RPT score, which implies that REITs actually add value as they engaged in more RPTs. This result is confirmed by Ooi et al. (2013) who examined the incidence of RPTs and their economic impact on Asian REITs. Contrary to the common perception that RPTs are detrimental due to wealth expropriation, the authors observed that RPTs actually have a positive impact on firm valuation and isolate the benefits to flow primarily from the ad hoc acquisitions of properties from the REIT's sponsors.[7] An economic explanation to this phenomenon would be the efficient "supply chain" relationship where an affiliation to a strong conglomerate may be beneficial to a young and financially constrained firm which has high growth potential. This underscores the importance of the sponsor providing pipeline support for the newly listed REIT to grow, which is particularly relevant in the context of young REITs without any track record. Indeed, half of the sponsors of Asian REITs are property developers who develop and own sizeable portfolios of investment properties that may be transferred to the REIT at the appropriate time. In summary, although RPTs raises corporate governance issues, controversial RPT is unlikely given the relatively stringent process imposed by the regulators on RPTs, and the fact that most of the RPTs would also involve equity funding (see J. P. Morgan 2012).

7.5 REIT Managers' Fees

Since an externally managed REIT has no employees, the structure generates an array of fees from the Trust to the Manager, the Property Manager, and the Trustee. In particular, the Manager performs all work on behalf of the Trust in exchange for fees, which include a base fee, a performance fee, and in some cases,

[7] One third of the properties acquired by J-REITs and S-REITs between 2002 and 2007 were procured from related parties. On the "fairness" of the transaction price of assets transferred from the controlling shareholders to the REIT, Ooi et al. (2011) did not find any significant difference in the abnormal returns associated with news of related and arms-length property acquisitions by Asian REITs. Thus, the evidence suggests that sponsors do not sell the properties to the REITs at an inflated or discounted price.

acquisitions/divestment fees. Base fees and performance fees can take many shapes, from a flat percentage of the AUM to a percentage of net income conditional on a pre-determined benchmark, or any combination in-between. Thus, the amount of fees payable to the REIT manager is another contentious issue linked to an externally-managed REIT.

Table 7.4 summarizes the compensation structure of the external managers of 20 S-REITs. The annual base fee of the managers is dependent on the size of the asset portfolio, ranging from 0.10 % to 0.50 % of AUM. In addition, the managers receive an incentive fee which is often charged as a fixed percentage of the portfolio's "income", with the definition varying across REITs. In a few cases, it is defined as cash flow, while in other cases, it is defined as gross income. The most popular definition though is net operating income (NOI) which is adopted by 65 % of the S-REITs. Since it is calculated net of expenses, it is argued that REIT managers are also incentivized to control operating costs. Table 7.4 shows that the incentive fee ranges from a low of 3.0 % to a high of 5.25 % of a REIT's net property income. In addition, the external REIT manager is also entitled to charge an acquisition fee, generally 1 %, and a divestment fee of 0.5 %. In most instances, the sponsor also provides property management services and leasing services, for which separate charge will be charged.

The annual base fee earned by the average REIT manager is approximately US$ 5.0 million (based on an average base fee of 0.375 % and portfolio size of US$1.34 billion). The performance fee contributes another US$ 1.2 million (based on 4.22 % average percentage fee and US$35.5 million average annual net income) to the manager's fees, giving a combined remuneration of US$ 6.2 million annually. As a percentage of AUM, the total compensation of S-REIT managers is approximately 0.54 %. Given the low rental yields of prime real estate in Singapore, the fees translate to around 17.5 % of net revenue earned, which is not an inconsequential amount.

Table 7.4 also shows that 5 of the 20 S-REITs linked the payment of incentive fee to a predetermined benchmark, which could either be based on the trust's performance in the preceding year, or the sector's performance in the current period. They are Ascendas REIT, MacArthurcook REIT, Ascott Residence Trust, Cambridge REIT and Prime REIT. Employing an internal historic benchmark, Ascendas REIT and MacArthurcook REIT managers will only be paid an incentive fee (0.10 % of AUM) if their distribution per unit (DPU) grows by more than 2.5 % year-on-year.[8] Similarly, Ascott Residence Trust's manager will be entitled to an incentive fee only if its gross profit increases by more than 6 % annually.[9] The incentive fee hurdle for the managers of Cambridge REIT and Prime REIT, on the other hand, is linked to an external index which tracks the performance of other

[8] The incentive fee increases to 0.2 % of AUM if the DPU growth exceeds 5 %.

[9] The incentive fee is equivalent to 1 % of the difference between the financial year's gross profit and 106 % of the preceding year's gross profit.

Table 7.4 Fee structure of Singapore REITs

NO	REITs	Date of listing	Base fee (% of asset value)	Performance fee	Acquisition (%)	Disposition (%)	Benchmark for incentive fee
1	Capital Mall Trust	Jul-02	0.25	2.85 % of gross revenue	1.00	0.50	No
2	AREIT	Nov-02	0.50	0.1 %, 0.2 % of asset value	1.00	0.50	Yes
3	Fortune REIT	Aug-03	0.30	3 % of net property income	1.00	0.50	No
4	Capital Commercial Trust	May-04	0.10	5.25 % of net property income			No
5	Suntec REIT	Dec-04	0.30	4.5 % of net property income	1.00	0.50	No
6	Prime REIT	Sep-05	0.50	5 %, 15 % of excess returns	1.00	0.50	Yes
7	Mapletree Logistic Trust	Jul-05	0.50	3.6 % of net property income	1.00	0.50	No
8	Ascott Residence Trust	Mar-06	0.30	4 % of gross revenue + 1 % of excess returns	1.00	0.50	Yes
9	Allco Commercial Trust	Mar-06	0.50	3.5 % of net property income	1.00	0.50	No
10	K-REIT Asia	Apr-06	0.50	3 % of net property income	1.00	0.50	No
11	Fraser Centrepoint Trust	Jul-06	0.30	5 % of net property income	1.00	0.50	No
12	CDL Hospitality Trust	Jul-06	0.25	5 % of net property income	1.00	0.50	No
13	Cambridge Industrial Trust	Jul-06	0.50	5 %, 15 % of excess returns	1.00	0.50	Yes
14	CapitaRetail China Trust	Dec-06	0.25	4 % of net property income	1.50	0.50	No
15	First REIT	Dec-06	0.40	5 % of net property income	1.00	0.50	No
16	MacArthurcook Ind. REIT	Apr-07	0.50	0.1 %, 0.2 % of asset value	1.00	0.50	Yes
17	Ascendas India Trust	Aug-07	0.50	4 % of net property income	1.00	0.50	No
18	Parkway Life REIT	Aug-07	0.30	4.5 % of net property income	1.00	0.50	No
19	Saizen REIT	Nov-07	0.50	Nil	1.00	0.30	No
20	Lippo Mapletree Indo REIT	Nov-07	0.25	4 % of net property income	1.00	0.50	No

Source: Ooi (2009)

This exhibit tabulates the compensation structure of 20 REITs listed on the Singapore Exchange as at April 2008. Acquisition (disposition) fees are stated as a percentage of the purchase (sale) price of the property

REITs. In addition, their incentive fee is charged in two tiers depending on the extent of outperformance.[10]

In his study on remuneration structure of S-REIT managers, Ooi (2009) evaluated the effectiveness of the base fee, incentive fees, and performance benchmarks in promoting superior performance. The evidence shows that firstly, REIT performance is inversely related to the size of the base fee, implying that REITs that pay a bigger base fee tend to register lower performance. Secondly, the size of the incentive fees has a positive impact on REIT performance. This is consistent with the notion that incentive fees align the interests of the managers with that of the shareholders. Thirdly, REITs that adopt performance benchmarking performed better than those without performance benchmarking. Fourthly, the market also rewards sponsors that structure their managers' remuneration on a low base fee and a high performance fee which has a hurdle benchmark.

In summary, remuneration structure of REIT managers has a positive influence on stock pricing during the IPO as well as on their performance over the long run. The results have a practical implication on REIT sponsors in Asia, who typically retain control of the asset management company. While they may structure a REIT to pay high management fees, the market is not blind to this possibility. In particular, the market appears to penalise such structures with a higher price discount during the IPO. Thus, the potential benefits of earning higher recurrent management fees have their boundary. On balance, the empirical results indicate that it may be better for the sponsors to structure the manager's fee to be based more on performance, rather than on asset size. Not only do the sponsors get a better valuation at IPO, the REIT shareholders also enjoy higher returns since the managers are motivated to work harder for their fees.

7.6 Conclusion

Moving forward, the Asian REIT markets will continue with their growth trajectory. A number of property owners operating in existing REIT markets have announced plans to launch new REITs. In addition to publicly listed REITs, the first open-ended private J-REIT was launched by Nomura Real Estate Development in 2010, followed by other asset management companies set up by Mitsubishi Estate, Mitsui Fudosan and Goldman Sachs (CBRE 2012). These developments

[10] The performance fee is calculated in two tiers: Tier 1 performance fee equal to 5 % of the amount by which the total return of the trust index exceeds the total return on the benchmark index, multiplied by their equity market capitalization. Tier 2 performance fee is applicable only when the total return of the trust index is in excess of 2 % per annum (1 % for each half year) above the total return of the benchmark index. This tier of the fee is calculated at 15 % of the amount by which the total return of the trust index is in excess of 2 % per annum above the total return of the benchmark dex, multiplied by their equity market capitalization.

coupled with ongoing efforts to introduce REITs in untapped markets, such as China and India, promise a bright prospect for Asian REITs.

Currently, almost all the existing REITs in Asia are externally managed. Since their fees are pegged to the AUM, external managers have understandably sought to increase the size of the REIT portfolio. Although empirical studies have shown that such aggressive strategy to grow by acquisitions, both through arms-length transactions and RPTs, has not been detrimental to shareholder's wealth, it cannot be guaranteed that this will remain in the future with REITs starting to broaden their investment scope overseas. By venturing overseas, any benefits from scale economies would have to be weighed against the risk that real estate is essentially a local game. Moreover, it is expected that investors will become more discerning of good corporate governance and management practices. Extrapolating the experiences in the US and Australia, which started as externally managed models but have over time gravitated towards the internally managed structure, a key milestone for the development of the Asian REIT markets would be the internalization of the REIT management. Moving forward, we will see further improvements in the corporate governance practices in Asia to align the interests of the sponsors and investors.

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Part III
European REITs

Chapter 8
The French REIT Market: The SIIC Regime

Ingrid Nappi-Choulet

8.1 Introduction

The French REIT or SIIC (Société d'Investissement Immobilier Cotée) regime was introduced in France in 2003. At that time, France was the third country in Europe to follow the US REIT model, after the Netherlands (FBI in 1969) and Belgium (SOCAFI in 2003). Until then, most real estate investment vehicles were not listed. The regime has helped France's listed property sector to grow rapidly, and the number of listed property companies who have opted for the SIIC regime has increased fourfold, from 11 in 2003 to 48 between 2003 and 2008, before the current financial crisis. Since then, consolidation of the SIIC industry has taken place through mergers. The number of SIIC has fallen from 48 to 38.

For the real estate industry, the aim in 2002 was to provide the Paris financial sector with a vehicle to facilitate the financing of non-residential real estate. But the objective was also to respond to the competitive development – and pre-eminence in the French real estate market – of foreign real estate funds at the end of the 1990s. Some major opportunistic investment funds, mainly created and managed by US investment banks, were very active at that stage in the Paris region, becoming the main investors in the commercial real estate market (Federation des Societes Immobilieres (FSIF 2007)).

The rapid growth of the sector in the 2000s has contributed positively to the performance of the Paris stock market. Figures from the IEIF (Institut de l'Epargne Immobilière et Foncière) show that the market capitalisation of the SIIC sector increased fivefold from €11.1 billion in 2003 to €53.9 billion at the end of December 2007. Today, with a market capitalisation of close to €48.2 billon at the end of December 2012, the capitalisation of the 38 SIIC exceeds that of real estate companies on the London Stock exchange (PwC 2012a, b). These vehicles represent the second largest property commercial portfolio owned by listed

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_8, © Springer-Verlag Berlin Heidelberg 2013

property companies in Europe after the UK. Today, SIIC represent 3.5 % of the total Paris Stock Exchange market capitalisation, compared with 1.21 % in 2003 when the regime was introduced. These capitalisation levels, considered as high in Europe, remain relatively low however when compared to those encountered in some Asian/Pacific countries such as Singapore, Japan or Australia (where listed property companies may represent 10–30 % of total stock exchange capitalisation) or even Hong-Kong (45 %).

SIICs are today the key actors in major urban development programs and large-scale project such as the renovation of La Defense business district, the urban renovation of Lyon and Marseille, or the Forum des Halles in Paris.

8.2 The SIIC Regime

The French SIIC regime, created in 2003 upon the initiative of the French federation of the listed real estate companies ("Fédération des Sociétés Immobilières et Foncières" – FSIF) allows listed property companies, under certain conditions, to elect for exemption from corporate income tax and capital gain income (Baker and McKenzie 2013). To qualify, SIICs are *inter alia* required to distribute each year their profit as dividend. At least 85 % of the current profit derived from property rental activities must be distributed before the end of the following fiscal year, and 50 % of any capital gains realised on sale of properties before the end of the second year.

The tax transparent regime is available to companies listed on a French regulated stock market, with a minimum share capital of €15 million and whose primary purpose is the acquisition or ownership of rental property. Companies fulfilling these two criteria and whose corporate purpose includes holding/controlling direct/indirect interests in rental property investment or development companies that are themselves tax-transparent or have opted themselves for SIIC status, are also eligible. Dividends received from subsidiaries that have elected to be taxed as SIIC must be redistributed in full before the end of the following year. The regime was also considered to be favourable since capital gains realised within a SIIC were taxed at a rate of 16.5 % (rather than 33.33 %) and at 19 % since SIIC5.

Since its introduction in 2003, the regime has been significantly improved, completed and extended by many tax amendments referred to as SIIC 2, SIIC 3, SIIC4 and (in 2008) SIIC 5. The amendments in the 2004, 2005, 2006 and 2008 Finance Acts include fiscal incentives for corporate property owners to sell their real estate assets to SIICs and certain other unlisted property funds. SIIC 3, introduced in December 2005, extended the regime to transactions concerning the sale of SPVs holding property or rights associated with property lease-financing (credit-bail).

Following the success of SIIC 3, SIIC 4 was introduced in an amendment to the Financial Bill for 2006. It includes several provisions which amended the SIIC regime with the aim of diversifying control of the capital of a SIIC, and thus

avoiding the creation of captive SIIC with a single controlling shareholder. SIIC 4 limits the direct or indirect participation of any single shareholder to 60 % of the company capital (to be completed before end 2008), and imposes a minimum free float of 15 % at the time of an IPO. This measure very clearly targets those SIICs created by institutional investors solely for fiscal reasons, as opposed to the economic goals originally promoted by the government and the FSIF (French listed property Federation). On a fiscal level, the new amendment seeks to guarantee effective payment of tax by all French or foreign shareholders in the capital of a SIIC. It thus targets those accumulating tax breaks on both sides of international borders. This includes, for example, Spanish investors benefiting from their reciprocal tax agreement with France, and funds located in Luxemburg or other tax shelters. Finally, a provision introduced by SIIC 4, encourages SIIC companies to invest in a new category of real estate assets: hotels, cafés, and restaurants.

SIIC 5, introduced by the Finance Bill for 2009, has led to major changes in the SIIC regime. It has postponed the entry into force of the 60 % shareholding threshold, increased the 16.5 % exit tax rate up to 19 %, modified rules applicable to exit from the SIIC regime, increased the 16.5 % exit tax rate up to 19 %, and extended the scope of the SIIC regime (Baker and McKenzie 2013).

These progressive SIIC reforms have encouraged corporate owners, notably those with property held on their balance sheet for a number of years and which would generate significant capital gains on resale, to re-cycle their real estate assets to SIIC under a favourable tax regime. In doing so these companies can avoid the normal corporate tax of 33 % on capital gains, by paying an 'exit' tax of 16.5 % before SIIC5, increase to 19 % since the new regime (gains are taxed at the reduced rate provided that the acquiring entity undertakes to keep the asset for at least 5 years), and distributing 50 % of any capital gain on property sales within 2 years. Such a change has facilitated property outsourcing by industrial and service companies and created significant opportunities for them to spin off real estate assets into SIIC.

Certain corporates have also set up their own SIIC – for example the French retailer Casino which created a captive SIIC (Mercialys) in 2005 to hold its retail property portfolio. Mercialy's assets comprise a portfolio of well-located shopping centres, most of which are adjacent to hypermarkets and supermarkets owned by the Casino group. The assets represent a total of 147 locations throughout France, and a total around 547,000 square metres of gross lettable area.

Since 2003, the SIIC sector has expanded and diversified in successive waves (FSIF 2013). The first wave included 11 property companies which opted for the SIIC tax status as from fiscal 2003. These were principally the largest existing French listed companies such as Unibail or Klépierre. In 2004, seven new SIIC were created and in 2005, ten further property companies joined the regime, including a number set up by corporates (Mercialys or Foncière des Murs for example) via the SIIC 3 amendment. The wave of options and introductions accelerated in 2006 and 2007, with 16 and 14 new SIIC respectively. Since 2008, five more property companies have opted for the SIIC status. Due to the last

Table 8.1 Updated list of French listed property companies and their conversion to the SIIC regime

SIIC		Conversions to SIIC
AFFINE R.E.		*2003*
FONCIERE DES REGIONS		*2003*
GECINA		*2003*
ICADE		*2003*
KLEPIERRE		*2003*
SILIC		*2003*
SOCIETE FONCIERE LYONNAISE		*2003*
UNIBAIL-RODAMCO SE		*2003*
ADC SIIC		*2004*
FONCIERE PARIS NORD		*2004*
SIIC DE PARIS		*2004*
TOUR EIFFEL		*2004*
ACANTHE DEVELOPPEMENT		*2005*
ALTAREA-COGEDIM		*2005*
FONCIERE DES MURS		*2005*
MERCIALYS		*2005*
ANF IMMOBILIER		*2006*
CEGEREAL		*2006*
EUROSIC		*2006*
FDL		*2006*
IMMOBILIERE DASSAULT		*2006*
KLEMURS (radiée en mars 2013)		*2006*
PAREF		*2006*
FONCIERE PARIS FRANCE		*2006*
ZUBLIN IMMOBILIERE FRANCE		*2006*
ARGAN		*2007*
BLEECKER		*2007*
FONCIERE ATLAND		*2007*
FONCIERE DES 6e et 7e ARR. DE PARIS		*2007*
FONCIERE INEA		*2007*
SCBSM		*2007*
SELECTIRENTE		*2007*
TERREIS		*2007*
FREY		*2008*
MRM		*2008*
CFI - Compagnie Foncière Internationale		*2009*
FONCIERE SEPRIC		*2009*
PATRIMOINE ET COMMERCE		*2011*
Pan European SIICs		
HAMMERSON	UK	2004
WERELDHAVE	NL	2004
CORIO	NL	2005
EUROCOMMERCIAL PROPERTIES	NL	2005
VASTNED RETAIL	NL	2005
WAREHOUSE DE PAUW	BE	2005

(continued)

Table 8.1 (continued)

SIIC		Conversions to SIIC
MONTEA	BE	2007
SEGRO	UK	2007
COFINIMMO	BE	2008

Source: IEIF-FSIF (2013)

financial crisis of 2008, there has been a high concentration of SIIC's which has modified the SIIC panorama by reducing the total number of SIIC to 38 (Table 8.1).

The capitalisation and the free float of the 38 French SIIC at the end of 2012 are exhibited in Table 8.2. At this time the three largest SIIC exceeded €5 billion market capitalisation on the Paris Stock Exchange. These three French companies were also in the top five European REITS in 2012, with Unibail-Rodamco (€16.7Bn) taking pole position ahead of the British property company Land Securities (€7.4Bn) in terms of capitalisation.

8.3 Positive Effects of SIIC Regimes

Based on data collected by IEIF, the FSIF has recently drawn up an economic, fiscal and social assessment of the SIIC system. One key finding of this analysis has been to demonstrate the capacity of SIIC to raise new finance through the stock market. Over the period 2004–2007, SIICs raised some €3 billion in fresh equity capital. This represents an efficient source of funding, not only for their own development, but also for corporates in other sectors of the economy which have been able to unlock capital by recycling their real estate assets to the SIIC. The year 2007 was a very active year for the SIICs which raised some €4.8 billion in the stock market, ten times more than the €216 million raised in 2003 (Fig. 8.1). For the same year, close to €2.8 billion was raised from new stock market listings, and more than €1.1 billion was raised through other market operations, principally capital increases by existing companies (€1.138 billion). The capital raised represented over half of the total capital raised by all European REITs and equivalents, confirming France's position as one of Europe's most dynamic REIT markets.

Following the 2007–2009 recession, SIICs have regained their vitality with a strong activity on the bond market. In 2012, they raised some €767 million in the stock market and more than €6.1 billion through bond issues. The capital thus raised represented 43 % (IPOs excluded) of the total capital raised by all European REITs and equivalents.

The new funding thus raised has had a significant effect on the long-term investment capacity of the SIIC sector – despite an effective cap on borrowings (there is no statutory cap as in certain REIT regimes). From €1.54 billion in 2003, investments made by the SIIC have multiplied by almost tenfold to close to

Table 8.2 Capitalisation and free float of French SIICs at the end of 2012

SIIC	€ M	Floating captial (in %)	SIIC	€ M	Floating captial (in %)
UNIBAIL-RODAMCO SE	16,783	100	ARGAN	163	60
KLEPIERRE	5,988	50	FONCIERE INEA	160	30
GECINA	5,325	35	KLEMURS	127	20
FONCIERE DES REGIONS	3,665	50	AFFINE R.E.	122	60
ICADE	3,480	45	PATRIMONIE & COMMERCE	121	25
SOCIETE FONCIERE LYONNAISE	1,652	15	IMMOBILIERE DASSAULT	108	20
MERCIALYS	1,578	35	FREY	106	20
SILIC	1,460	60	SELECTIRENTE	66	45
ALTAREA-COGEDIM	1,277	25	FONCIERE SEPRIC	66	35
FONCIERE DEVELOPPEMENT LOGEMENTS	1,246	15	ACANTHE DEVELOPPMENT	53	40
FONCIERE DES MURS	1,105	10	BLEECKER	50	10
EUROSIC	729	5	SCBSM	45	25
SIIC DE PARIS	581	15	PAREF	42	40
FONCIERE DES 6e ET 7e ARRONDISSEMENTS DE PARIS	450	20	CFI-COMPAGNIE FORCIERE INTERNATIONALE	40	25
ANF IMMOBILIER	429	40	FONCIERE ATLAND	29	20
TERREÏS	338	40	ZUBLIN IMMOBILIERE FRANCE	27	35
TOUR EIFFEL	272	85	ADC SIIC	20	45
CEGEREAL	262	30	MRM	5	70
FONCIERE PARIS FRANCE	226	10	FONCIERE PARIS NORD	1	100
			TOTAL 38 SIIC	**48,195**	

Pan European SIICs	€ M	Floating captial (in %)	Pan European SIICs	€ M	Floating captial (in %)
HAMMERSON	4,291	100	WERELDHAVE	1,041	100
CORIO	3,301	100	WAREHOUSE DE PAUW	712	75
SEGRO	2,256	100	VASTNED RETAIL	623	95
COFINIMMO	1,472	95	MONTEA	160	45
EUROCOMMERCIAL PROPERTIES	1,236	80			
			TOTAL	**15,092**	

Source: IEIF (2013)

€9 billion in 2006–2007. Data for 2010 indicated more than €5.65 billion of investments in acquisitions and construction/works and renovation.

The SIIC regime has contributed to a transformation in the property investment market in France (principally the commercial real estate market) which has

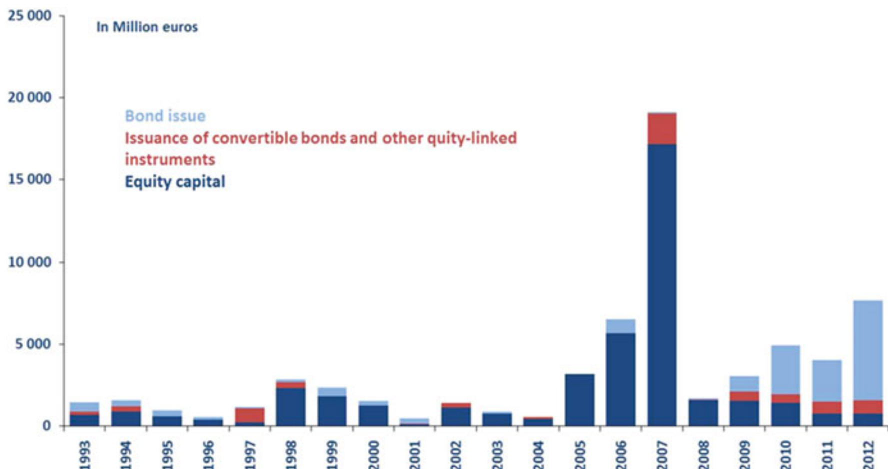

Fig. 8.1 Capital raised by property companies (in €million) (Source: IEIF 2013)

experienced a rise in the number of domestic property companies active in the market. SIIC companies were among the largest buyers before the financial crisis of 2007, accounting for 43 % of total investment in 2006, compared to 18 % in 2005 and significantly ahead of Private Investment Funds (32 %). Figures from CBRE show that the volume of investment by SIIC rose from €2.8 billion to nearly €10 billion in 2006 though this dropped back to €8 billion in 2007. Assets held by SIICs have significantly increased between 2003 and 2011 (+26.8 % per annum in m^2), due to the increased number of companies opting for the SIIC regime and due to growth strategies implemented by the SIICs. The last data show that SIICs tend to invest mainly within the Paris region and large regional cities such as Lyon, Marseille and Lille. In 2012, the real estate stock held by SIICs represents over 33 million m^2, invested mainly in offices and shopping centres (for 70 % of the total surface area under investment and 77 % of the total value). According to the FSIF, SIICs are projected to invest €17 billion in new real estate projects over the 2012–2016 period in France, which should generate more than 88,700 full time workers per year in the construction/public works sector and 33,700 jobs in the retail industry.

The introduction of the SIIC statute has also had a significant impact on national and local tax revenues. Since 2003, the conversion or 'exit' tax payable by property companies on opting for SIIC status has generated an annual tax revenue flow of some €330 million, representing a total amount of more than €2.5 billion, to which can be added the tax generated on capital gains realised by corporate outsourcing of property assets towards the SIIC, and the stamp and transfer duties payable to local government on sales. According to the FSIF, the contribution made by SIICs to public finance revenues by way of their corporate tax payments and their shareholder's income tax payment represented 61 % of the taxable base in France in 2013.

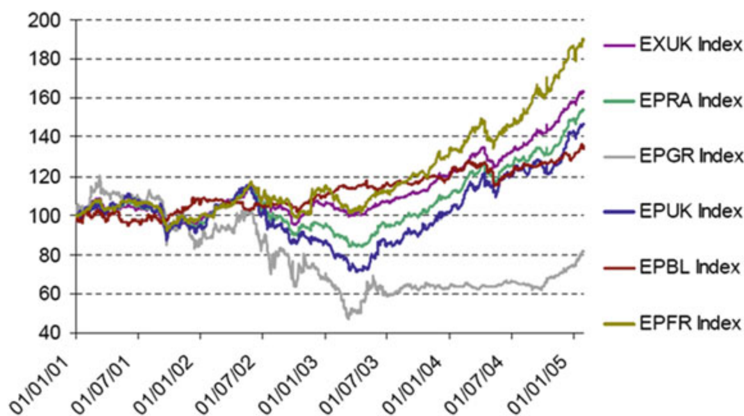

Fig. 8.2 Evolution of the performance of property companies in Europe (Source: Batsch et al. 2005)

The extra liquidity provided by the SIIC in the market, the switch to current value accounting under IFRS rules and the absence of any latent tax liability on capital gains have contributed significantly both to a more fluid property investment market, and also to a re-rating of the French listed property sector by stock exchange investors. Before the SIIC regime was introduced, property companies generally traded at a discount to Net Asset Value (NAV) which historically averaged around 20 %.

Many SIIC saw both their NAV (at market value as estimated by an independent valuer) and share prices rise significantly between 2004 and 2006, coupled with an increase in trading turnover, and almost all property companies' shares were trading at a premium to breakup NAV until mid 2007. For example, the Tour Eiffel SIIC which opted for the SIIC regime in 2004 recorded a premium against its NAV of 17 % in 2005 and 63 % in 2006 respectively. The new trading conditions in the market since the effects of the 'sub-prime' financing crisis became apparent in August 2007 has had a significant effect in the sector – both on the value of the underlying assets, and on corporate valuations as risk-premia are reassessed.

A comparison of the performances of property companies in different European countries highlights the over-performance of the EPRA France index (Batsch et al. 2005) during this period. In November 2002, the French index showed an over performance of 15 % compared to all the other European indices (Fig. 8.2) reflecting speculation at that time regarding the adoption of a REIT statute.

The introduction of the SIIC regime continued to boost the performance of the French listed property sector. For the 2003–2012 period, the SIIC index out-performed the Paris Euronext SBF CAC all Tradable, with a performance of +233 % (compared to 17 % for the 1999–2002 period). In 2006, SIIC recorded on the Paris stock exchange historical performances for all property companies: +68.4 % for Icade, +67.9 % for Klépierre, +60.4 % for Unibail and +40.1 % for Foncière des Régions. For the 2006–2012 period, the SIIC index has seen a slump

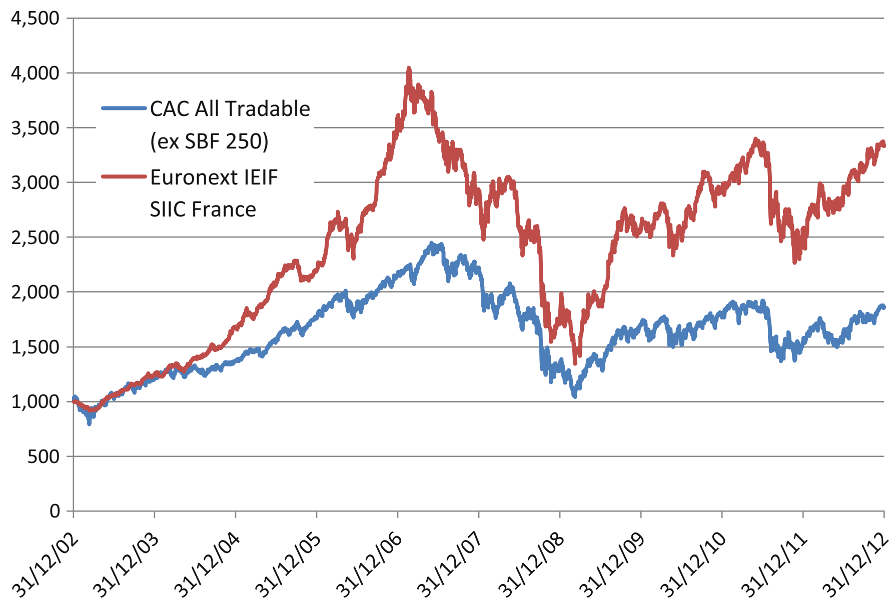

Fig. 8.3 Performance of the SIIC index (IEIF, January 2013)

in its performance due to the financial crisis but has experienced a lower decline than the Paris Euronext SBF CAC all Tradable (respectively minus 7 % against minus 14 %). In 2012, the index still out-performed (+29 %) the Paris Euronext SBF CAC all Tradable (+21 %) (Fig. 8.3).

8.4 Conclusions

By allowing listed property companies to opt to become tax-transparent, the SIICs represent France's version of the Real Estate Investment Trusts concept. The regime was enacted by the Finance Bill for 2003 and has been considered as a model for other European countries.

The regime has helped France's listed property sector to grow rapidly. At the end of 2012, 38 French property companies had opted for SIIC status. These vehicles represent a market capitalisation of around 48 billion euros, the second in size in Europe after the UK market. The regime has also had a leveraging effect on the stock market level, raising share prices and increasing trading. Since the 2008 financial crisis, the SIICs have slowed down their investments and are today faced to the increase of their debt, the drop in value of their net assets and the new environmental constraints of the Grenelle Environnement Forum with the greening of their assets.

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Chapter 9
UK REITs - Are they delivering what was expected?

Karen Sieracki

9.1 Introduction

UK REITs finally got their lift off 1 January 2007 after 30 years discussion and the Housing Investment Trusts (HITs) debacle. The main hurdle was HM Treasury and its concern about tax leakage to its coffers, not the investors. Nine UK listed property companies became REITs at 1 Jan 2007 with a market capitalisation of £36.9bn. Capital gains tax savings were in the region of £4.7bn.

The timing of the institution of UK REITs was not good as the peak of the UK real estate market happened in June 2007 with the trough occurring 2 years later June 2009, loosing on average 42 % capital value (IPD Monthly). There has been some recovery as measured by IPD, but the only one segment which recouped all the capital loss as at end December 2012 was prime Central London offices. The impact of this on UK REITs was the take over and/or restructuring of some REITs as loan covenants were breached and loan payment deadlines loomed.

July 2012 saw some UK Government changes to UK REITs which were helpful:

- Abolition of 2 % of total capital value entry charge.
- Cash qualifying as a good asset which assisted start up REITs in the raising of money.
- Diverse ownership rule for UK institutions.
- Three year grace period for new REITs to obtain a reputation and raise equity.
- Relaxation for a UK REIT to be listed on a "recognised stock exchange" which enabled those companies on AIM to obtain UK REIT status.

By the end of 2007, there were 16 UK REITs. At the end of March 2013, there were 23 UK REITs with 19 listed on the London Stock Exchange and 4 listed on the Channel Islands Stock Exchange. From 2008 to March 2013 there were only 8 new

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_9, © Springer-Verlag Berlin Heidelberg 2013

UK REITs. One UK REIT, Brixton Estates plc was taken over by another UK REIT Segro plc in 2009. Therefore, the vibrancy of the UK REIT sector has been muted with few new entrants during a time when capital volatility dominated the UK real estate market. The UK Government did not nurture this sector by being proactive in making the rules more amenable. Concern is still articulated as to the viability of UK REITs and the wholehearted lack of investor support. Other issues are valuation, specialist or diversified UK REITs and the operating company/property company model.

Another development has been Property Authorised Investment Funds (PAIFs) which were given HM Treasury approval in 2010 which enabled property unit trusts to enjoy tax relief for the investor. There were three PAIFs at the end of March 2013 (Royal London Property Fund, Schroder UK Property Fund and M&G UK Property Fund) which can be seen in part as competition to UK REITs in offering no double taxation and tax free dividends. This Chapter will discuss the road to the formation of UK REITs, their institution and future potential developments.

9.2 The Pre UK REIT Dialogue

There has always been interest by the real estate investment community for a tax transparent securitised vehicle in the UK for the past 30 years drawing mainly from the US and Australian experience. There had been no tax neutral securitised property vehicle for the UK. Instead investors in listed UK property companies were doubly penalised in terms of the tax on income and capital gains. The investor emphasis in the UK was on collective real estate investment vehicles. To own real estate directly was not an option open to many investors, whether they were individuals or institutions. The quest was to provide a tax efficient vehicle for collective investment in real estate.

Many real estate investors in the 1980s and 1990s structured their investments offshore or through limited partnerships to achieve collective investment status and to reduce the tax burden to the Exchequer. The choice of vehicles was not wide. There were costs involved in setting up such vehicles and tax leakage still occurred. Liquidity was also another important factor. Table 9.1 below briefly lists the options at the time.

In 1996, Housing Investment Trusts (HITs) were established in the UK with the aim to encourage both institutional and individual investment in private housing rental schemes through tax advantages (Crook and Hughes 1998). The UK Government wanted to increase the provision of private rented housing by encouraging investment in HITs. Institutions in the UK (pension funds and insurance companies) had shied away from residential investment due to the issues involved in housing management and the difficulty in obtaining a critical amount of stock. This all compounded the effect of too many restrictions and complications for investment in the residential sector.

Table 9.1 Collective vehicles for indirect investment in UK real estate in the 1980s and 1990s

Vehicle type	Tax treatment
Listed property companies	Double taxation on income and capital gains
Unauthorised Property Units Trusts (PUTs)	Designed for UK tax-exempt institutions such as charities and pension funds to invest collectively in property. If the investor is one of these, no tax on income or capital gains
Authorised Property Unit Trusts (APUTs)	APUTs pay tax on income at basic rate. Relatively heavy regulatory framework
Property Investment Trusts (PITs)	PITs exempt from capital gains tax on shareholdings but subject to corporation tax on assessable income
Housing Investment Trusts (HITs)	Established by the government in 1996 giving tax transparency to residential investment vehicles. Not a success due to removal of Advanced Corporation Tax and unworkable restrictions
Limited partnerships	Set up by statute 1907 and 2000 Acts. Partners affected by sale or acquisition of "units" by other partners. Partnership transfers attracted stamp duty tax. Needed to have particular framework so not to be treated as a corporate
Jersey Property Unit Trusts (JPUTs)	Offshore, non payment of full Stamp Duty (since revoked) but 0.5 % payable on purchase of units. 20 % tax on rental income. Capital gains exempt
Guernsey Property Unit Trusts (GPUTs)	Offshore, non payment of full Stamp Duty (since revoked) but 0.5 % payable on purchase of units. 20 % tax on rental income. Capital gains exempt
Isle of Man Property Unit Trusts	Offshore, non payment of full Stamp Duty (since revoked) but 0.5 % payable on purchase of units. 20 % tax on rental income. Capital gains exempt
Listed Property Trusts (LPTs)	Dual listing (Channel Islands and London). First one in 2003. Often described as UK's "offshore REITs"

HITs were not a success for many reasons. Firstly, residential was the only sector for investment. There was no choice of sector. Secondly, professionally managed funds were still penalised compared to individual direct investors because they had to pay a corporation tax of 24 %. There was not a level playing field with direct ownership. To be equal, the tax treatment of HITS would have to be 20 %. Thirdly, as HITs were to be listed to provide liquidity, the market value had to be at least £30m and traded on the London Stock Exchange according to its listing rules at the time. There would also be the hurdle that the stock market would most likely discount the share value below the asset value.

Fourthly, Business Expansion Scheme companies or properties that were let on assured tenancies could not be transferred to a HIT. These were usually new properties so would have been ideal stock. HM Treasury did not want investors to have the double benefit of no tax. Fifthly, there was the difficulty of building sufficient properties or finding the stock. If average property values were £50,000, then at least 600 properties would be required to meet the £30m desirable level for Stock Exchange listing at this time. This would also run counter to the six month rule for Stock Exchange listing.

Sixthly those companies which could be seen as "seed" HITs would have to compete in an unfavourable tax environment before they achieved HIT status. Seventhly, Government proposals were to exclude properties worth more than £85,000 (or £125,000 in London). This excluded one in five privately owned residential buildings. In the South East, this excluded one third of all private sector stock. Eighthly, vacant possession values were higher than tenanted values, so potentially available properties were more likely to be sold before they were relet. Ninthly, the 1997 Budget prevented institutions from recovering Advanced Corporation Tax on distributions. Finally, HITS were unable to distribute capital gains following portfolio sales.

There was only one HIT. Savills, the chartered surveying firm, developed a Housing Investment Trust called Savills' Residential Property Trust (SRPT). The Trust's placing document was issued in December 1997 with the intention to raise £80m of equity to purchase 2,000 units in the first 6 months, followed by a further target of 3,300 units to be acquired by the end of the second year. Savills' case for investment was based on increased rental and capital growth for the residential sector (Barnes 1996). Savills raised nearly £50m but it did not proceed to flotation due to two main investors withdrawing in January 1998.

The main problems with SRPT was its blind pool approach, its ambitious purchasing programme within the stated time frame and the ability to find that particular stock to meet the stated rental and capital growth forecasts. Detailed stock acquisition criteria were not disclosed in the Memorandum. No other HITs were launched. The UK institutions were very sceptical of the efficacy of HITs. The risks associated with the private rented sector were felt to be: illiquidity, management costs, voids, taxation, public perception and political uncertainty (Mansfield 1998). Therefore, no demand from the buy side emerged.

The real estate investment community in the UK decided to widen the field after the HIT debacle by concentrating on the REIT format for commercial property. The industry's various organisations (Investment Property Forum, Royal Institution of Chartered Surveyors, British Property Federation and the Corporation of London) joined together to produce a seminal report on Property Securitisation in the UK. This was the first time such a group came together to agree and fund this report (IPF 1999).

The report was submitted to the Treasury in 1999 and made the case for UK REITs. This was based on the belief that real estate investment market efficiency would be improved and that UK REITs would help to ensure that UK real estate remained competitive as an investment asset. It was thought that introduction of UK REITs would cause a fall in the cost of capital and UK REITs would increase the amount of property stock for investment. Other beneficial effects would be the lower volatility in bank lending and less business cycle instability. There was also the consideration that UK REITs would broaden the investor base in UK real estate on a more global basis and increase liquidity in this investment class. These beneficial effects would have no tax loss to the Exchequer, providing a tax neutral position for its implementation.

There were high hopes that the report would engage the Treasury as it demonstrated the UK REIT would have a more or less tax neutral position by using the Treasury's own model and assumptions in its calculations. However, this was not the case. The Treasury disagreed with the findings, particularly on the tax neutral aspect and declined to become further involved.

A hiatus developed between the real estate investment community and the Treasury for several years. In 2003, the Treasury initiated discussions with the real estate community via the Investment Property Forum, British Property Federation and the Royal Institution of Chartered Surveyors. It was becoming more apparent to the Treasury that alternatives were being found to avoid tax such as the LPTs, JPUTs and the GPUTs which met institutional investment real estate needs and as the interest for real estate investment grew from both the institutional and retail investors. Arguments for UK REITs also included the observation that the UK was the only G8 country not to have a REIT. On the European scene, France established SIICs in December 2003 (Chap. 8) and Germany was proposing legislation for GREITS to start in 2007 (Chap. 10).

The Pre Budget Report in December 2003 announced that a consultation paper would be produced in the 2004 Budget. In March 2004, the government published the consultation document on UK REITs entitled "UK Real Estate Investment Trusts: a discussion paper". This was widely welcomed by the real estate investment community and participation was broad. The Chancellor announced in his December 2004 Pre-Budget Report that the government would not introduce REITs in 2005, but would have a discussion paper ready by the March Budget 2005.

The real estate investment community remained in close dialogue with the Treasury over the following 2 years. The main areas of discussion were: levels of distribution, permissible gearing, conversion charge and development. Other areas of concern were: eligible sectors, the minimum number of properties and shareholders, together with the maximum size of a shareholding. The type of listing and on what exchange were also important issues, together with whether or not private UK REITs would be allowed as well as what activities could be ring fenced within the UK REIT entity. The March Budget 2006 stated that UK REITs were to be established 1 January 2007 with Treasury guidelines released in November 2006.

9.3 UK REITs Today

UK REITs were borne on 1 January 2007. The main requirements were the following summary points:

- A UK REIT must be UK resident company, closed ended, listed on a recognised stock exchange (not AIM). The only permissible exchange therefore was the London Stock Exchange.

- The UK REIT was a property rental business whose activities should comprise at least 75 % of the overall company with regard to both its assets and total income and should have at least three properties with no one property more than 40 % of the total capital value.
- Shareholding greater than 10 % would be tolerated if tax exempt status was only given to the 10 %.
- 90 % distribution of net taxable profits (after interest and capital allowances) must occur. Rents from owner occupied property were not tax exempt.
- Gearing was to be 1.25 interest cover ratio.
- Developments must be held for 3 years minimum to be tax exempt from capital gains.
- There would be a conversion charge of 2 % capital value.
- The new UK REIT entity was permitted to have 12 months grace to satisfy 75 % income and asset test (from March 2007 Budget). Money could be raised via a blind pool to become a REIT.

Nine UK listed property companies converted on 1 January 2007 with a market capitalisation of £36.9bn. Table 9.2 details those listed property companies which were the first to convert to REIT status.

The listed UK property companies that became REITs benefited from not having to pay capital gains tax. The savings have been significant. Table 9.3 illustrates the REIT conversion bonus.

The extent of the potential saving depended upon how efficient the property companies were in their tax planning. UK REITs were now in a beneficial position over their peers when purchasing a private property company. On purchase of the company, the UK REIT must pay the 2 % conversion charge to convert it into a UK REIT. By doing this, the UK REIT purchaser immediately negated all the capital gains tax liabilities of that private property company.

Since June 2007, there were some changes to UK REIT rules. As at May 2008, Enterprise Inns had been authorised by HM Revenue and Customs that it could list as a UK REIT pending an internal restructuring to meet the requirement that 75 % of its income be derived from property rental. Enterprise Inns constituted 7.700 tenant pubs. This UK REIT conversion could take several months but it did not happen. Other pub groups such as Mitchells & Butlers and Punch Taverns monitored this but they also did not convert.

Two other groups considered REIT status: Crest Nicholson (house builder listed on the London Stock Exchange) and Terrace Hill Group plc (AIM listed) which had acquired a 49 % interest in Nationwide's at home portfolio of 2,253 flats. However as house prices fell, this became a non-event.

Another development was that Land Securities was looking to divide in November 2007 into two UK REITs – office and retail despite the UK real estate market being on its knees. Personnel had been allocated to the different sector entities. Debt, which had been secured over the entire portfolio, was renegotiated. It was an expensive and laborious process in such UK tight credit and real estate market conditions. After 1 year, the demerger was abandoned.

Table 9.2 UK REITS as at 1 January 2007

Company	Market cap (£bn)	Estimated cost of conversion (£m)
Land Securities	10.99	300
British Land	8.97	315
Liberty International	5.08	146
Hammerson	4.51	96
Slough Estates	3.71	73
Brixton	1.56	38
Great Portland	1.14	26
Workspace	0.87	20
Primary Health Properties	0.12	4.5
Total	**36.90**	**1,020**

Source: Estates Gazette, Property Week, Reita, Cazenove

Table 9.3 Capital gains tax write offs for UK REITs

Company	CGT saving (£m)	2 % conversion fee (£m)	Potential saving (£m)
Land Securities	1,900	300	1,600
British Land	1,600	338	1,262
Liberty International	1,037	154	883
Hammerson	457	100	357
Slough Estates	426	82	334
Great Portland Estates	127	28	99
Brixton	126	42	84
Workspace	100	19	81
Primary health properties	50	5	25
Total	**5,793**	**1,068**	**4,725**

Source: EG

Despite continued lobbying by the UK real estate investment community and with the market in dire straits, the UK Government did nothing. A new UK Government was elected in May 2010 with the anticipation of the UK real estate community that this new government (Conservative-Liberal coalition) would be more helpful than the last one (Labour). This did bear fruit and July 2012 saw some UK Government changes to UK REITs which were helpful:

- Abolition of 2 % of total capital value entry charge.
- Cash now qualifying as a good asset helping start up UK REITs to raise money.
- Diverse ownership rule for UK institutions.
- Three year grace period for new UK REITs to gain reputation and raise equity.
- Relaxation for UK REIT to be listed on a "recognised stock exchange" which enabled those companies on AIM to obtain UK REIT status.

The main push was to encourage new entrants into the UK REIT sector. As at March 2013, there were two new UK REITS: Ground Rents Income Fund (August 2012) and LondonMetric Property (Jan 2013).

Table 9.4 UK REITs as at 31 March 2013

Company	UK REIT date	Stock exchange listing	Type	Asset value (£m) (date)
ApexHi Property Fund Ltd	Aug-11	Channel Islands	Diversified	n/a
Big Yellow	Jan-07	LSE	Self storage	£771m (Sept 12)
British Land	Jan-07	LSE	Diversified	£10,400m (Sept 12)
Derwent London	Jul-07	LSE	Offices	£2,859.6m (Dec 12)
Glenstone Property Group	2009	Channel Islands	Retail	£72.57m (2012)
Great Portland Estates	Jan-07	LSE	Offices	£2,161m (Sept 12)
Ground Rents Income Fund	Aug-12	Channel Islands	Ground rents	£48.0m (Dec 12)
Hammerson plc	Jan-07	LSE	Retail	£5,458m (Dec 12)
Hansteen Holdings plc	Oct-09	LSE	Industrial	£1,005.7m (Dec 12)
Highcroft Investments plc	Apr-08	LSE	Diversified	£40.18m (June 12)
Intu (formerly Capital Shopping Centres Group plc)	May-10	LSE	Retail	£1,671m (Dec12)
Land Securities plc	Jan-07	LSE	Diversified	£10,330m (Mar 12)
Local Shopping REIT	May-07	LSE	Retail	£184m (March 12)
LondonMetric Property	Jan-13	LSE	Diversified	£1,050m (Jan 13)
McKay Securities	Apr-07	LSE	Diversified	£222.44m (Sept 12)
Mucklow (A & J) Group	Jul-07	LSE	Diversified	£254.5m (Dec 12)
NewRiver Retail	Sep-09	Channel Islands	Retail	£219.2m (Sept 2012)
Primary Healthcare Properties plc	Jan-07	LSE	Healthcare	£622.4m (Dec 12)
SEGRO	Jan-07	LSE	Industrial	£4,700m (Dec 2012)
Shaftesbury plc	Apr-07	LSE	Retail	£1,828.2m (Sept 12)
Town Centres Securities plc	Oct-07	LSE	Diversified	£309.58m (Dec 12)
Warner Estate Holdings	Apr-07	LSE	Retail	£663.2m (Dec 12)
Workspace Group plc	Jan-07	LSE	Offices, industrial	£781m (Sept 12)

Source: Company accounts, KASPAR

Six years down the line, there have been changes as shown in Table 9.4 below. There are now 23 UK REITs.

The main changes since January 2007 were:

- Slough Estates plc changed its name to Segro plc in May 2007.
- Brixton Estates plc was taken over by Segro plc in July 2009.
- Capital Shopping Centres Group plc demerged from Liberty International in May 2010.

- Hammerson plc sold its office portfolio by November 2012 and was now 100 % retail in UK and France.
- Capital Shopping Centres Group plc renamed itself as Intu Properties plc in February 2013.

9.4 UK Real Estate Downturn and Debt

The UK real estate downturn was a big wake up call for those property companies and investors who had high levels of debt. These levels became exacerbated as capital values fell. This had a big impact across the real estate investment community which included UK REITs.

There were several lessons to be learned:

1. Take preventive action in renegotiating the debt before the real estate crash happens.
2. Diversify the sources of debt in terms of type, cost and maturity.
3. Do downside scenarios.
4. Do not over borrow.

Table 9.5 details the current debt situation of UK REITs from the respective company accounts. Columns are blank where there was no available data. The UK REITs listed on the Channel Islands Stock Exchange had poor information.

Out of a total asset value of around £29.339bn (different company account dates so this figure must be treated as an approximate one) there was on average £9.885bn of debt (same comments as per asset value), showing an average 33.7 % gearing level.

Most UK REITS had undergone debt restructuring since the UK real estate market crash in June 2007. Not only did debt need to be restructured, but capital also needed to be raised. Some UK REITs had to raise dilutive equity and/or sell the best assets at reduced prices in order not to breach debt covenants. Some UK REIT survived, others did not. For some UK REITs, having a Central London portfolio was their saviour as capital values recovered the most quickly for this segment.

The many different types of debt used were: bank loans, revolving bank debt credit facility, overdraft, syndicated bank loan club deals, convertible unsecured loan stock, insurance company loans, long term mortgages, debentures, finance leases, unsecured US private placement bond and retail bond. The two new developments were for some UK REITs to raise money in the US via a US private placement bond (e.g. British Land and Great Portland Estates) and the UK retail bond (e.g. Workspace). The UK retail bond format started in 2010 and acquired the London Stock Exchange platform in the summer of 2012. Issuance for 2012 was £1.7bn with expectations of £3bn for 2013 (LSE).

UK REITs needed to be careful of the debt cocktail in terms of type, maturity and cost. There are several ways to mitigate the impact of their debt overhang. Equity was raised via shares for some UK REITS (e.g. Land Securities, Great Portland Estates and Workspace) but this had the effect of diluting equity held by

Table 9.5 UK REITs current debt situation

Company	Asset value (£m) (date)	Net debt (£m)	Gearing (%)	Weighted Av cost of debt (%)	Av debt duration (years)
ApexHi Property Fund Ltd	n/a	n/a	40	n/a	n/a
Big Yellow	£771m (Sept 12)	£277.2m	35.90	4.24	n/a
British Land	£10,400m (Sept 12)	£5,017m	46	4.40	9.4
Derwent London	£2,859.6m (Dec 12)	£874.8m	45.60	4.51	6.1
Glenstone Property Group	£72.57m (2012)	£19.36m	37.10	n/a	n/a
Great Portland Estates	£2,161m (Sept 12)	£735.2m	56.30	4.30	7.5
Ground Rents Income Fund	£48.0m (Dec 12)	£0m	0		
Hammerson plc	£5,458m (Dec 12)	£2,036m	53	5.00	7
Hansteen Holdings plc	£1,005.7m (Dec 12)	£444m	39	3.20	2.7
Highcroft Investments plc	£40.18m (June 12)	£0m	0		
Intu (formerly Capital Shopping Centres Group plc)	£1,671m (Dec12)	£164m	10	5.20	4.8
Land Securities plc	£10,330m (Mar 12)	£3,183.2m	59.20	5.00	10.9
Local Shopping REIT	£184m (March 12)	£133.9m	260	n/a	3.32
LondonMetric Property	£1,050m (Jan 13)	£376m	n/a	3.50	3.5
McKay Securities	£222.44m (Sept 12)	£108.0m	48.60	5.00	n/a
Mucklow (A & J) Group	£254.5m (Dec 12)	£63.7m	35	n/a	n/a
NewRiver Retail	£219.2m (Sept 2012)	£132.6m	60.50	3.88	3.16
Primary Healthcare Properties plc	£622.4m (Dec 12)	£38.9m	60.90	n/a	6.9
SEGRO	£4,700m (Dec 2012)	£2,090m	51	4.90	8.4
Shaftesbury plc	£1,828.2m (Sept 12)	£556.7m	44.20	5.43	6.8
Town Centres Securities plc	£309.58m (Dec 12)	£165.4m	53.40	4.50	n/a
Warner Estate Holdings	£663.2m (Dec 12)	n/a	n/a	n/a	n/a
Workspace Group plc	£781m (Sept 12)	£393m	n/a	n/a	2.7

Source: Company accounts

existing shareholders if they did not take up the offering. Real estate disposals was another way but one needed to look at the relationship of the sale price to the debt level, particularly where values had fallen. Other ways were: asset management to increase value, development proceeds, rental growth driven capital gains as well as cyclical valuation uplifts.

The cost of debt was not only the margin over LIBOR but there were arrangement fees, interest rate swaps and currency hedging. The size of the margin over LIBOR was also dependent upon the company's credit status. A better credit status made debt cheaper than if the credit status was poor.

Most UK REITs needed to reschedule their debt in the wake of the severe capital downturn in the UK real estate market. However, there are two UK REITs which might not make it: Local Shopping REIT and Warner Estate Holdings. Local Shopping REIT has a gearing level of 260 % with its entire bank loan of

£133.9m due during 2016 (Company accounts March 2012). Its asset value was £184m (March 2012) and there was no debt diversification. For Warner Estate Holdings it was in negotiation with its three lenders. It was trying to dispose of assets (asset value £663.2m Dec 2012) which were difficult due to the experienced capital loss which had not been recovered in the market (Company accounts Dec 2012).

UK REITs are subject to the following main risks which must be managed to be successful: strategic, financial, investment, operational and compliance. Strategic risks take into account the type of portfolio and its performance within the global and macroeconomic context. The main financial risks are solvency and covenant breach which requires constant monitoring as well as ensuring there is sufficient headroom between capital value and debt levels if capital values decrease and/or debt levels increase. Investment risks take into account the real estate cycle and the appropriateness of investment plans within that cycle and the anticipation of valuation movements. The execution of decisions is the important factor here. Operational risks are those concerning the business such as health and safety, IT disruption, environmental impact, ability to motivate key staff and breach of anti-bribery and corruption legislation. Compliance risks deal with legal or regulatory sanctions, material financial loss or loss of reputation.

9.5 Performance

The performance of UK REITs has been volatile in the short term (1 year) and medium term (5 years) as illustrated in the chart below. Over the long term (10 years) UK real estate companies' performance is similar to that of direct real estate market as measured by IPD (Fig. 9.1).

The EPRA Index consists of 29 different companies with 14 UK REITs and 15 UK listed property companies (EPRA Dec 12). In terms of the global developed real estate sector, the UK comprised 5 % by total value compared to the US which is the largest at 45 % as shown in the pie chart below (Fig. 9.2).

2012 was a good year for UK REITs performance with Great Portland Estates plc the best at 54.06 %, whereas the worst performer was London & Stamford Property at 7.02 % which merged with Metric Property Investments to form London Metric in January 2013 (EPRA Dec 2012). Table 9.6 below shows the 1, 3 and 5 year performance figures for the 14 UK REITs in the EPRA index.

Over the past 1 and 3 years, Central London had seen good performance but it is now finishing. This has been reflected in the above average performance of those UK REITs which have focused solely on Central London such as Great Portland Estates and Derwent London. Hammerson did well as it sold its Central London office portfolio to concentrate just on retail.

There is also concern about the viability of large out of town shopping centres and whether or not the life of the concept has now been shortened. Intu is an example as there has been a reduction in car journeys, the rise in the cost of petrol

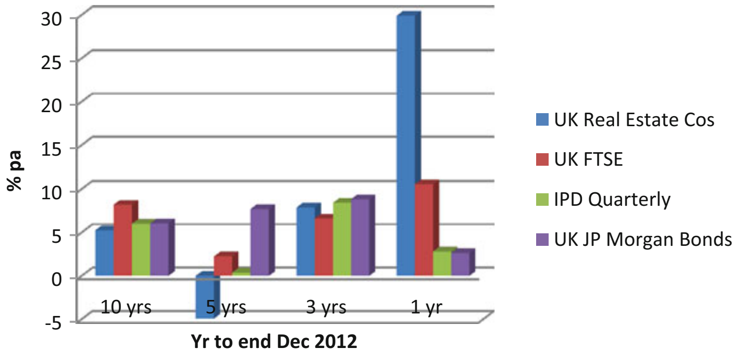

Fig. 9.1 Total return asset classes % pa year to end Dec 12 (Source: EPRA, IPD)

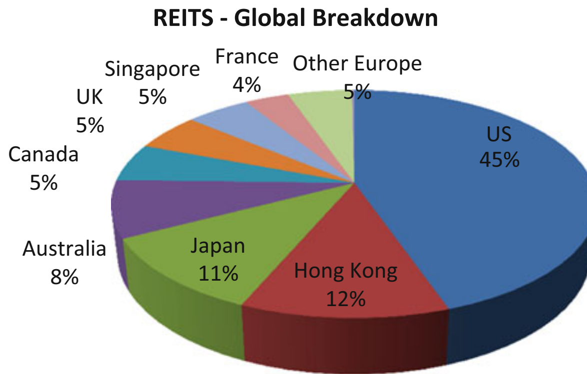

Fig. 9.2 Global developed listed real estate, breakdown by country (Source: EPRA)

Table 9.6 Performance of UK REITs, 1, 3 and 5 years to end Dec 12

UK REIT	1 year	3 years	5 years
Land Securities	32.64	9.24	−6.03
British Land	27.33	10.28	−1.89
Hammerson	40.36	8.25	−3.31
Intu	17.29	−0.33	−8.49
Derwent London	37.2	18.52	9.69
SEGRO	25.63	−5.41	−17.82
Great Portland Estates	54.06	21.43	8.9
Shaftesbury	22.8	14.72	9.58
London & Stamford Property	7.02	0.85	4.77
Hansteen Holdings	10.68	3.16	−1.29
Big Yellow	45.94	2.07	−2.67
Workspace	37.67	11.72	−30.49
Primary Healthcare Properties	15.72	12.13	5.56
Mucklow (A & J) Group	26.19	8.43	5.24

Source: EPRA

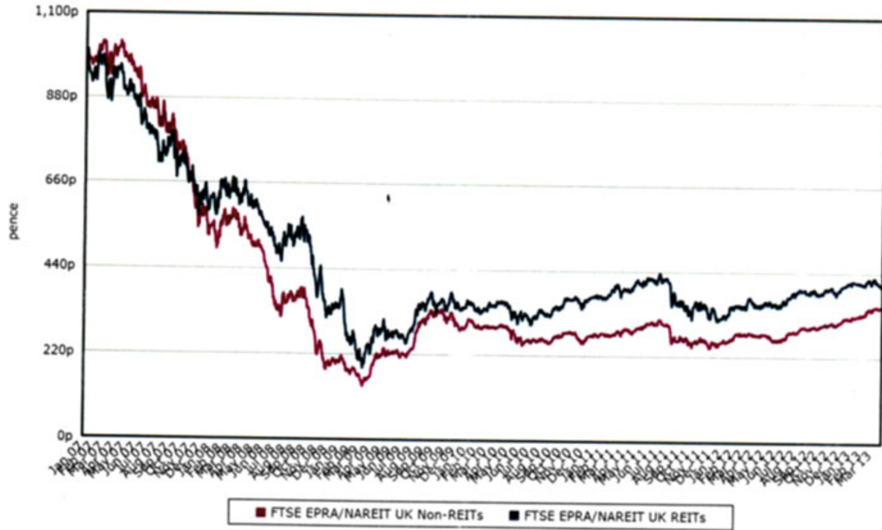

Fig. 9.3 UK REITs and UK non REITs share price performance (Source: EPRA)

and the growing influence of internet shopping, all affecting out of town shopping. Increased leisure, food and beverage activities at these locations are not necessarily the answer to draw the shopper to a "new experience". A "new experience" remains "new" for only a determined period of time before it then becomes old.

Since January 2007, UK REITs have generally outperformed UK listed property companies as seen in Fig. 9.3 below illustrating share price movements.

9.6 Future Developments

The UK REIT sector is still relatively young and developing being just over 6 years old. However, there are several concerns within the investment market about their continued viability and dynamism. UK REITs still comprise about 1.5 % of the total FTSE All Share by market value. The main concern is that there is not an easy, viable mechanism for developing the UK REIT sector with start ups. The property sector (both listed and unlisted) did suffer from capital value falls on average of 42 % peak to trough (June 2007 to June 2009 IPD Monthly). However, in the recovery phase of plus 17.8 % (June 2009 to October 2011 IPD Monthly) there was little new UK REIT activity. The new cash and the institutional club rules helped but there has been minimal activity.

The March 2007 Budget did offer a lifeline to fund management houses and their property funds for tax transparency but it took over 3 years for such funds to appear. The March 2007 Budget said that Authorised Investment Funds (AIFs) would be eligible for tax transparent treatment. Retail UK real estate funds were eligible to be

an AIF and the issue of taxation had been raised in October 2006 following the publication of the Investment Management Association Report entitled "Taxation and the Competitiveness of UK Funds". This development was applicable to the fund management houses that had UK real estate funds. However the fund would need to become an Open Ended Investment Company (OEIC) first. Property OEICs would then be able to elect to operate on the same basis as a UK REIT which meant exemption from tax at the OEIC level with the payment of tax at the investor level. Tax exempt investors would receive their dividends gross. At the time, there was a 20 % tax on rental income.

Restrictions did apply to dividends paid to shareholders who have 10 % plus shareholding. This had implications for life funds that substantially seed some of these real estate funds. At first the UK Government did not envisage any requirement for entry or membership charge for any new real estate fund AIF regime. This new regime was to be restricted to AIFs whose investment portfolio was mostly brick and mortar property or held shares in UK REITs. The Financial Services Authority (FSA) regulated OEICs. Regular valuations (i.e. daily) and unit pricing methodology were required. The March 2007 Budget ruling on AIFs did not take effect immediately as the Treasury needed to issue guidelines after consultation with the fund management industry.

This did not work and the Treasury was constantly lobbied by the real estate industry with regard to its ineffectiveness. The Treasury was continually obsessed about the perceived loss of Stamp Duty Land Tax (SDLT) in the setting up of the feeder funds. The Association of Real Estate Funds (AREF) was the main group to push for Stamp Duty Tax provisions (2007–2011) in the seeding of commercial real estate property funds which were now termed Property Authorised Investment Funds (PAIFs). As the larger life and pension funds would be the main beneficiaries in seeding such funds, AREF maintained there would be no reduction in SDLT as the real estate would continue to be held in existing structures. Parity of tax treatment with other vehicles was important for the success of PAIFs.

There is a sizeable pool of UK real estate funds that could become eligible for a PAIF. There are 86 UK real estate unlisted funds which cater mostly for the institutional market (INREV May 2013): 46 are core UK real estate funds, 33 are value add and 7 are opportunistic. They all have various structures such as being open, closed, JPUT, GPUT, LPT, PUT, APUT or limited partnership. As discussed previously, they all suffer from some tax leakage. Not all funds would convert as PAIFs need to be onshore and together with the associated costs in achieving this; it remains an option for a few funds who are seriously investigating it.

The Royal London Exempt Property Unit Trust was the first fund to convert to a PAIF in May 2010 (£188m size). There continued to be a hiatus and Schroder's SEPUT was the second in July 2012 (£1.5bn). M&G Property Fund converted to a PAIF in January 2013 (£2bn). In March 2013, Scottish Widows Investment Partnership and Canada Life have stated conversion intentions to a PAIF by the end of 2013.

PAIFs require approval from the Finance Conduct Authority (the new Financial Regulatory Authority as at April 2013) to operate which takes 6 months for an

initial response which usually requires amendments. There are three strands of income which must be reported separately but united in one payment to the investor: rental income, dividend returns from property shares and interest income returns from free cash or cash equivalents. Also, all existing unit holders need to vote on conversion to the PAIF. The cost of a conversion is in the region of £1-£2m which is borne by the fund management house, not the investors. Therefore to convert to a PAIF, time and cost considerations are important as well as business execution and real estate market timing.

Another trend on which the investment market is waiting a verdict is whether UK REITs will become more specialised in their sector focus. Hammerson achieved this by selling its £627m office portfolio in November 2012 and becoming specialist in UK and French retail with 22 out of town retail parks and 20 large shopping centres. There are 8 diversified UK REITs and 15 specialist REITs so it looks like the trend is for the specialist route.

Valuation of UK REITs is another area that is being monitored. At the moment, the traditional model for listed UK property companies has been on a discount to Net Asset Value (NAV) basis. UK REITs are mainly valued either quarterly or semi-annually according to the Royal Institution of Chartered Surveyors rules (RICS) and some have their direct property performance calculated by the Investment Property Databank (IPD). They are therefore in that performance universe.

One of the main justifications for UK REITs is that it is an income stock and not as volatile as the general equity market due to its real estate base being structured on this income return. Following this presumption, the valuation model should logically be based on the income stream, not the capital value. The focus should be on the net operating income that is distributed as income which is the main investment rationale. To date, there has been no change in the valuation model for UK REITs. Any change would have implications for assessment of the sector as well as for the RICS valuation process and the IPD universe.

9.7 Summary

The focus is on capital and how to attract it to different real estate investment platforms. Currently, there is a more fluid real estate investment landscape with more choice and a wider investor pool. The size of the UK REIT market as a percentage of total market value (1.5 %) has not really improved since UK REITs were introduced in January 2007. The average UK REIT dividend yield is 3.6 % (EPRA) which dissuades investors who need income. The Property Income Distribution (PID) is paid from UK REITs' rental income.

As UK investors become older, income is more of a necessary requirement. Therefore, some investment which needs income has migrated to bonds, government gilts and equities with high dividends. The UK REIT market should pay attention to this or risk becoming an investment irrelevance.

Global funds are more common with different mixes of asset types and with UK REITs an important constituent. A true European REIT which overcomes the barriers of different jurisdictions and taxes would be an important aim but it appears to be many years away. The issue is how much investors and the various UK governments love UK REITS. The track record so far has not been encouraging. However, there could be some hope with the changing demographics and its income needs making UK REITs recognise this and changing their structure to accommodate it.

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Chapter 10
German REITs: Limited Market Dynamics or Future Growth?

Bernhard Funk and Ramón Sotelo

10.1 Introduction: Real Estate and the Capital Market in Germany

In Germany due to the experience of hyperinflation in 1923, real estate plays an important part in the mindset within society. Ever since Bismarck's days in office, investments in apartment buildings have played an important role as a means of retirement provision. However, real estate has only recently been recognized as a professional industry in Germany (Schulte and Schäfers 2004) where holding real estate traditionally belonged in the realm of private asset management. The business activities of real estate agents are regulated by the German Civil Code (*Bürgerliches Gesetzbuch*, BGB) while commercial agents are regulated by Commercial Code (*Handelsgesetzbuch*, HGB). The economic impact of the real estate industry is still considerably underestimated. The ifo Institute for Economic Research and the German Society for Real Estate Research (*Gesellschaft für Immobilienwirtschaftliche Forschung*, gif) prepared a report in 2005 describing the scope and importance of the real estate industry (IFO 2005). According to the IFO-report, real estate constitutes some 88 % of the total capital stock in Germany.

Germany has a universal banking system that is highly competitive and yields low margins partly due to its three-tier structure of private banks, co-operative banks and savings banks/state banks. Public capital markets for equity play a subordinate role in Germany, both in terms of economic resources as well as in terms of the international integration of the economy. Public capital markets in equity continue to play a below-average role for investors, which is in part due to the hitherto dominant pay-as-you-go financing of the public pension system.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_10, © Springer-Verlag Berlin Heidelberg 2013

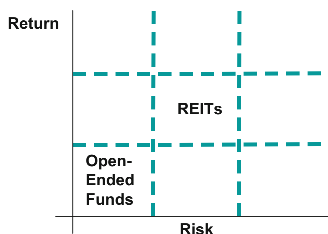

Fig. 10.1 Risk-return position of REITs (Source: Knoflach 2004). It is taken from a presentation on 15/10/2004, prepared at the early stages of the discussion by Barbara Knoflach, managing director of SEB KAG, and at the time speaker of the real estate committee of the German Investment Fund Association BVI

The German real estate investment market is fundamentally different from other real estate investment markets with indirect real estate investments made almost exclusively via private markets. Although in the second half of the 1990s a broad discussion took place regarding the creation of public listed companies, it did not gain sufficient momentum to achieve market capitalization of a size that is acceptable both to institutional and to international investors.

Open-ended real estate mutual funds have the dominant market share of available indirect real estate vehicles in Germany. As of January 2013, open-ended funds had 117.7 bn. Euro assets under management. Thereof, open-ended real estate mutual funds held 81.7 bn. Euro in assets under management.

At the beginning of the discussion concerning the introduction of REITs in Germany in year 2003, there was widespread fear that REITs could push open-ended real estate mutual funds out of the market. Most industry representatives therefore tried to differentiate REITs from open-ended real estate mutual funds using the anticipated return and the associated risk as distinguishing criteria (see Fig. 10.1).

According to this classification open-ended real estate mutual funds are defined as products belonging to the core risk class and REITs as growth class instruments. However, in contrast to this view German open-ended real estate funds have traditionally primarily invested in office space, a type of use that implies relatively high volatility of rents – due to the lower price elasticity of the demand as compared to the residential and retail markets – and therefore a relatively high risk. Moreover, German open-ended real estate funds were permitted to engage in property development on a considerable scale (section 67, Investment Act, Investmentgesetz – InvG). Open-ended special funds are a form of the open-ended real estate fund, with only a limited number of institutional investors. Although open-ended special funds can make theme-oriented investments by agreeing upon guidelines restricting investments to certain themes, fungibility of the participations is limited for the investor due to the lack of exchange trading.

The development of REITs in Germany has been influenced not only by the trend towards indirect investment vehicles, but also by the necessary differentiation of indirect real estate investment vehicles. The experience of the US is, that the majority of investments through US-REITs are focused, and diversified.

Open-ended real estate funds are virtually unable to invest in a theme-oriented manner, because in such a case any redeployment of capital in the investors' portfolios would lead to a drain of liquidity from the funds. The crisis of a Dekabank fund, which marked the beginning of the crisis of the open ended property funds in 2004/2005 can be seen as an example of the inability to invest on a focused basis. Dekabank offered the investor a choice of two funds, one with a focus on Germany and the other investing globally. The redeployment of capital from the fund primarily investing in Germany to the fund with a global investment focus led to a liquidity problem in the Germany-focused fund. This issue form Dekabank posed a challenge to other open-ended real estate funds, as a lot of these were holding overweight positions in Germany in their portfolios as a result of historical developments and due to the former investment regulations at that time of the Investment Company Act (*Kapitalanlagesetz*).

Differentiation of the product range implies a further dimension. Open-ended real estate funds deliver two types of service to the investor; on the one hand a real estate-related service, as the investment company operates and manages the property holdings, and on the other hand a portfolio-related service, as the investment company continuously optimizes the portfolio, for example in terms of diversification aspects.

Open-ended real estate funds are not able to deliver the real estate-related and the portfolio-related part of their service separately. This lack of separation contravenes two trends, namely that towards differentiation of products and that towards focussing on the core business. It also creates problems on the supply side because a globally diversified open-ended real estate fund is not be able to offer the best real estate-related service for every type of use at every location, and direct investments with low fungibility make efficient portfolio management more difficult. With the diversified open ended funds there are also problems on the demand side as institutional investors in particular wish to deliver portfolio management services themselves and as a consequence are not willing to pay a fee for these, yet they do have an interest in direct investment vehicles that deliver real estate-related services.

REITs could become a potential investment vehicle for open-ended real estate funds, thereby allowing funds to focus on portfolio-related services. Furthermore theme-oriented REITs with their business area defined by region and/or by type of use could focus on delivering real estate-related services, hence REITs and open-ended-funds can make use of their core competencies to the full extent. REITs should not be considered an alternative to open-ended real estate funds, but as a supplementary vehicle to the latter. The US experience shows that REITs in the majority of cases are held by institutional investors who offer portfolio-related services to their investors. In Germany insurance companies could also hold a major part of their real estate investment assets via REITs. In the USA small investors play only a minor role as shareholders of REITs, however by pooling institutional investors and retail investors in one REIT, market liquidity can be increased.

10.2 The Introduction of REITs in Germany: A Chronology Until 2007

In Germany, company taxation as a direct form of taxation historically used to be based on the constitutionally binding principle of individual performance. This principle not only applied to companies but to equity owners as well. Until the corporation tax reform of 1999/2000 any corporation tax paid was fully allowable against the shareholder's individual income tax. Until the corporation tax reform, all German joint-stock companies were tax-transparent with regard to corporation tax, so that no separate REIT status was necessary to achieve this aim. This rather reasonable principle of tax transparency disagreed with the interests of the German Revenue Service as foreign shareholders were able to avoid taxation in Germany in part or in full due to double-taxation treaties in general and EU directives in particular. With the corporation tax reform of 1999/2000 the tax transparency of equity was abolished. Consequently, the subject of real estate corporations lost importance after the reform, even more so as Germany has a long tradition of non-listed indirect real estate investments such as closed-ended and open-ended real estate funds, which are tax-transparent. After the abolishment of tax transparency for equity, the executive administration of the Federal Ministry of Finance (BMF) and parts of the political community were somewhat reluctant to develop new tax-transparent vehicles such as REITs.

In 2003, the Initiative for the German Financial Market (*Initiative Finanzplatz Deutschland, IFD*) was founded with the aim of promoting issues directly related to the German financial market such as product innovations, but also issues with indirect influence on the market such as the corporation tax reform. The introduction of REITs in Germany was on top of the agenda of IFD, followed by the reduction of bureaucracy in the investment market and the diffusion of public-private partnerships.

The IFD's first initiative for the introduction of REITs was started in the autumn of its founding year in 2003. In the spring of 2004, the Ministry of Finance commissioned a survey undertaken by ZEW/ebs and titled "New Asset Classes: An International Comparison of Private Equity and REITs", which was delivered to the Ministry in January 2005. Key conclusions of the survey were: the introduction of REITs in Germany was considered welcome; a German REIT should have a latitude comparable to US REITs; listing on a stock exchange should be optional; strict free-float requirements should be avoided; and REITs should be allowed to serve as a financing vehicle for all types of use of real estate. The survey was not able to provide a solution to the question raised by the Ministry of Finance as to how taxation of foreign investors could be ensured. In connection with the receipt of the survey the government officially announced the introduction of REITs.

In parallel to the ZEW/ebs survey (Becker et al. 2005; Sotelo 2006a, 2006b, 2007; Sotelo et. al. 2006; Schulte and Schäfers 2004), the IFD developed recommendations for the introduction of REITs. While the survey commissioned by the Ministry of Finance primarily referred to general economic interrelationships, IFD's comments

focused on ensuring taxation of foreign investors. This was done in view of the Ministry of Finances concerns over a possible shortfall in tax revenues in connection with the introduction of REITs. The initial and unexpected tax revenue losses resulting from the corporation tax reform of 1999/2000 had left a strong impact on the Ministry's tax department. The Ministry also saw the risk that the issues regarding the taxation of foreign investors, the solution to which the mentioned corporation tax reform had been, would come back on the agenda with the introduction of a REIT structure. In February 2005, the IFD recommended the introduction of a REIT designed as a stock corporation. The vehicle was to be tax transparent by means of tax exemption on the corporate level, and by offering the possibility of deducting dividends as costs. This IFD suggestion was deemed unacceptable by the financial administration and in particular by the working group of federal and state representatives meeting in March and April 2005, because there were fears that the planned measures for ensuring taxation of foreign investors and particularly of investors from other EU states could be interpreted as a treaty override. The IFD subsequently developed further recommendations for the design of REITs, which became known as unitary model (*Einheitsmodell*) and separation model (*Trennungsmodell*).

In 2005 Angela Merkel was elected Federal Chancellor. The coalition agreement of winter 2005 stipulates the introduction of REITs, subject to the condition that reliable taxation of all investors is provided for and that a positive impact on the real estate market and on local investment conditions are to be expected. While the issue of reliable taxation was considered mandatory by both coalition parties, it was especially the Social Democrats who aimed to achieve positive effects on the real estate market thus incorporating aspects of residential housing and social policy. The phrase referring to "positive local investment conditions" was based on the fear that non-real estate companies who would now be able to use REITs to sell real estate off their books more easily and using tax privileges could now possibly decide to shift their economic activity in particular industrial production to foreign countries even faster.

During the electoral campaign for the regional elections of 2005, Franz Müntefering, at the time SPD leader, in an interview on 17 April 2005 had started a debate about the role of private equity firms by referring to them as locusts, meaning ruthless company raiders. The so-called locust debate had a considerable influence on the design of German REITs. To explain this agenda, the following background information may be helpful.

Both in the Federal Republic of Germany and particularly in the German Democratic Republic, there had been considerable state interventions in the residential housing markets in the aftermath of World War II. Housing policy in Germany comprises broad development programmes with direct subsidies for residential housing as well as tax incentives for new buildings, tax privileges for public utility housing enterprises, and very social orientated tenancy law. In times of tight budgets, and usually not based on a better understanding of regulatory policy in general, some municipalities started selling their housing enterprises after the federal administration had previously practically disposed of all its indirectly held residential properties with the sale of the railway company's social housing

portfolio (*Eisenbahnerwohnungen*) and the sale of housing company GAGFAH to Fortress.

Especially in parts of the SPD parliamentary group, the sale of public housing companies was heavily criticized. In an interview with the *tageszeitung* newspaper on 25 January 2006 Ortwin Runde, MP (SPD), turned the "locust" debate into a "cockroach" debate. Private equity firms that had bought residential portfolios were generally suspected of being unwilling to respect the interests of their tenants. With support of *Deutscher Mieterbund*, Germany's influential tenant's association, a campaign was started opposing any further privatization of public residential properties. Both the locust debate and the cockroach debate were politically unpredictable, because they addressed primary feelings in large parts of the population. There was no rational or scientific basis for the discussion, as has been shown by various studies.[1]

In February and March 2006, several talks took place at the Ministry of Finance, among them top-level talks in February 2006, but no breakthrough was reached for the German REIT. Especially the issues regarding the trust asset model (separation model, *Trennungsmodell*) remained. The final breakthrough was achieved for political reasons: London had announced the introduction of a REIT structure starting in 2007 and the issue of reliable taxation of foreign investors, also a priority in the UK discussion, had been solved by means of scattered property. German policy makers recognized that it could not be their aim to implement a structure that would be airtight with regard to EU law, they accepted that a residual risk regarding taxation of foreign investors from other EU states would remain and that in the end it would also be a question of political negotiations within the EU to maintain the situs rule to be applied in taxation of real estate income.

Ensuring reliable taxation of foreign investors was at the focus of the discussion about the German REITs. Germany was not willing to follow the French approach and accept that companies from other EU states could acquire shares in German REITs meaning the situs rule usually applied in the taxation of real estate income would be violated.

The lobby group of the private owners of housing stock and of the developers (BFW) tried late, but hard to introduce the option for the non-listed REIT in order to open the market also to smaller companies by publishing a report on the importance of non-listed REITs for the whole market. This survey is published (Sotelo et al. 2006).

It is noteworthy that neither the Ministry of Finance nor the expert community had realized the possible importance of the predictable outcome of a judgment by the European Court of Justice on 14 September 2006 (Stauffer case, C 386/04). In that ruling, the ECJ established that the location of an entity within the EU may not be relevant for the question of its taxation. In the present case, a tax office in

[1] These are the surveys of the Berlin Senate, of the idw (Institute of Public Accountants) and the *Deutscher Verband* (German Association for Housing, Urban Development and Town and Country Planning).

Munich intended to apply the rule of limited tax liability of foreigners to an Italian non-profit foundation, although a comparable structure of a non-profit and therefore tax-exempt foundation exists in Germany. Transferring this thought to European REITs, it may be concluded that an EU-REIT is not subject to limited taxation in another EU country that also has the legal institution of a tax-transparent REIT. Thus, the situs rule applied in taxation would be breached in the same way it is currently being breached within the Federal Republic of Germany itself: For example, a person living in Munich does not pay taxes on income from a property located in Berlin to the Berlin tax office, but only to the Munich tax office. If this correlation had been recognized by the opponents of the German REITs, political uncertainty would have been the result, particularly in the federal states, with unpredictable consequences for the introduction of REITs in Germany. Up to now, the federal government has rejected this interpretation of the ECJ ruling in the Stauffer case, on the grounds that in their view the French REIT and the UK REIT are not comparable to the legal institution of the German REIT. In policy terms, this is a game-theory dilemma for the EU member states, as the possible tax exemption of REITs from other EU states could depend on a country introducing its own REIT structure. If and when the economically potent EU states have introduced REIT structures and these are able to invest in all EU states with REIT structures in a tax-transparent manner, *one* REIT structure should hence be able to establish itself across the EU. It is, however, politically improbable that those EU states whose REIT structure does not manage to establish itself on a wider scale will abolish their own REIT structure, in which case even the dominant REIT structure would no longer be able to invest in a tax-transparent manner across the EU.

As is outlined from a financial theory perspective in Chap. 1 and corresponding with the experience from the United States, Australia, and Japan, the quality of a REIT is mainly determined by adequately defined latitude and the freedom of choice regarding listing on a stock exchange.

After a preliminary draft in August, a first draft was presented by the Ministry of Finance's administrative staff in September 2006. On 21 October 2006, the Saturday before the opening of the ExpoReal real estate fair, State Secretary Axel Nawrath announced that residential property would be excluded from German REITs. Hence the Ministry had given in to the pressure from the SPD parliamentary group and from Construction Minister Wolfgang Tiefensee. The *Bundesrat* passed the German REIT law on 30/03/2007.

10.3 The Structure of the German REIT

The German REIT in its current form has the following characteristics based on Deloitte (2006).

10.3.1 Regulatory Concept

10.3.1.1 Corporate Governance

The German REIT (G-REIT) is a regular stock corporation subject to company law and commercial law, unless the REIT law stipulates otherwise (section 1 para. 3). Its company seat and management must be in Germany (section 9). REITs must have a minimum stated capital of € 15 million and all shares must be designed as voting shares of the same class (sections 4, 5). The REIT company name must refer to the special category of *REIT-Aktiengesellschaft* (REIT stock corporation) or *REIT-AG*; the company is also registered as a *REIT-Aktiengesellschaft* in the register of companies (sections 6, 8). The law limits borrowing to the effect that the equity capital may not fall below 45 % of the REIT's immovable property assets (section 15).

The law does not provide for any special product or management supervision by the Federal Agency for Financial Market Supervision (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin). The REIT shares must be admitted for trade on an organised market (section 2 para. 5 *Wertpapierhandelsgesetz*, Law on Securities Trading) in an EU member state or in another contracting state of the Agreement on the European Economic Area (EEA) (section 10 para. 1). Before the listing of the REIT there can be a Pre-REIT-status for a maximum time of 3 years, which can be extended by BaFin by 1 year upon application (section 10 para. 2).

10.3.1.2 Pre-REIT

Although the pre-REIT itself is not yet exempt from tax on profits, it can already take advantage of exit tax privileges, meaning that if real estate is sold only half of the hidden reserves disclosed in the process are taxable. The constituent elements of the pre-REIT are, pursuant to section 2:

- A stock corporation with the same limited business purpose of a REIT AG in accordance with section 1 para. 1,
- Proven compliance with the asset and earnings requirements of REITs (section 12) and
- Registration with the *Bundeszentralamt für Steuern* (Federal Central Tax Office), which is granted upon application.

10.3.1.3 Free Float

The law contains detailed regulations concerning the free float of capital and various provisions regarding compliance with the free float requirements and its control, as well as sanctions in case of violations. An important provision ensures the taxation of foreign investors in Germany by means of the so-called UK model,

which limits direct shareholdings to a maximum of 10 % of shares minus one (section 11 para. 4). In this manner, the respective regulations of double taxation treaties and the parent-subsidiary directive are bypassed. For larger shareholdings these would lead to a further reduction of the capital gains tax, in the extreme case to as little as 0 %. This 10 % restriction only applies to direct participations; it is therefore possible for a controlling shareholder to hold 10 % or more in indirect participations, in particular by means of intermediary vehicles.

In order to ensure the existence of a free float of shares and avoid listed non-public REITs, the law further stipulates in section 11 para. 1 that at the time of admission to trading on a stock market at least 25 % of the shares must be held in free float. Permanently, the free float requirement is 15 % of shares. Free float is defined as the shares of those shareholders holding less than 3 % of the voting rights in the REIT AG (section 11 para. 1).

To ensure compliance with the free float requirements, the law contains an array of graduated instruments. These include stricter notification and disclosure requirements of the REIT AG towards BaFin than those stipulated by the German Law on Securities Trading; special duties of the statutory auditor with respect to auditing and notes; limitations of shareholders' rights; and finally graduated sanctions in the form of compensations for free float shareholders, tax penalties and, particularly in case of recurrence, full loss of the tax-exempt status (section 1 para. 4, section 11 para. 2, 3 and 5, section 16 para. 2–5, section 18 para. 3 and 5).

10.3.1.4 Business Activity

The law regulates business activity with provisions requiring registration of a real estate-focused, passive business purpose including a definition of permitted investments and business activities; it contains regulations regarding assets and gross profits and furthermore provisions regarding permitted participations of the REIT AG.

Registered Business Purpose

The registered business purpose of a REIT must be limited to:

- "Purchase, holding and sale of title of ownership and rights of use in rem to real estate in Germany and foreign countries (fundamentally, rights to immovables and other similar rights), with the exception of existing rental housing property, as well as the management relating to renting and leasing of such real estate and necessary real estate-related ancillary services, and
- Purchase, holding, management and sale of real estate partnerships" (section 1 para. 1).

The term ancillary services as used in the draft encompasses only such "activities that serve the main business activity, and therefore concern the REIT's

own holdings" (section 3 para. 4). Real estate-related activities are considered to be only such activities that serve "the management, maintenance and further development of real estate holdings (in particular, technical and commercial property management, rental property management, marketing activities, project management and property development)" (see section 3 para. 6). If such activities are to be performed for (non-group) third parties meaning external property holdings, a taxable REIT service company must be founded to provide these real estate-related ancillary services (see section 3 para. 5, section 12 para. 3).

Assets and Gross Profits

Further important regulations regarding the permitted business activity of a REIT AG are the rules regarding permitted assets and gross profits. These regulations apply to pre-REITs, as well. At least 75 % of the REIT AG's total assets must be immovables, real property (and buildings) and similar rights (section 12 para. 1 in conjunction with section 3 para. 8). At least 75 % of the REIT's gross profits must be derived from the business of renting, leasing and selling immovable property (section 12 para. 2 and 4).

In order to determine the total assets of a REIT AG and their composition as well as gross profits, assets and in particular real property holdings must be assessed at market value in accordance with IFRS in the REIT's single entity financial statements (section 12 para. 4). The valuation at IFRS market value is also mandatory for the verification of the other indicators contained in so-called business structure norms of the REIT law. These are, in particular, gross profits, the value of average holdings as referred to in the norm restricting real estate trading (section 14), and the company assets to be determined for the purpose of limiting borrowing (section 15 REIT-E).

Permitted Real Estate Trading

The company may "within a term of 5 years (derive) gross profits from the sale of immovable assets that amount to (no more) than half of the value of the average holdings of immovable assets within the same period" (section 14 para. 2). The value of the average holdings depends on the IFRS market values. Sales and holdings of (permitted) real estate partnerships and/or foreign property companies must be included in this calculation. Put simply, within a rolling period of 5 years, the REIT AG may sell a maximum of 50 % of its holdings. Assuming relatively continuous sales, REITs can sell in the range of 10 % of their holdings each year. The application of a 5-year period allows for a sufficiently flexible scope for action. However, the 75 % asset requirement must be observed at the same time, hence bulk sales are limited. Moreover, there is a factual prohibition barring the sale of real estate the company has bought under the reduced entry tax conditions within a period of 4 years (on the vendor's level; section 3 no.70 EStG, Income Tax Act).

Participations

The government's draft is restrictive with regard participations. Only three different types of participations are permitted.

1. A REIT AG may hold so-called REIT service companies. These are 100 % subsidiary companies that provide real estate-related ancillary activities against payment for third parties (and also for the parent company) and that are wholly liable to tax. If such third-party services are to be provided, the foundation of a subsidiary of this kind is mandatory (section 3 para. 2). The law defines real estate-related ancillary activities against payment as such services performed for external asset holdings "that serve the management, maintenance and further development of real estate holdings (in particular, technical and commercial property management, rental property management, marketing activities, project management and property development)" (see section 3 para. 5 und 6). Furthermore, the assets of REIT service companies must not exceed 20 % of total assets of the REIT AG after discounting the required distribution and the retained capital gains as determined in the IFRS group statements. A corresponding rule applies to gross profits (section 12 para. 3 and 4 sentence 2). If a REIT service company pays out dividends to the REIT, these amounts are also subject to the REIT's obligation to distribute 90 % of its profits.
2. Besides REIT service companies, REITs may also acquire, hold, manage and sell shares in real estate partnerships (section 1 para. 1 no. 2). The draft does not contain any further participation requirements in this respect and it does not restrict the amount of such shareholdings. Real estate partnerships are considered to be such partnerships that have the same limited registered business purpose as a REIT and pursuant to the company agreement or articles are only allowed to acquire similar assets as a REIT (section 3 para. 1).
3. Moreover, special purpose companies for foreign real estate are permitted (see section 3 para. 3 REIT-E). This rule has been conceived for situations in foreign countries where real estate may only be acquired through special purpose companies. A REIT AG may hold a 100 % interest in such companies, provided they exclusively acquire foreign property and are limited to holding and managing these property holdings. Of course, such companies are subject to taxation (usually in the foreign country).

10.3.1.5 Accounting Procedures and Profit Distribution

Assets must be valued at market values in accordance with IFRS for the purposes of calculating and auditing the indicators referred to in the so-called business structure norms of the law (see section 12 para. 4 sentence 1); these are, in particular, assets and gross profits, furthermore the value of the real property used for verifying the limits of real estate trading (section 14 para. 2), and the value of the assets for the purpose of calculating maximum borrowing (section 15). In principle, calculation

of the aforementioned indicators is based on the single entity financial statements of the REIT AG, where assets must be valued at market value in accordance with IFRS (section 12 para. 4 sentence 1).

A REIT must distribute at least 90 % of its distributable profits to its shareholders. While the first rough draft of August 2006 based calculation of the distribution potential on the IFRS profit, the distributions shall now be calculated in the REIT AG's single entity financial statements in accordance with German Commercial Code (HGB), and a number of noteworthy special regulations apply.

1. The law provides that solely the linear depreciation method is permitted in the calculation of distributable earnings (section 13 para. 2). Even in case of a future introduction of tax incentives REITs shall not be able to function as vehicles for marketing tax-oriented real estate investments.
2. The law offers a right of choice to either retain or distribute the depreciation amounts, it thus treats REITs equal to open-ended real estate funds in this respect.
3. Furthermore, the law introduces a 50 % capital gains reserve based on section 6b Income Tax Act (EStG); these reserves, which initially diminish the amount of distributable profits, must within a 2-year period either be transferred to acquired or manufactured immovable assets, or they must be liquidated, thus adding to profits, 90 % of which must be distributed (section 13 para. 3).

10.3.1.6 Auditor's Duty

The auditor has to establish during the statutory audit whether the REIT AG's activities comply with sections 11–15 of the law (free float, assets and gross profits, minimum distribution, real estate trading and borrowing) and with any additional regulations of the articles of association (for example regarding borrowing or additional distribution of depreciation amounts) where applicable.

10.3.2 Taxation Framework

10.3.2.1 Taxation of Real Estate Transfers to a REIT (Exit Tax)

(a) Sales to REITs and Pre-REITs (List)

The law provides that under specific circumstances only half of the hidden reserves disclosed during the sale of real estate to a REIT shall be subject to taxation. This tax reduction applies both to income tax and corporation tax, as well as to transaction tax. This privilege shall be granted for a limited time only. Sale and lease-back is permitted.

The buyer REIT may not sell the real estate bought under the above-mentioned privilege during a period of 4 years after conclusion of the contract; a buyer pre-REIT must be recorded in the register of companies as a (listed)

REIT AG within this period. Otherwise, the vendor is has to pay the full tax retrospectively for the previously exempted amounts.

(b) Change of Status of a Real Estate Company to a Tax-Exempt REIT
The 50 % taxation of disclosed hidden reserves also applies in such cases where existing taxable real estate companies change into the tax-exempt status after transformation in line with the regulatory code of a REIT. At the time the tax liability ends a final tax balance sheet must be prepared in which all assets are valued at their partial values (section 13 para. 1 and 3 sentence 1 KStG, Corporation Tax Act). For the purposes of corporation tax and transaction tax, the hidden reserves to be disclosed in this context are to be assessed at only 50 % of their value (section 17 para. 2).

10.3.2.2 Current Taxation of the REIT AG

If the REIT complies with all qualifying requirements, it is exempt from corporation tax and transaction tax, effective from the start of the financial year in which the REIT AG is registered in the register of companies (section 16 para. 1, section 17 para. 1). The exemption from taxation on profits applies to all income. There is no partial tax liability, unlike the UKREIT (so-called ring-fence concept). The REIT AG must file special tax declarations that enable the tax administration to verify compliance with the different REIT qualification requirements (section 21 para. 2). The tax exemption does not apply to REIT service companies and special purpose companies for foreign property holdings.

10.3.2.3 Current Taxation of Shareholders

In its basic design, the taxation of REITs is guaranteed through the full taxation of its distributed dividends at the shareholder level and the statutory obligation to distribute 90 % of distributable profits. Dividends from REITs are principally considered income from capital in accordance with section 20 para. 1 no. 1 Income Tax Act (EStG). REITs are required to withhold capital gains tax of 25 % on its dividends (see section 20 para. 1 and 2 REIT-E). Public utility bodies under German fiscal law are fully exempt from this tax; other tax-exempt bodies and German legal persons governed by public law receive a tax refund of 10 %. For foreign shareholders of a REIT the withholding tax is not refundable. However, the applicable capital gains tax rate is regularly reduced to 15 % by double taxation treaties. Foreigners do not benefit from substantial holdings privileges stipulated in some double taxation treaties, which would limit the applicable capital gains tax rates even further; this is prevented by the 10 % limit of shareholdings.

Corporations from other EU states as shareholders are also subject to this regular withholding tax. The principles of the parent-subsidiary directive do not apply as REITs are fully tax-exempt and furthermore the participation levels required for

reduction of the capital gains tax pursuant to the directive are excluded in a REIT by law.

10.3.2.4 Sanctions

In order to ensure compliance with the qualifying requirements in the future, the draft contains several measures and sanctions. The various information and notification requirements with respect to the free float of shares have already been mentioned (section 11 para. 2 and 4), as well as the auditor's duties with respect to the statutory audit and the special tax declarations (sections 1 para. 4, 21 para. 2). If real estate trading is carried out beyond the permitted limits, the tax-exempt status shall be repealed for the first time in the financial year in which the limits have been exceeded (section 18 para. 2). In case of violations of the 75 % restrictions for assets and gross profits, there are penalties partially at the discretion of the fiscal authorities; the procedural rules for corporation tax apply accordingly (sections 16 para. 3 and 4 in conjunction with section 21 para. 1). Similar sanctions apply in case of violations of the 90 % profit distribution rule (section 16 para. 5). In case of recurring violations of the free float requirements, of the borrowing limits, or of the provisions regarding assets, gross profits and profit distribution, the tax exemption privilege can also be repealed (section 18 para. 3–5).

10.4 Evolution of German REITs After Introduction of the Law

10.4.1 Current REIT Company Market Overview

The G-REIT legislation 2007 had been awaited by industry for many years. One would assume that the segment found favourable reception following its inception though data may proof differently. Table 10.1 lists major German listed real estate companies and their G-REIT status.

The first company to transition to the G-REIT format was Alstria Office REIT, which registered in year 2007. As shown in Table 10.1, only four companies have opted for the G-REIT status in Germany since introduction of the German REIT law in 2007. This represents roughly less than 9 % of the total market capitalization of major listed real estate companies in Germany. It is evident that G-REITs overall are smaller companies as gauged by market capitalization, whereas the "big players" did not choose G-REIT status. Put in a European perspective: Germany had only 0.7 % of its total real estate assets held in listed property companies in 2012, whereas UK had 4.7 % and France 2.8 % according to EPRA figures.

Alstria Office, following its conversion to REIT-status, experienced problems with the 45 % minimum equity requirement implemented in German legislation.

Table 10.1 Overview: Major listed German real estate companies

Company name	Market capitalization in mn. Euro as of March 2013	G-REIT status
Alstria Office REIT	714	Yes
AVW Immobilien	34	No
Colonia Real Estate	203	No
Design Bau	8	No
Deutsche EuroShop	1,700	No
Deutsche Wohnen	2,399	No
DIC Asset	365	No
Fair Value REIT	41	Yes
Franconofort	55	No
GAG Immobilien	683	No
GAGFAH	1,856	No
GBWAG Bay. Wohnen	1,310	No
GSW Immobilien	1,627	No
Hahn Immobilien	28	No
HAMBORNER REIT	323	Yes
Helma Eigenheimbau	45	No
IFM Immobilien	111	No
IVG Immobilien	313	No
JK Wohnbau	63	No
Kommunale Wohnen	88	No
Patriza Immobilien	436	No
Youniq	56	No
POLIS Immobilien	117	No
Prime Office REIT	188	Yes
TAG Immobilien	1,170	No
VIB Vermoegen	200	No
Total	14,133	

Source: Goronczy, Stefan: Real Estate Quarterly, HSH Nordbank, March 2013

Based on this rule a clear limit for the leverage with debt is given. It may be concluded that there was no smooth start for the G-REIT segment in its first 5 years.

Undoubtedly, this does not constitute a success story for the German REIT format. Furthermore, it should be noted, that to-date it has become obvious that the REIT-format does attract any new companies in Germany. Thus, the number of companies transitioning into pre-REIT status under German law was also limited. A significant number of plans to convert companies into REIT format or offspin REIT-units were abolished. One of the most prominent was the example of an assumed but not executed offspin REIT unit of IVG.

10.4.2 Factors Hindering Market Growth in Germany

Reasons for this suppressed market dynamics have to be identified. Market dynamics in the German commercial investment market does not seem to be a suppressing factor. According to Trombella (Trombella 2013), the German commercial investment market ranked number 2 in transaction volume in Europe in year 2012 with more than 25 billion Euros in commercial transactions (Trombella 2013).

Thus, it can be concluded, that market size and dynamics in commercial real estate investments are not the limitation for evolution of a dynamic REIT regime in Germany. On the contrary, it may be noted that the dynamics of the German commercial investment market should – under normal circumstances – be quite beneficial to the growth of a viable G-REIT regime.

Several causes of the suppressed growth may be identified. These may be categorized as follows:

(a) No growth pertaining to the market timing within the global financial crisis
(b) No growth pertaining to limitations in the German REIT-law
(c) No growth pertaining to the investor sentiment and stock market culture in Germany.

10.4.2.1 No Growth Pertaining to the Market Timing Within the Global Financial Crisis

The G-REIT legislation does not allow the formation of Private REITs. This is different from the sector in the United States. In United States, Private REITs can be considered the first step towards forming a listed REIT. As listing is a mandatory requirement in Germany, the dynamics of the stock market play an important role for G-REITs.

Unfortunately, the legislation of G-REIT was just put into effect when the global financial crisis, triggered by problems in US housing and MBS markets, set-in with full force between 2007 and 2009. Stock prices of German indices declined, torn down by the spillover of global financial markets in London and New York.

In effect it became very difficult for companies to either go public or to raise secondary capital in the equity markets between 2009 and 2010. It is no wonder that these effects were also encountered by German real estate companies either considering merely listing or considering listing and REIT status.

Germany evolved as the economic powerhouse in Europe between 2010 and 2012, exceeding GDP growth of most other European countries. Unemployment was surprisingly low, and retail sales were strong. In effect, investment in the German real estate market became quite attractive for national and international investors. The strength of German retail market also benefitted the stock pricing of companies such as Deutsche Euroshop, especially investing their portfolios in German retail properties.

Germany, having experienced not only two disastrous wars but also two serious meltdowns of its currency in the twentieth century has always been a country where investors are very anxious about inflation risk. The development of the Euro crisis in association with a very low interest-rate environment therefore triggered intensive reallocation of investments into assets assumed to be less inflation-prone such as real estate and stocks.

Listed real estate companies experienced considerable upswings in stock pricings. The Euro crisis helped the listed real estate sector, after all. For many years, most German listed real estate companies had stock pricings below their Net Asset Value. Those huge discounts melted away for a small number of companies during the Euro crisis.

For instance as outlined by Goronczy (2013), aforementioned retail portfolio specialist and non-REIT company Deutsche Euroshop experienced premiums to NAV of 15 % in March 2013, and non-REIT Deutsche Wohnen a 30 % premium, whereas G-REITs such as Alstria Office or Prime Office still were trading at discounts between 15 % and 60 % below NAV at the same time.

It may be concluded, that the REIT-format cannot be assumed to trigger any preferences among investors compared to other investment vehicles, giving it advantages against the pure listed company. It may even be argued that the REIT-format was almost irrelevant for valuation of listed real estate companies in Germany.

On the contrary, the business model of these companies played an important role. Companies with clear-focussed investment strategies towards apartments – for instance Deutsche Wohnen – and towards retail – for instance Deutsche Euroshop – achieved pricing gains.

Companies with diversified portfolios, or specialized on office product, and/or with a project development business line were not rewarded by the markets in terms of stock pricings.

10.4.2.2 No Growth Pertaining to Limitations in the German REIT-Law

The current legislation attracted a lot of criticism from the real estate industry, from industry associations, lobbying groups and other sources. As the German industry association ZIA on behalf of various industry groups noted in a letter to the German Ministry of Finance in 2010 (ZIA 2010), estimates had forecast approximately 40 G-REITs in 2010, but only three G-REITs existed at that time. Furthermore, comparisons to other countries were drawn: US had more than 170 REITs, and UK more than 20 in year 2010 according to EPRA figures.

From 2008 to 2010, the effects of the financial crisis hit listed G-REITs, as obtaining financing became more difficult. NAVs of property portfolios went down, thus hurting financial covenants of existing financings. ZIA therefore called to question the minimum equity requirement of 45 % for G-REITs. Further points for improvement of the 2007-legislation as discussed in 2010 called for changes in

the provisions for minimum free float and for maximum participations. In addition, it was suggested by ZIA to change the double taxation of reserves that occurs when a company changes status into the G-REIT regime.

One very important complaint was that the current G-REIT legislation excludes REIT status for companies that hold residential real estate (apartments) built before January 2007. In effect, this excludes a very relevant set of major holding companies of apartments in Germany to transition into REIT status.

Historically, political parties in Germany have been very reluctant to touch the prohibition of apartments in the 2007 G-REIT legislation. This stems from the strong culture of tenant rights in Germany and from the low ownership rate for residential property in Germany. The ownership rate is about 42 % on average, compared with almost 70 % in the United Kingdom (Voigtländer 2008). This average figure for the German market underestimates the true situation in big cities. For instance, in the capital Berlin, the ownership rate for apartments is less than 14 % (Voigtländer 2008). Politicians repeatedly voiced that converting big German apartment holding companies into the REIT status would trigger significant changes for tenants. It was assumed that following the pressure of the market forces from shareholders seeking return, these companies would increase rents, antagonize tenants with less favourable incomes and lead to a culture of cold capitalism.

Where these statements were in general not supported by fact, the voices nevertheless found widespread echo in the political process. Conservatives, social democrats, and the Green (environmentalist) party became were happy with the exclusion of apartments in the 2007 G-REIT regime after introduction of the law. In effect, the quest for improvement of the G-REIT laws after 2007 by the real estate industry's lobbying groups were largely unsuccessful. This did not only pertain to inclusion of apartments, but also to the other minor suggestions for free float and taxation as listed in this paragraph.

The latest challenge from regulation is the implementation of the European AIFM-directive into German law. For this purpose, a new law called "Kapitalanlagegesetzbuch" (abreviation KAGB) has been designed. BaFin has published a circular letter on June 14th, 2013. The G-REIT will be exempted from the AIFM-directive for listed vehicles as these companies do not constitute "collective investment undertakings" as set-out in the original directive as long as the G-REIT is an operated company.

10.4.2.3 No Growth Pertaining to the Investor Sentiment and Stock Market Culture in Germany

In United States, both institutional and private investors invest in REITs. Institutional investors especially became important players since the 1990s after legislative changes were passed. In Germany, this is very different. Overall, it may be summarized: German retail investors are almost insignificant for G-REITs and the scope of German institutional investors investing in G-REITs is very limited.

As for German retail investors, the financial crisis and the losses associated with the decline in stock indices caused investors to seek safe haven investments. In the retail distribution network of the banking industry, where REIT stock would normally be promoted, it is very difficult for investors to include G-REITs in their portfolios. First, they would only have the choice of four companies. Second, the four companies are quite small. Third, the companies – in comparison to non-REIT listed real estate companies – overall do not offer very sophisticated business propositions (id est focus). Fourth, adding to this restraint, the average German investor is reluctant to take on stock market risk anyhow.

According to the DAI association (Leven 2013), the share of the population over 14 years holding stocks is less than 14 % as of January 2013. This figure is low in spite of the fact that the general German stock market index DAX increased by almost 30 % in 2012. Global REIT funds, which hold both German and international listed companies, usually would not consider the four G-REITs, because the fungibility and liquidity of these stocks is not appropriate for larger managed stock funds (i.e. mutual funds).

Domestic German institutional investors are also reluctant to look at G-REITs. The insurance companies and pension schemes, which represent an important fraction of the total set of institutional investors, are governed by German legislation that promotes low risks. Taking risk in asset pricings is in contrast to the predominant investment philosophy of this investor group. NAV fluctuations, especially to the downside, are not wanted. As stocks, G-REITs, may impose downside risk on the valuations due to stock price fluctuations; this is not the preferred way to invest in real estate. The insurance industry would have preferred the Private REIT with lower valuation volatility, but this option is not available in Germany. The clear competitor and substitute is the German Specialfund, a fund structure unknown of outside Germany.

By March 2013, 35.9 bn. Euro (BVI 2013) were invested in German Specialfunds assembled with companies organized in the BVI industry association accessible only for institutional clients as governed by law. Specialfunds have continuously grown their assets under management in the last years (Gläsner and Piazolo 2013).

NAV-valuation in Specialfunds is preferred by German institutional investors over volatile stock valuations and Fair Value accounting under International Accounting Standards in listed real estate companies. The perception of these investors is that a public listed company format comes at a price. The industry association DVFA and authors Rehkugler and Beck (2009), reflecting the impact of valuation effects on investor sentiment, questioned the sense and relevance of Fair Value Accounting for listed real estate companies. As changes in valuations of underlying property portfolios are reflected in the profit-and-loss accounts under International Accounting Standards (IAS/IFRS), companies may try to smooth these effects. According to Rehkugler and Beck, this would imply that companies may try to build reserves in times of high appreciations and to unlock the reserves in times of declining property values. Anyhow, the discrepancies between stock movements and underlying NAVs pose a problem for certain investor groups.

A new opportunity for G-REITs seemed to arise when the important market for German open-ended funds ran into problems. The year 2012 saw the peak of this evolvement. The market for open-ended funds is the biggest segment of various indirect real estate investment routes in Germany, with total assets at more than 80 bn. Euro as of January 2013. At this time, 22 % of German open-ended funds, measured by total assets, were in the process of being dissolved. A further 2 % were "frozen", not allowing redemptions by investors. In total, almost 18 bn. Euro in capital bound in real estate was ready to be sold by open-ended funds to distribute the returns to investors by 2017 at the latest (BVI 2013).

Intuitively, this would imply that G-REITs may benefit from the crisis. However, as the German open-ended fund is a retail product, it boasts liquidity (by allowing redemptions) and low risk (by means of diversified real estate holdings). In January 2013 alone, public open-ended funds for retail clients had net inflows of 1bn. Euro, whereas Special Funds for institutional clients had net inflows of 500 mn. Euro in the same period (Katzung 2013). During this time, the biggest open-ended funds run by banking institutions with extensive branch networks reaped the highest inflows from fund investors. Concluding, even in the midst of the crisis of the open-ended-fund industry, inflows and demand from private clients persisted and did not constitute ground for G-REITs to flourish.

More complex would be the vision to dissolve open-ended funds and convert this structure into a G-REIT. Unfortunately, German legislation does not offer provisions to cover this transition in a smooth way. The legal process for a transformation would therefore imply that the open-ended fund under current German investment law would need to be dissolved, and then the properties be sold to a newly formed REIT. This would trigger tax on the hidden reserves and other issues. Whilst the transition would be compelling, the transition of a German open-ended fund into a G-REIT is remote given the legal obstacles as well as the very different retail investor preferences for the two products.

10.4.2.4 Market Pricing, Liquidity Aspects and Investor Preferences

Figure 10.2 shows the FTSE EPRA/NAREIT Germany Index between years 2000 and 2013. Total Return shows strong fluctuations. For instance, in the boom years of European real estate up to year 2007 – just before the financial crisis – market pricing became very ambitious. After 2007, the financial crisis did not spare the markets for listed public real estate. However, the Euro crisis triggered new momentum and in 2012 stock pricing gains were impressive. The FTSE EPRA/NAREIT Germany-index rose 22 % in 1 year by mid-March 2013. The listed sector again matched investor preferences. The Euro crisis is a mirror of the optimistic asset valuations. Stocks and real estate were the choice amidst the "Euro Angst".

Figure 10.3 shows the market capitalization of the EPRA FTSE/NAREIT Germany index from 2000 to 2013. It is apparent that the pricing of German listed companies has only recently outpaced the previous boom cycle of 2005–2007, with the upswing commencing in year 2012.

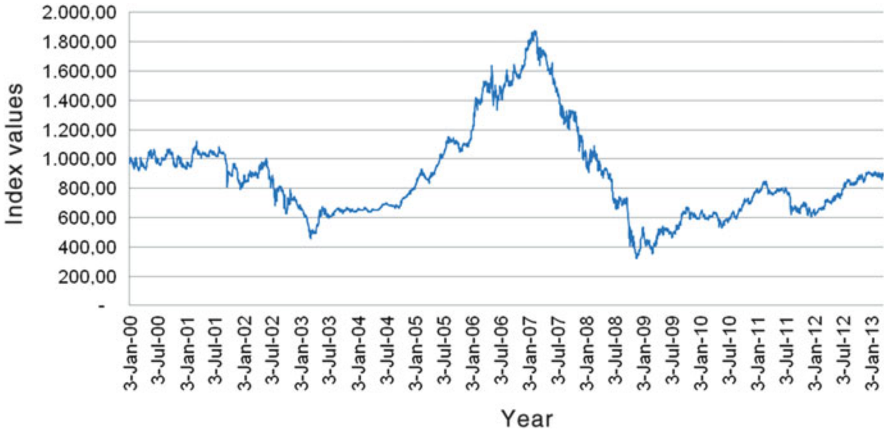

Fig. 10.2 Total Return für EPRA FTSE/NAREIT Germany Index 2000–2013 (Source: EPRA 2013b)

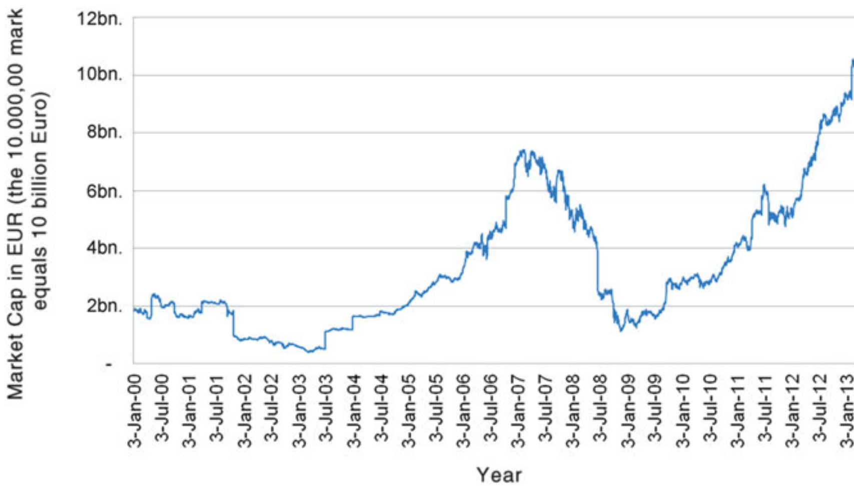

Fig. 10.3 Market capitalization for EPRA FTSE/NAREIT Germany Index 2000–2013 (Source: EPRA 2013b)

Plotting corresponding total returns for each year for the same period shows considerable volatility in performance from year to year for Germany's listed segment (Fig. 10.4).

In November 2012, the industry association EPRA announced, that Germany has the potential to significantly grow its REITs market and that the crisis of open-ended funds may be the starting point. Stating that "Germany has by far the smallest listed real estate sector of any major economy globally, due to historical structural

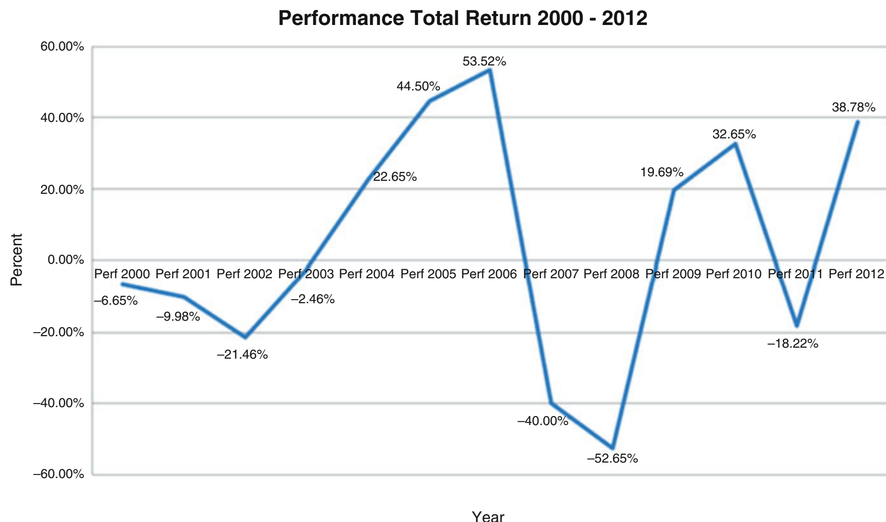

Fig. 10.4 Total return in EPRA FTSE/NAREIT Germany Index for each year between 2000 and 2013 (Source: EPRA 2013b)

obstacles to the market's growth.", the industry association stressed the benefits of listed vehicles, especially transparency and liquidity compared to German open-ended funds. It was mentioned that "listed German property companies have raised just under 3.0 billion Euro in equity since 2007", whereas France boasts a REIT-sector with a total of 35 companies and a market capitalization of 46 billion Euro at the same time (EPRA 2013a).

There seems to be a "chicken or egg" problem in Germany. International investors are reluctant to tap the potential of the German listed market because of liquidity concerns. If a sovereign wealth fund or a US pension fund wants to acquire German real estate via listed vehicles, the liquidity of these companies is too low for the investment volumes of these investors.

The solution would be growing existing listed companies in Germany. But the key questions remains how to grow the segment, when investors are not attracted to provide capital – and vice versa. The listed sector has been and seems to continue to struggle with this equation. If equity is not available as wanted, then debt would need to substitute and fill the gap. Unfortunately, debt is scarce following implementation of Basle II and Basle III accords and the banking sector's focus on low-risk investments in real estate. Hence, it remains difficult to obtain financing for project developments and even for core investments, larger financings above 40–70 mn. Euro, depending on the property type, will not be granted by a single bank.

One key question for listed vehicles is, whether the financing is obtained at the company or at the property level. As Nowotny (2013) points out, a bond poses refinancing risk. The creditor has direct access to the assets of the listed company.

Nowotny stresses cases in which listed property companies had to trigger an increase in equity capital at unfavorable terms, as equity was needed immediately to replace maturing bonds in the wake of the financial crisis.

Nowotny sees advantage in non-recourse financings at the property level. In the non-recourse structure, the holding company (REIT) is shielded from the refinancing risk. Furthermore, he assumes that the interest rates achievable with investment-grade bonds are equal to conservative financings with loan-to-values of 50 % or less. If the bonds should benefit from pledges to real estate, the properties are not unencumbered anymore. Therefore, there may be conflict in financing strategy to simultaneously combine bonds with encumbered assets. However it should be noted, that encumbered assets are not positively assessed by rating companies.

Having discussed financing opportunities for listed companies, the minimum equity requirement for G-REITs limits the scope of debt or other debt instruments used to finance G-REITs. A minimum equity requirement puts the G-REIT in difficult territory if equity markets experience phases of low interest from the investment community and substituting equity with debt is not as flexible as for other listed companies.

10.5 Interpretation and Outlook

After a long contemplation period, German legislators finally decided to introduce the German REIT in 2007. Key clauses unique to the German model include the mandatory listing requirement and the cap on leverage.

The experience from virtually all successful REIT introductions has been that REITs are successful if and when they offer a solution for an acute crisis of different financing vehicles or real estate financing markets as a whole. The success of REITs in the USA, Australia, Japan and France can be explained from this perspective. Therefore, a relationship was seen by many between the simultaneous discussion about the introduction of REITs in Germany and the signs of crisis in some open-ended real estate mutual funds. The Euro crisis and the crisis of Germany's open-ended mutual funds promised new opportunities for the G-REIT. However, up to the publication of this chapter, Germany lists only four companies in G-REIT status. Only a limited number of listed non-REIT companies benefitted from the euphoria for real estate investments, provided they focus on residential real estate investments or shopping centers. To date the sector has not positioned itself for "takeoff".

In order to understand the reasons behind the design of the German REITs, it is helpful to classify the market players by their differing interests with respect to the two main criteria for the success of a REIT; namely adequate latitude and optional listing on a stock exchange (Fig. 10.5).

Figure 10.5 charts the latitude on abscissa and optional stock exchange listing on the ordinate.

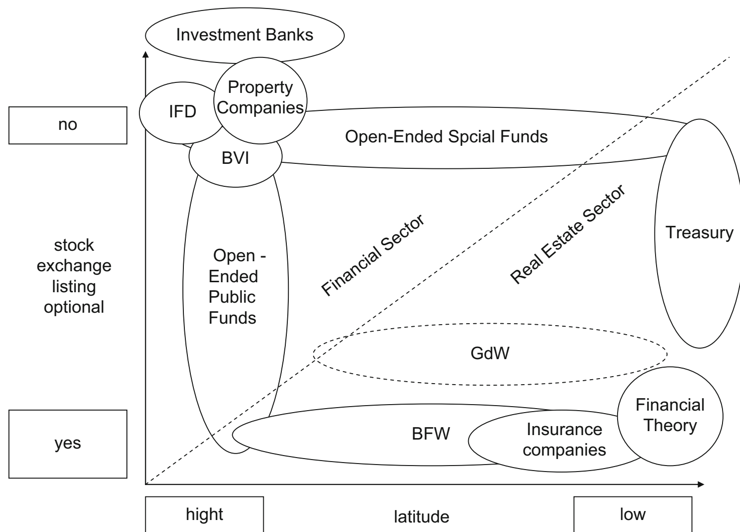

Fig. 10.5 Interests in the German REIT
Key:
BFW Bundesverband freier – Immobilien- und Wohnungsunternehmen e.V.
Lobby group of private developers
GdW Bundesverband deutscher Wohnungs- und Immobilienunternehmen e.V.
Lobby group of housing companies (public and privately owned)
BVI Bundesverband Investment- und Assetmanagement e.V.
Lobby group of the Open-Ended-Funds
IFD Intiative Finanzplatz Deutschland

In an initial phase, the open-ended real estate funds considered REITs a possible competition product to the existing Open-Ended-Funds and were looking for a differentiation of REITs from the existing open-ended real estate mutual funds. This was done under the assumption that REITs could or rather should have a different risk-/return structure than the open-ended mutual fund. Figure 10.5 shows the rationale behind this. If REITs are supposed to be able to invest in a risk-oriented manner, this also implies that REITs need to have rather high latitude (Chap. 1). In part due to the simultaneously developing crisis of the open-ended real estate mutual funds representatives of this fund category were keen on influencing the discussion about the introduction of REITs. On the other hand, the question of making stock exchange listing optional was of no special importance for the open-ended real estate mutual funds at the outset of the discussion. Rather the contrary was true. Initially, only REITs listed on a stock exchange were seen as possible competitors to the open-ended mutual funds due to a similar level of liquidity of both asset classes.

The experience from the United States shows that REITs act primarily as investment vehicles for institutional investors and to a much lesser extent they

are in demand by retail investors. Open-ended special funds are a sub-class of the open-ended real estate fund based on the same legal foundation, the Investment Act (*Investmentgesetz*) and are represented by the same lobbying organisation, the German Investment Fund Association BVI. They realized that making stock exchange listing optional would open the possibility of non-exchange traded REITs, a product which in the general market view would have led to a cut-throat competition at the expense of open-ended special funds. The position of the open-ended special fund representatives was therefore to plead for a listing requirement for REITs. The special funds' main clients are insurance companies and pension funds.

The position of the BVI was therefore the common denominator of the interests of open-ended mutual funds and special funds. The association recommended the introduction of a REIT that is granted high latitude in order to differentiate it from the open-ended mutual fund and for which listing on a stock exchange is compulsory in order to differentiate it from special funds.

German real estate corporations have no lobbying representation of their own. The main actor among the real estate corporations was IVG, the only German real estate corporation listed on a stock exchange with a market capitalisation and free float of a size considered relevant by international institutional investors. A second reason for IVG's considerable influence in the discussion was its strong fund business. Unfortunately, IVG's business went into trouble. The company entered a phase of self-administered insolvency ("Planinsolvenz") in summer 2013.

Private REITs were seen as a very strong competitor to special open ended funds. IVG as a company already listed on the stock market wanted to limit tax privileges to this group. Furthermore, the investment banks were interested in listed REITs with a high latitude and perceived the potential for a high volume of business in the IPO-market, resulting from the exit tax privilege.

The majority of the insurance companies wanted a REIT with optional stock exchange listing and clearly limited latitude. This position is in line with the interests of the insurance sector. Furthermore, insurance companies usually have indirect real estate holdings hence the representation of real estate issues is achieved in part through these vehicles. The influence of the insurance sector on the REIT legislation therefore remained marginal.

In Fig. 10.5, a dotted line runs diagonally from the bottom left to the top right separating the interests of the financial sector, which can be found in the resulting upper triangle, and the interests of the real estate sector in the lower triangle. The *Deutscher Mieterbund* (DMB, German Tenants' Association) must also be counted as part of the real estate sector, as an association of users.

While the umbrella organisation of the free housing sector BFW initially seemed to miss the subject of REITs, in 2006 it commissioned a further survey in an attempt to steer the process towards making stock exchange listing optional. Regarding the question of permitted latitude, there was dissension within the BFW. On the one hand, presumably following free market principles, they wanted the greatest possible latitude, and on the other hand, in this case they also saw competitive distortions due to the exemption of REITs from corporation and trade tax with respect to the

project development and property development business. BFW's policy was therefore to concentrate on making stock exchange listing optional.

The German Association of Housing and Real Estate Companies GdW, which primarily represents communal and co-operative former public utility housing companies, had been rather cautious in the debate about the introduction of REITs. Some people thought, ownership of housing stocks by publicly owned companies makes a difference (IfS 2007), other showed, it does not (Senatsverwaltung der Finanzen 2006). REITs would initially not have granted the member companies any substantial benefits, because the so-called EK 02 issue had not yet been solved. The EK02 problem was the following: When the public utility housing sector was transformed into the free market economy in 1990, companies were allowed to raise their existing book values to market values, leading to a higher basis of valuation for depreciation purposes and as a result taxable profits decreased dramatically in the following years. In accounting terms, an EK 02 basket of equity was formed on the liabilities side of the balance sheet. The total of all EK 02 equity positions was almost € 90 bn. The legal regulations regarding the appreciation of assets provided that in case of distribution before the year 2019 these profits would have been subject to retrospective taxation. As REITs are distribution-oriented, this vehicle would not have been suitable for most GdW members. In the meantime, there has been an agreement regarding the EK 02 baskets of equity and this issue is no longer an obstacle for the future integration of residential housing portfolios into REITs. A number of GdW members also wished to exclude residential property from REITs in order to thwart the possibility of disinvestment for private equity firms who had accumulated residential property. Also, by this means municipalities would no longer be able to privatise their housing companies directly via REITs.

The Ministry of Finance was in favour of a REIT structure with limited latitude and a listing requirement. The limitation of latitude was advisable for reasons of regulatory policy in order to avoid competitive distortions in relation to the commercial real estate sector. Also, it was intended to inhibit private equity funds from using the legal structure of REITs for investments; this was before it became clear that residential portfolios would not be an object of REITs. There were also successful attempts to inhibit disinvestments of private equity funds via REITs even beyond residential portfolios, by granting the exit tax reduction only for real estate that had been held in the books by the selling or transforming company for at least 5 years on 01/01/2007. The Ministry of Finance was interested in the listing requirement as by this means supervision could formally be performed through the stock exchanges and the capital market, making supervision by BaFin unnecessary. Due to the negative experience with closed-ended funds (an example is the crisis of *Bankgesellschaft Berlin*) there was a wish to avoid creating a new vehicle for the grey capital market.

The financial and the real estate industry have partially similar but also partially different interests. The IFD as a leading coordinator in the introduction of REITs in Germany was not able to adequately involve the real estate sector in the discussion, part of which is the tenant's association *Deutscher Mieterbund*. IFD has not been able

to achieve incorporation of the real estate sector's interests in REIT structure, not even in an abstracted sense, and defended the obligation of listing for German REITs.

The strategy chosen by IFD has obviously not paid off. Part of the housing industry, which was not integrated in the political process driven by IFD took action and together with a number of SPD MPs used their channels to rule out residential property from REITs. By achieving this, they did a disservice to REITs, municipalities and even themselves as housing companies. Exclusion of residential property is unfavourable for REITs. Residential portfolios are perfectly suited for REITs, being real estate with extensive management needs. First, the homogenous types of use equal a business focus. Second heterogeneous tenant base reduces credit risk. As evidenced by the first 5 years of G-REIT history, without the residential portfolios, the REIT volume and the competitiveness of German REITs within the EU suffered.

The resulting lack of private REITs and residential REITs places Germany at major disadvantage. From a regulatory policy perspective it is imperative to make the exit tax applicable for all companies, regardless of the legal structure and provenance of the buyers.

Following the passage of the "Law About the Introduction of German Real Estate Corporations with Shares Listed on a Stock Exchange", in short the REIT law, the market has developed badly or not at all, as was to be expected.

After passage of the REIT law, another discussion emerged and it was promoted and summarized by Cadmus (2007). Apart from a number of smaller annotations regarding tax issues, which may almost be interpreted as editorial errors by the legislator that can easily be rectified, Cadmus sees some fundamental problems regarding the REIT law for reasons based on game theory. For example, there are a number of requirements for upholding the REIT status that the management board is accountable for and able to control, such as compliance with the regulations regarding the limitation of borrowed capital or the rule defining the latitude of REITs to the effect that no more than 50 % of the assets may be sold within 5 years. Even though compliance with these rules can become difficult or even impossible in case of extreme market distortions, it still remains the responsibility of the management board to comply with these rules using an adequate risk management system.

A different case is compliance with the regulations regarding the ownership structure and the free float of shares. For example, one shareholder could pressurise the other shareholders by threatening to hold more than 10 % of capital, because in that case the REIT status would be lost, and, as the case may be, civil claims of former real estate vendors who had previously benefited from exit tax privileges could arise. Even more bizarre is the rule regarding the minimum free float of shares in section 11 para. 1: the minimum free float requirement is considered breached already in the case that shares are held on behalf of a third party (see sections 22 and 23 *Wertpapierhandelsgesetz,* Law on Securities Trading), something the management cannot effectively control. These two regulations regarding ownership structure and free float therefore result in incalculable risks both for the shareholders and for the management in connection with opportunistic, albeit rational, behaviour of individual minority shareholders.

The rule regarding the ownership structure, according to which no shareholder may hold more than 10 % of the capital, is based on tax policy considerations. The privileges arising from double taxation agreements as well as those resulting from EU legislation always start at a shareholding level of 10 %. There are good reasons for the assumption that the regulations about the minimum free float of shares in section 11, para. 1 (which would not have been necessary to ensure taxation of foreign shareholders) has been included in the law in order to avoid being charged of bypassing EU law before the European Court of Justice. The ownership structure rule in paragraph 3, however, which is necessary for reasons of taxation can be described as another form of the minimum free float requirement of paragraph 1. Consequentially, the issues related to the minimum free float requirements could be solved by simply omitting this passage. This is not the case for the requirements of paragraph 3 for tax reasons.

Shifting the risks involved in the violation of the free float requirements to the REIT company is logically consistent, as neither the federal nor the state authorities are willing to assume the risks of revenue losses, and therefore the industry had to assume the risk. From the point of view of the affected management boards it may be comprehensible to demand a reform of the REIT law to the effect that the risks of a violation of the free float requirements should be taken from REITs and imposed on the taxpayer, because the REIT's management is not able to control compliance with these. However, considering the evolutionary history of REITs, it is highly unlikely that there will be a political majority for any measure of this kind during the current legislative period.

An additional issue to be considered is that it is in particular the smaller companies who have to expect potential opportunistic behaviour from individual shareholders. Companies such as IVG or Alstria REIT AG believe they can protect themselves better from opportunistic behaviour because of their size and importance in the capital market.[2] In this way, Cadmus's argument even becomes a selling point for the large companies, because with their bigger volume they can credibly reassure vendors that there is a smaller risk for them to lose exit tax privileges.

What is remarkable is that the debate initiated by the European Court of Justice has barely been noticed. On 14 September, 2006 the ECJ ruled in the so-called Stauffer case that within the EU the location of a legal entity may not be relevant for the question of taxation. Therefore, an Italian non-profit foundation that is tax-exempt in Italy cannot be subject to limited taxation in Germany, if there are comparable local non-profit foundations that are exempt from tax liabilities. This verdict can be interpreted as a European policy breakthrough; however, it leads to the situation that other European REITs investing in Germany will most likely no longer be subject to limited taxation if and when a comparable REIT structure exists in Germany. The coalition agreement and the federal government were always

[2] Quote Dr. Georg Reul, IVG AG and Dr. Michael Börner-Kleindienst, Alstria Office AG, at ExpoReal on 09/10/2007.

eager to ensure reliable taxation of foreign investors in German REITs. What was neglected, however, was the issue of taxation of foreign EU REITs in Germany. In the wake of the Stauffer case Germany with its REIT structure now fully competes with other EU states.

10.6 Conclusion

German politics has not used the time and experience of the last 5 years to improve the current G-REIT legislation. Neither has the inclusion of residential real estate nor the abolishment of the mandatory listing been touched. By not allowing housing stock from before 2007 the most important asset was forbidden for REITs and by asking for the listing of the REITs from the beginning, the most important investors in REITs like insurance companies and pension funds could not take part. As long as these amendments are not made, REITs will not be able to play a significant role in the German capital market. In the USA, it took decades to finally have functional REITs at the beginning of the 1990s – why should Germany be any faster? However, it lacks political agenda to improve the existing vehicle. This differentiates Germany from the United States.

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Chapter 11
Fifteen Years of Italian Real Estate Investment Funds Across Different Market Cycles

Laura Gabrielli

11.1 Introduction to Italian Real Estate Market

Between 1997 and 2007, Italy experienced a period of sustained growth in the real estate market and capital value growth has been strong in all sectors, as has income return on the commercial real estate sector. The real estate market was expansive and has been transformed by the introduction of new financial instruments as well as through foreign investors.

During this decade, different innovations and changes have been introduced in the market as bank mortgages' securitization, real estate spin-off, public real estate assets disposal, investment opportunities in new developments as well as in re-use of brownfields, new forms of professional management of real estate portfolios, and the introduction of property funds. Those opportunities and trends opened the domestic market to foreign investors, improving the sector and its overall transparency. Cross-border investors remained focused on high quality assets, mainly in the two major cities of Rome and Milan and, within those cities, the principal property investments available were offices and retail. In the residential sector, 80 % of families own their house, so investment in this sector was limited and with very low yields.

In 1999, the first Real Estate Investment Funds (REIFs) were introduced in the market. The timing of the introduction coincided with the upward trend of the property cycle and REIFs have been one of the investments that contributed to the development of the market. Their rapid diffusion was predominantly related to their status of as a tax efficient vehicle for property investments as well as a good opportunity for portfolio diversification.

After 2008, real estate investments and capital flows froze and the transaction activities dramatically reduced due to the lack of finance and to the dependence of

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_11, © Springer-Verlag Berlin Heidelberg 2013

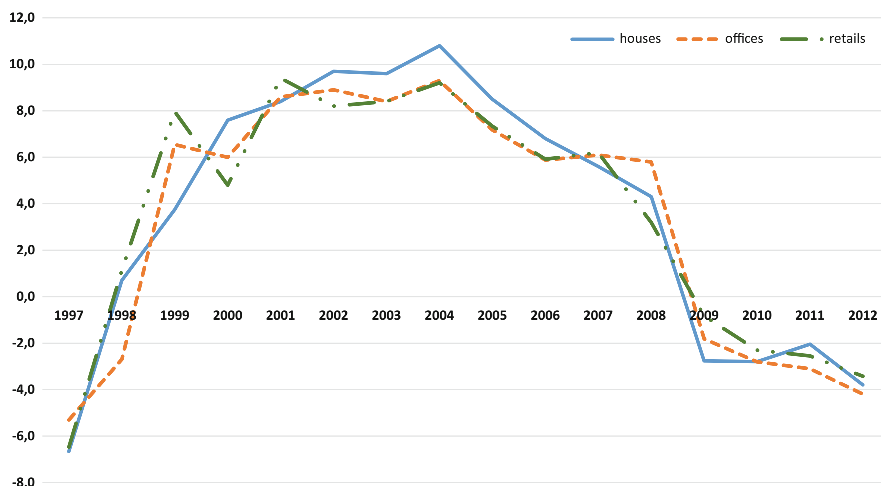

Fig. 11.1 Price variation (%) for houses, offices and retail – Nomisma, 1997–2012

the sector on leverage. The downturn in the real estate market has seen a massive decrease of property transactions (since 2005, – 47 % of residential and – 45 % of non-residential transactions, dropping down to 1985 level), while house prices have declined by 10 % since 2009 (Fig. 11.1). The purchase of a house via a mortgage plummeted 38 % and investments in residential and non-residential sectors dropped 21 % from 2008 and 32 % from 2003, respectively (Fig. 11.2). Recent public real estate assets disposal opportunities have struggled to attract bids.

Weak domestic demand and business activity as well as a rising unemployment rate were part of a continuous contraction of Italian economy. Lack of competitiveness, subdue bank lending, falling consumer spending, and political uncertainty suggest that the recession will continue throughout 2013 and the Italian economy will not experience any expansion. As industrial activity continues to decline, the industrial market suffers from a lack of demand and vacancy, with a poor prospect for the sector. In the office sector, international investors remain cautious and very selective as the political situation is not stable and the economy remains weak. In the retail market, investments remain constrained by financial restriction, weak consumer power and the overbuilding of shopping centres and retail warehouses. This has affected the performance and attractiveness of Italian Real Estate Investment Funds.

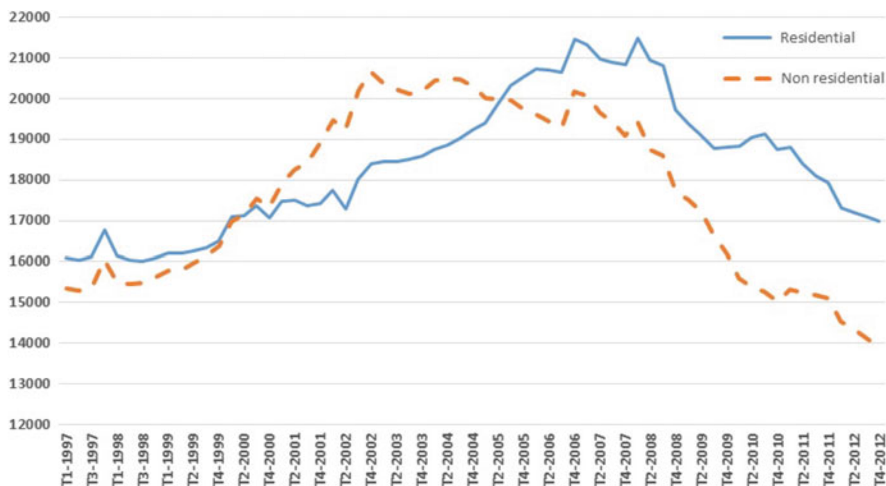

Fig. 11.2 Investment in residential and non-residential sectors – Istat, 1997–2012

11.2 Italian Real Estate Investment Funds

Italian Real Estate Investment Funds were first introduced in January 1994 through Law No. 86, which built upon previous legislation in 1983 and 1993 relating to open-end and closed-end funds respectively (Laws No. 77, 23/3/83 and No. 344, 14/8/93). Known as “Fondi di Investimento Immobiliare”,[1] they are pools of assets represented by units and managed on behalf of investors by a SGR (Società di Gestione del Risparmio – Saving Managing Company).

It wasn’t until 1998 that the attractiveness of REIFs was realised with the introduction of the D.lgs. 58, 24th of February 1998 (TUF[2]). This amendment repealed Law 86/1994 and redefined the definition of private and public saving within common funds. Prior to TUF, REIFs were much more inflexible. They had to operate within strict parameters relating to the characteristics of the fund, the operational restrictions and the functional scheme of the fund. This proved to be much too prescriptive and was considered an obstacle to entry into the market.

D.L. 351 of 25th September 2001, which became Law 410 of 23rd November 2001, introduced certain modifications to allow greater flexibility in the operation of REIFs. Law 410/2001 was concerned with liquidity in the property market, by introducing rigor and transparency and facilitating the use of public saving in indirect property investment and encouraging the disposal of property by more

[1] Real Estate Investment Funds.

[2] TUF stands for Testo Unico della Finanza. See also Ministerial Decree n. 228, 24th May 1999, Bank of Italy Regulation, 20th September 1999.

institutions. Transfers, buying and selling of properties in conflict of interests[3] were allowed. Other changes were introduced with further new laws[4] permitting funds to have the chance to create a REIF through property transfer, so that the new funds can benefit from an existing portfolio. In the past, this opportunity was a prerogative of public funds only. Different limits to leverage and a new tax system were introduced in order to boost the performance of REIFs in the market. The characteristics of closed-end funds were maintained introducing an element of flexibility with the opportunity to issue new units during the lifetime of the fund. The new funds were more transparent as they allowed investors to know the returns of properties and their valuation.

Law n. 122 dated 30th July 2012 introduced a new definition of REIFs, defined as an independent pool of assets collected from multiply investors (pluralità di investitori), with the aim of investing according to an investment plan. This new law stresses the separation of assets and liabilities of the investment funds from those of the SGRs and of each investors, providing that the fund is liable for the obligations incurred on its behalf by the related SGR.

Different entities are involved in REIFs activities. The SGRs asset management companies are supervised by the Bank of Italy and Consob[5] and regulated by provisions contained in different regulations issued by those two entities, together with the Ministry for Economic Affairs.

The SGR has a legal obligation to maximise the fund wealth and thus, the value of the shares through the active and efficient management of the property portfolio. The SGR is core in the decisions and investment strategies for the fund, it collects financial resources from the investors and buys properties, real estate rights and shares in properties companies according to the regulations. The added value of the fund is returned to the investors, while the SGR is paid a management fee by the funds.

A REIF is not a legal entity but rather a pool of investments held by multiple unit holders. REIF and SGR must be separate entities and the fund's asset cannot be held directly by SGR.[6] Special laws and rules have been introduced in order to ensure this separation and to avoid transactions, which demonstrate conflict of interest. The funds must be deposited with an authorized Bank (called Depository Bank[7]),

[3] Properties in conflict of interests are all properties of equity holders and with other companies that belong to the group.

[4] D.M. 47 of 31st of January 2003 from the Ministry of Economy and Finance, the Law 326 of 24th November 2003, the Law 350 of 24th December 2003, the Law 63/2005, the Law 262/2005 and the Law 266/2005.

[5] Consob: Commissione Nazionale per le Società e la Borsa – Companies and Stock Exchange National Commission, which is the Italian regulatory authority for financial markets.

[6] SGR must be an Italian joint – stock company (Società per Azioni, SPA) which can carry out the activity of management of investment funds complying specific regulatory requirement and upon authorization and supervision of Bank of Italy.

[7] The bank must be an Italian bank or an Italian branch of an EU bank, with professional experience, minimum assets and structure which guarantees an efficient management of the investments.

which carries out each transaction on the basis of SGR's instruction. This Bank is responsible for ensuring the fund's liquidity. The SGR has to prepare fund Prospectus,[8] which contains the operational rules and must be approved by the Bank of Italy before offering the units to the market and the investors,[9] with the exception of speculative funds, whose Prospectus does not need a prior approval.[10] Regulation defines the investors' participation in the fund, rights and obligation of fund's investors as well as the SGR and the depositary bank. The Prospectus sets the investment criteria, thresholds, the type of funds, the duration, the asset allocation, the governance the distribution of earnings, the risk concentration, the procedures for the fund's disposal, and other relevant issues. Moreover, SGR has to provide detailed information on financial profile, income structure and price trend of funds.

There is an external and independent valuation of the real estate held by a fund twice a year.[11] The SGR has to ask experts' opinion about the fair value of property which is going to be sold or bought by the fund. Different laws and regulations in the last decade have tried to introduce rules and best practice guidance in order to support high standards, objectivity and transparency of property valuations,[12] as well as the relationship between valuers and SGRs. There are a very small number of actors undertaking property valuations (Colombo and Marcelli 2009). Indeed, two major property valuation companies are responsible for the 75 % of the market, which may compromise the "independency" requested by legislation. However, fund managers remain completely responsible for real estate valuation and they are not obliged to comply with valuers' reports. The Bank of Italy provides general guidance for real estate valuation approaches.

REIFs are listed on the Italian Stock Exchange and shares are traded in the Market of Investment Vehicles (MIV). A quotation in the stock market is required if the individual share has a price of less than € 25,000. The quotation must be completed by 24 months after the subscription period. The fund length must not be over 50 years while there is not any indication about the minimum length required. REIFs can ask the Bank of Italy for a 3-year extension in order to sell all the properties included in the portfolio.

[8] In Italian "Regolamento".

[9] Regolamento sulla Gestione Collettiva del Risparmio, Bank of Italy, 14/04/2005.

[10] Law n. 122, 30/07/2010 and Law n. 106, 12/07/2011.

[11] See D.M. N. 228 of 24th of May 1999 for valuers' requirements.

[12] See Bank of Italy's Measure, 14th of April 2005; Bank of Italy and Consob Communication, 29th July 2010; Bank of Italy and Consob Communication 29th of October 2007; Assogestioni's Guidelines, 27th of May 2010.

11.3 Characteristics and Assets of REIFs

Italian REIFs can invest in:

- Real estate assets, real estate rights and shares in real estate companies;
- Listed and un-listed financial instruments;
- Bank deposits;
- Receivables and securities embedding receivable and any other asset that is traded and that has a value determinable on biannual basis.

In 2008 SGRs were allowed to invest part of their portfolio in units of other REIFs, both Italian and Foreign REIFs, or in SIIQs.

The principal requirement is that not less than two thirds of their equity should be held in real estate assets, real estate rights and in real estate companies' shares. However, this is rule can be relaxed to not less than 51 % as long as it is countered by holdings of 20 % or more in property related financial vehicles such as securitised properties or real estate rights. The remaining of the equity can be invested in financial instruments (listed or unlisted), bank deposits, receivables, transferable securities, which represent the liquidity of the funds.[13] These limits must be in place within 24 months of issue (or 48 for funds that invest in social housing).

Furthermore, regulations set out the following limitations on the activities of funds in order to guarantee an appropriate level of risk diversification. The fund may not invest, directly or through controlled companies, more than one third of its assets in one single asset; REIFs cannot be engaged directly in building activities though they can have more than 10 % of the equity in the share issued by the same building company.[14]

The amount of debt can be up to 60 % of the value of real estate asset, real estate rights and shares in real estate companies and the 20 % of other assets owned by the fund. The funds, which are not listed, can borrow money up to 10 % of the value of the fund in order to cover reimbursement.

Transfers, buying and selling of properties in conflict of interests are allowed with the following limits. The value of each property must not exceed 10 % of the funds value. The transaction made with shareholders of the SGR cannot exceed the 40 % of the total value of the fund, and the transactions made with the shareholders of the SGR and members of its group cannot exceed 60 % of the value of the fund. During the operation of the fund the value of those transactions are limited to 10 % of the total value of the fund each year. The investor must hold the shares subscribed after a contribution of assets to the fund for at least 2 years and for an amount not lower than 30 % of the value of the assets.

[13] According to Assogestioni, Funds' investments, in 2012, where divided in real estate and real estate rights (90.1 %), shares in real estate companies (2 %), transferable securities and liquidity (5.7 %), others investments (2.3 %).

[14] Bank of Italy, Measures 14th of April, 2005.

Unless the by-laws of the fund prescribe a distribution obligation, a fund has no obligation to distribute its profits during their lifetime. However, the funds are obliged to distribute all the proceeds deriving from their activity at the end of their duration.

11.4 Classification of Funds

Italian REIFs can be classified according:

– Type of investors;
– How funds are established;
– Their management;
– Legal form.

Classification according to investors includes public funds in which every investor could participate to the fund; private funds in which certain “qualified” investors can buy shares of the fund and speculative funds. Public funds, when units can be available to the public, are called “retail funds”. The private funds (or “institutional funds”) are dedicated to specific categories of investors, qualified for their financial experience of the market as property investors, banks and banking foundations, saving management companies, open-end investment companies (Sicav), pension funds, insurance companies, and other qualified investors.[15] REIFs for qualified investors have looser restrictions in comparison to public funds, as it is assumed that those investors have the know – how and the economic profile to undertake an investment with greater risk. While public funds cannot invest more than one third of the equity in just one property and no more than 10 % of the equity in shares issued by the same construction company,[16] in reserved funds those prudential rules do not apply.

Speculative funds (“hedge funds”) are highly risky with relatively few investors. These funds have greater freedom in their decision-making and as long as they operate within certain restrictions, they are extremely flexible. The minimum price for the share is €500,000 and the maximum number of investors is 200. Those funds operate, virtually, with no limitations.

A second classification is based on how funds were established. Ordinary funds (or “blind pool funds”) raise money through subscription and then invest in properties; contribution funds (or “seeded funds”) acquire properties (real estate

[15] Qualified investors are defined in art. 31 of Consob Regulation 11522/1998. Reserved funds were introduced by D.lgs. 58 of 24th February 1998 (TUF), and are designed only for qualified investors. These are investors and institutions with experience in finance. They could be: banks, management-investment companies (Sgr), pension funds, insurance companies, finance companies, open-end companies and funds, mutual funds and private investors whose skill in financing and trading is recognised.

[16] Bank of Italy, Measure 14th April 2005.

assets, real estate rights or interests in real estate companies) and then sell shares in the funds; mixed if shares are subscribed both with money and with properties.

In addition, under Italian Law there is a more general categorisation of REIFs according to whether funds are created with private property/money contribution or whether funds are created through the contribution of public properties. The funds created with the contribution of public properties are formed by transferring public properties in the ownership of public administration and other public bodies. Public funds have a different structure from private funds created by the transfer of properties and real estate rights. Investors immediately receive shares that can be sold later. The properties transferred must be more than 51 % value of the total fund.

Another classification is founded on different management styles, risk profile and investments. Funds can broadly divided in three main categories:

- Core funds: those are low risk investments, which invest in income producing property with high standard tenants, with long-term contracts, usually in Milan or Rome. They use a low degree of leverage.
- Value added funds involve moderate risk as usually they are characterised by property in need of renovation in order to enhance their income, resulting in higher appreciation that core funds.
- Opportunistic funds mainly focus on buying, developing and selling a property, trading, or other riskier investments. Those funds have a higher degree of leverage in order to generate greater appreciation.

Italian REIFs can have two legal forms:

- Closed-end funds, in which the entire amount of the capital is determined during subscription and cannot be modified. This kind of fund does not allow its investors to sell their units to third parties and the returns are achieved at the end of the period.
- Semi closed-end funds are allowed to increase or modify their value by issuing new shares, according to specific requirements (shares must be subscribed within 18 months after the subscription period). This form gives investors the right to redeem their units only at certain intervals, or at the end of specific periods, under precise circumstances and amount.

11.5 Taxation Issues

Since 1999, the legal framework has been changed on different occasions, boosting the growth of REIFs. Italian REIFs are fully tax exempt.[17] As they are not subject to IRES (corporate income tax) or IRAP (Regional tax based on productive activities). No withholding tax is charged on income from capital derived by the fund (interests on loans or bonds, or bank accounts, dividends).

[17] Until the year 2003 they were subject to a net wealth tax equal to 1 % on the average net accounting value of the fund. This tax was introduced in 2008 and it was repealed in 2010.

Dividends distributed by funds are subject to a 20 % withholding tax withheld by the SGR. Investors are taxed in a different way after the Law n. 122 dated 30th July 2010 and Law n. 106 dated 12th July 2011, which aim to target a particular group of funds, so-called “family funds” (Bianchi and Chiarera 2012), with a more restrictive fiscal regime. This new tax framework is based on definition of the “plurality of investors”. According to the new Law, REIFs are divided in two groups for tax purposes:

– Institutional REIFs;
– Non-institutional REIFs.

The first group includes funds entirely owned by any (or a combination of) public or private institutions, like states of public entities, pension funds and insurance companies, banks and other financial intermediaries, non-profit companies, corporate and contractual SPVs[18] owned for more than 50 % by any of the entities mentioned before. Also foreign institutional investors can invest with the same rules in REIFs, if included in the “White List”. All other investors have to invest through the Non-institutional REIFs.

In the tax regime for institutional REIFs, the profits (income and dividends) are subject to a 20 % withholding tax withheld by SGR. Income includes both dividends and capital gains obtained through redemption or sale of units. This withholding tax is considered an account payment for corporate entities and as final payment for all other investors.

The withholding tax, however, does not apply if the beneficial owners of the proceeds are either Italian pension funds or Italian investment funds. Foreign persons that are resident in countries that allow an adequate exchange of information with Italian tax authorities are exempt from such withholding tax. A list of states providing an adequate exchange of information is laid down in a Ministerial Decree.[19] In very general terms, these are the countries that have concluded a tax treaty with Italy and have agreed a fully-fledged exchange of information clause. Profits distributed to investors who are residents in other countries, which have a double taxation treaty, the more favorable treaty regime can be claimed.

Non-institutional REIFs have three different tax regimes according to whether their investors are:

– Institutional investors
– Other investors with more than 5 % of the REIF units
– Other investors with less than 5 % of the REIF units.

For investors with less than 5 % of the REIF units, profits are taxed upon distribution or are tax exempt, according to the same rules applicable to institutional funds (treaty relief is applicable). If the investors have more than 5 % of funds’ units the profits are attributed to the investor in proportion to the percentage of

[18] Special Purpose Vehicles.

[19] This is commonly referred as the “White List”.

participation in the fund, regardless of its actual distribution. For resident investors, income must be included in the annual taxable income and taxed on the basis of the investor's tax regime.

Other indirect taxes are applicable to the real estate investments, as, for example, Property Tax IMU (Municipal tax, at a rate of 0.4–0.7 % of the cadastral value), 21 % VAT, in general, depending on the type of real estate and on individual circumstances, mortgage and cadastral taxes.

11.6 Italian Real Estate Funds and Market Structure

Growth in the number of funds since 1999 has been rapid and at the end of December 2012, there were 201 REIFs in Italy run by 24 different SGRs with an overall investment value is €25.53 M (Fig. 11.3) representing a growth of 0.4 % in comparison to the previous year (but a reduction of 1 % in comparison to June 12). After a constant growth during last decade, the market is now stable. Real estate funds are about 10 % of the total Italian investment market making Italy the third European market,[20] after Germany and Holland, with the 11 % of the market. However, the size of Italian funds is relatively small, with 95.5 % of the funds having a net asset value below €600M and 24 funds below €100M.

Italian real estate funds have targeted both private and institutional investors. Of the 201 REIFs registered at the end of December 2012, 22 of the funds are open to all investors representing 11 % of market, while 179 are reserved for only certain qualified investors taking 89 % of the market (Fig. 11.4). During 2012, 22 new funds were introduced into the market, but those funds are only for qualified investors while the last REIF for public investors was introduced 5 years ago. Also, the number of those funds is declining due to the closure of some funds. In essence, the history of REIFs in Italy can be divided in two periods: from 1999 to 2005 when the market was dominated by retail funds, and the following period, when the funds for qualified investors sharply increased in number.

Another important issue is the growth of funds with the contribution of a property portfolio (Fig. 11.5), over-taking in 2006 the funds by subscriptions. Indeed, the former now represents 80 % of the total market.

Speculative funds (hedge funds), which were introduced in 2005, represent 25 % of the market, with a NAV of €1,300M and about the 20 % of the leverage of the market.

The main differences between private and public funds are summarised below.

- Public funds (16 out of 22) are mainly funds with subscriptions, while private funds are constructed with property portfolio contributions (152 out of 179).

[20] Scenari Immobiliari, *I fondi Immobiliari in Italia e all'estero*, 2012.

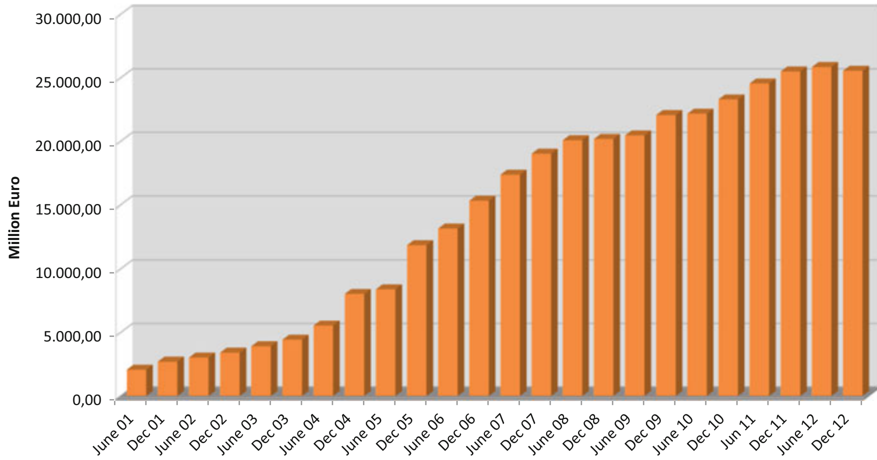

Fig. 11.3 The evolution of Italian REIFs 2001–2012

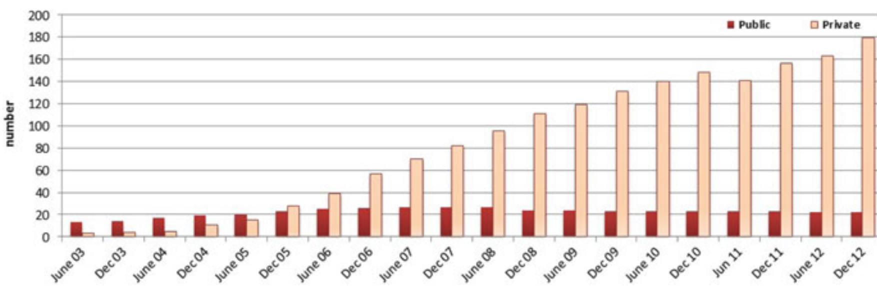

Fig. 11.4 The growth of the number of private REIFs 2003–2012

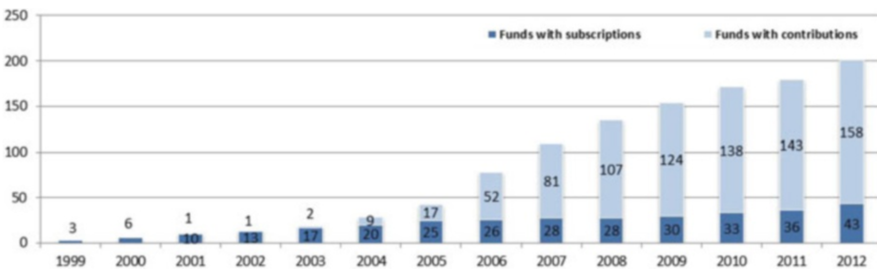

Fig. 11.5 The growth of the number of the funds created with property contributions

– Private funds (132 out of 179) are semi-closed funds[21] or (drawdown funds), which is possible only for 4 or 22 public funds.
– Portfolio composition: 48 private funds and 11 public funds have more that 60 % of their portfolio invested in offices.
– The total assets of public funds (retail) and private funds are diminishing.

The majority of the REIF vehicles in the Italian market are characterised by conservative management strategies. They tend to concentrate on a sector allocation in offices and retail. In other countries, where REIFs are well-recognised investment vehicles, there has been a natural segregation of fund types with specific funds concentrating on particular geographic areas, particular property sectors, development and regeneration or specific investment strategies. These have provided investors with a good alternative to the traditional REIFs. Many funds have exposure to real estate development, with a higher risk especially during the property market downturn.

As of December 2012, REIF allocation was 89.2 % by value invested in direct properties with the remaining amount split between liquid funds and indirect investment in property companies: €41,724M represented the total assets before the deduction of liabilities; the corresponding properties NAV was €37,208M. The activity mix of REIFs is mainly reserved to property and real estate rights, which are of increasing importance in the funds. There is poor diversification in all fund types. The majority of funds invest in offices, followed by retail and residential property (Fig. 11.6). The residential allocation has been boosted by the introduction of exclusive residential funds and those which invest in social houses. Investments in the industrial sector have been reduced in the last few years.

According to Assogestioni (2012), the part Italy with the greatest focus of REIFs (Fig. 11.7) is the North West (45.6 %), followed by the Centre (32.8 %), the North East (11.5 %) and South (8.2 %). Foreign investments are only 2.1 % and have fallen (in relative terms) with the increase in new domestic investments. REIFs invest abroad mainly in France, Belgium, UK and Germany.

The need to diversify more fully is the main issue for Italian funds, from the regional asset allocation perspective but especially in terms of sector allocation. Currently the funds seem to be poorly diversified and prone to risk with investments concentrated mainly in offices in Milan and Rome, the financial and the administrative capitals of Italy, and in trophy buildings, located in the best locations in these cities.

In December 2012 funds leverage was moderately lower in comparison to 2011 for public funds (€2,403M) while leverage has grown for private funds (€13,049M). Private funds had used 67 % of their possible leverage, while public funds use only 60 % of the possible leverage (Fig. 11.8).

[21] A semi-closed end fund allows an increase in the value of their initial capital by issuing new units.

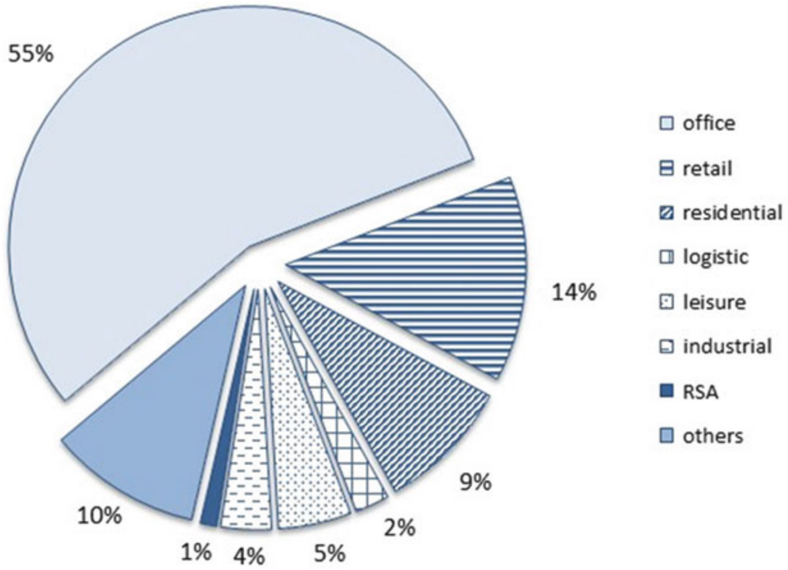

Fig. 11.6 Sector asset allocation in the REIFs, Assogestioni, 2012

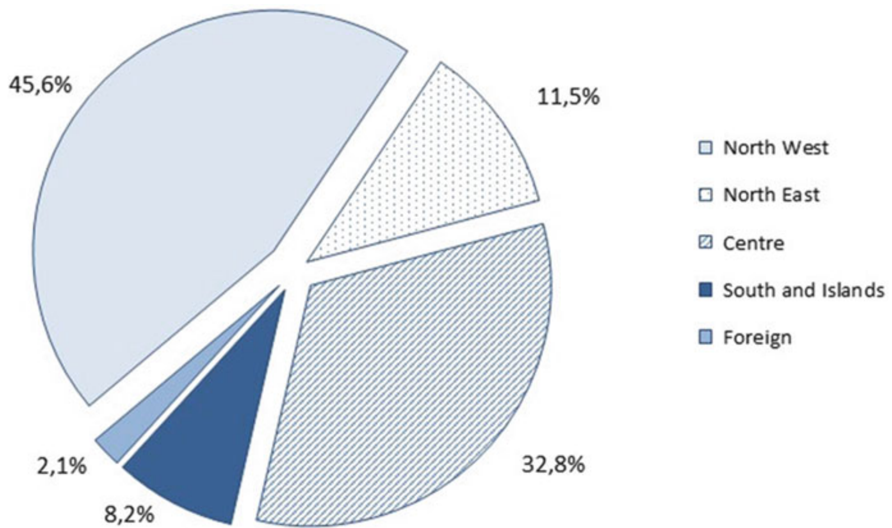

Fig. 11.7 Regional asset allocation in the REIFs, Assogestioni (2012)

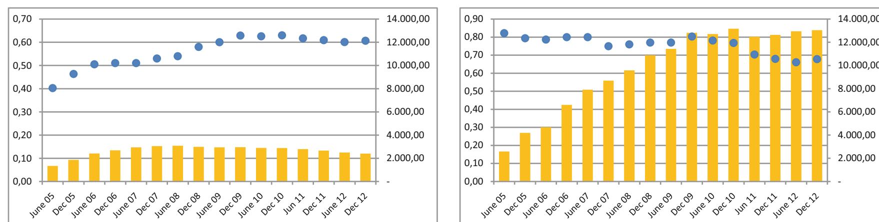

Fig. 11.8 Leverage and use of leverage – Assogestioni, 2012

11.7 Indexes and Transparency

The Italian market has experienced significant growth in transparency from a relatively low base level, largely due to REIFs. Within the Jones Lang LaSalle Global Transparency Index 2012, Italy, after a significant improvement in its transparency between 2004 and 2008, is now struggling to improve real estate transparency. The real estate transparency index in 2012 for Italy is 2.16[22] and is currently 20th in the index (below other European Countries as UK, the Netherlands, France, Switzerland, Germany, the Scandinavian countries, Ireland and Spain). The main issue is a paucity of available information at a national and local level and despite the progress made in the last decade, much needs to be done. In terms of corruption perceptions, Italy has a very low Index with more attention needing to be paid to the requirement for robust regulatory and legal frameworks, as well as transparency in real estate transactions. Performance indexes were introduced in 2000 by IPD,[23] and there is now three different indexes, namely the Annual Property Index,[24] the Biannual Property Index[25] and the Biannual Property Fund Index,[26] which were respectively +1.5 %, +0.5 %, −3.7 % on 31st of December 2012. The Property Fund Index (Fig. 11.9) showed a total return of −5.8 % for the full 2012, the second consecutive negative result and the lowest return in the index series.

The IPD Fund Index during 2012 showed a poor performance in comparison to equities (+13.3 % in the first half year and +11.7 % in the second half), bonds (+13 % in the first and +24.8 % in the second semester) and real estate equities

[22] Index goes from 1 (Highly Transparent market) to 5 (Opaque market).

[23] IPD – Investment Property Database, a UK based performance measurement company that has established indexing services in the UK (since 1988) and other countries around the world.

[24] The IPD Italy Annual Property Index measures ungeared total returns to directly held standing property investment from one open market valuation to the next.

[25] The IPD Italy Biannual Property Index measures ungeared total returns to directly held standing property investment from one open market valuation to the next.

[26] The IPD Italy Biannual Property Fund Index measures geared and ungeared fund total returns from one open market valuation to the next and analyses 42 funds with a Net Asset Value of 7.7 Million Euros.

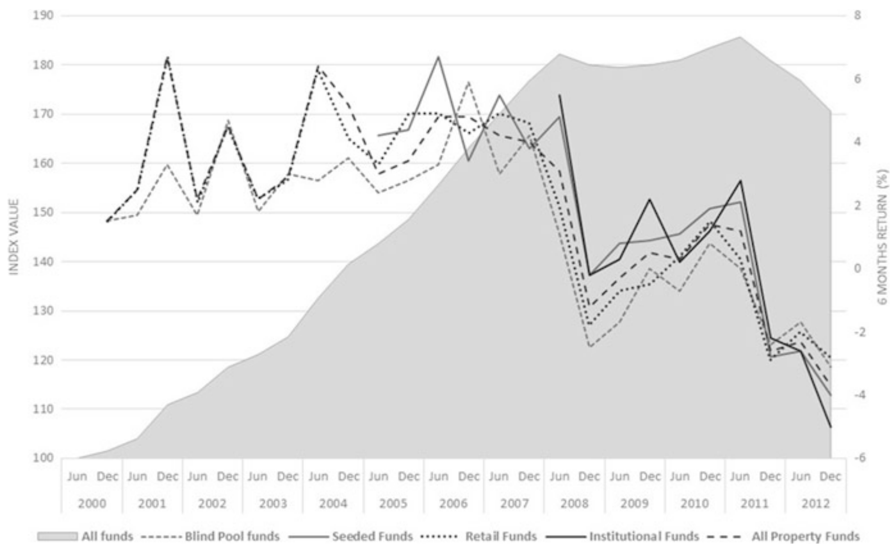

Fig. 11.9 IPD Property Fund Index, IPD data, December 2012

(+29 % and +27.7 %, first and second half year figures respectively). Nevertheless, in the long term, the 5-year annualised performance of funds measured by the IPD index showed a −0.8 %, compared to −11.4 % of equities and −20.4 % of real estate equities. During this period, only bonds recorded a positive performance with 6.2 %.

A further Property Fund Index, IFI, – Indice dei Fondi Immobiliari (Property Fund Index), provided by Trading System, considers the listed REIFs in MIV (Investment Vehicles Market) since December 2001.[27] This is a value weighted all share index, which shows the daily performance of property funds shares, weighted on their stock capitalization (factors in the size of the company). In total, 22 listed funds are included in this Index. The Paribas REIM Index is a value weighted all share index, founded in December 2002, shows the trend of these listed REIFs with an asset value of €1.900M, while the Paribas REIM DTN analysed the NAV discount of these funds (Fig. 11.10). They both consider the share price variation, the dividends and capital share refunds.

In 2012 the economic crisis affected all sectors, including the property market and also property funds. As shown by different indexes, the performance was very poor, and listed REIFs showed a performance of – 23 % in the listed market. At the beginning of 2013, the performance of listed REIFs turned positive, due mainly to the poor performance of bonds and a renewed interest by investors.

[27] The TradisSystem has also IFI – TR, Total Return Property Fund Index. It compares the different management of property funds, which reinvest the dividends.

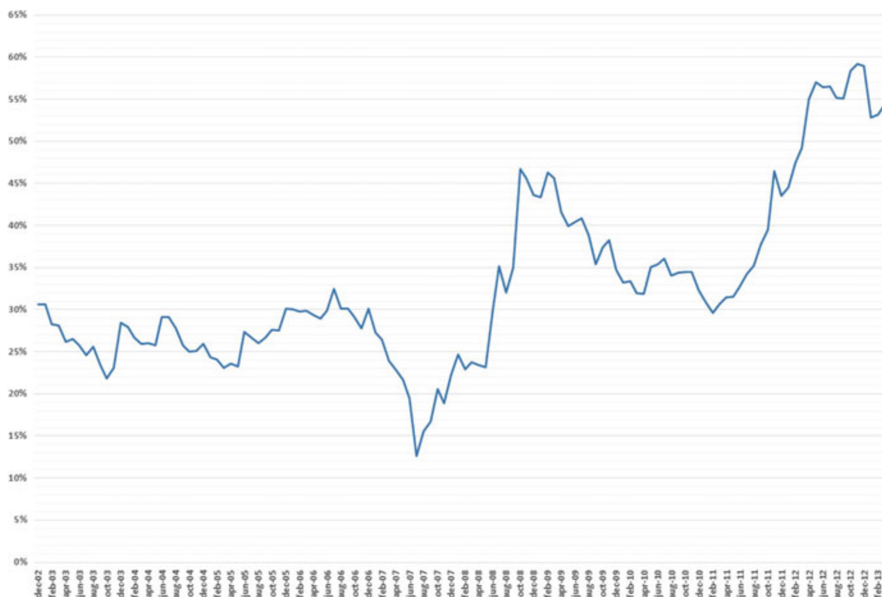

Fig. 11.10 Reim Dtn – BPN Paribas, December 2002–March 2013

11.8 Characteristics of Italian REITs

The Budget Law for 2007 (Law n. 296, 27th December 2006) and then Law n. 174, 7th September 2007 introduced rules for Italian listed real estate investment companies, a new type of real estate investment vehicle, on the model of Real Estate Investment Trusts. The tax exemption regime for joint-stock companies can be applied to all companies, which are listed on the Italian capital markets and mainly performing real estate activities. The legislation requires companies to be registered as “Società di Investimento Immobiliare Quotate” (SIIQ, Listed Real Estate Investment Companies). The nature of Italian REITs does not differ from other countries; they are listed property companies with tax advantages, owning and letting income-producing properties.

In general terms, an Italian company[28] with its main activity letting properties and which meets the conditions may be subject to a special income tax regime.[29] In order to qualify as a SIIQs a company has to be a joint-stock company incorporated under Italian company law and resident in Italy, mainly performing property-letting activities. The companies must be listed on the Stock Exchange and decide for the

[28] It could be an Italian permanent establishment of an EU real estate company whose shares are listed on a regulated market.

[29] SIIQ Regime.

SIIQ regime by the expiry date of the financial year preceding that in which the SIIQ Regime will apply. Such an election is irrevocable. The value of the leased properties in SIIQs must represent at least 80 % of the assets of the company[30] and the incomes from property rental activities must be at least 80 % of total revenue in each fiscal year.

The SIIQ's shareholders cannot directly or indirectly own more than 51 % of the voting rights and more than 51 % of the of the profit sharing rights. At least 35 % of the SIIQ shares are held by shareholders, which cannot directly or indirectly own more than 2 % of the voting rights or 2 % of the profit sharing rights. Finally, at least 85 % of the profit from the rental activity must be distributed to the shareholders. If the total net income is lower than the income coming from rental activity, then the 85 % can be applied to the distributable profit. The SIIQ must keep separate books for the rental activities and for all other activities and it has to disclaim in its financial statements the criteria used for the allocation of the costs to rental and the other activities.

SIIQ status may be subject to a capital gain, as the assets of companies applying for the regime will step up to the market value as of the closing date of the previous financial year (in which the ordinary tax regime is applied). The capital gains, net of losses, arising from the transfer will be subject to a 20 % substitute tax. This particular tax regime is applied only if the properties are held for at least 3 years. At the taxpayer's option, the market value can be used as the new book value of the SIIQ. If the option is not exercised, the gain will be considered to be from activities other than rental activities and taxed according to ordinary rules. The SIIQ is exempt from corporate income taxes, both a national and regional level, for the income retained from the rental activity. All the other activities are subject to the ordinary tax regime. SIIQ companies can benefit from an income tax exemption from corporate income taxes, IRES, and various regional taxes, such as IRAP, though subject to possible regional surcharges.

The company has to distribute, each year, at least 85 % of the income coming from the rented properties. If the distributable net profit is lower that the profit yielded in the rental activity, such percentage applies to all distributable profit. At shareholder level, the income coming from the distributions of the SIIQ is subject to a 20 % withholding tax. This rate is reduced to 15 % for the residential properties rented according Law 431/1998. Withholding tax is levied as a definitive payment or as advance payment of taxes due, depending on the status of the investor.

Withholding tax, however, does not apply if the shareholder is an Italian pension fund; an Italian investment fund; or if the income is part of the results of individual management of portfolio. Tax losses suffered from the company in the financial year before the SIIQ regime can be used to offset the taxable base of the substitute

[30] The concept of 'real estate properties' includes interests in SIIQs or Non-Listed SIIQs that qualify as long-term assets according to article 11(2) of Decree 28 February 2005, no 38. Dividends on the mentioned interests in SIIQs, which are paid out of profits relating to the real estate lease activity, qualify as revenues derived from the real estate rental activity.

tax due to the increasing value of the assets and income derived from the activities, other than the exempt rental activity. Any capital gain due to the contribution of properties in exchange for shares in the company can be subject to the ordinary tax or to a 20 % substitute tax, at the choice of the taxpayer. In the latter option, the receiving company must hold the properties for at least 3 years.

The Law does not provide for any specification for the minimum value of the real estate properties owned by the SIIQ, the level of the debt raised or the mix between commercial and residential properties.

In Italy, there are only eight SIIQs with a market capitalization of €559M (May 2013). The reason for their unsuccessful introduction into the market were, among the others, an unclear legal framework as some specifications are not yet provided, the tax regime is not efficient with a general indifference for this listed investment vehicle. The limits significantly restrict the possibility of creating a SIIQ and the diffusion of this investment vehicle in Italy.

11.9 Conclusions

The significant growth of REIFs during the last 15 years showed their potential as a successful investment vehicle. However, due to the liquidity of the financial instrument and the crisis of the market, at the moment funds represent an opportunity only for institutional investors (banks, pension funds, insurance companies) looking for a balance between security of capital and good opportunities of income growth. In the last few years, no new retail fund was launched in the market, and only funds for qualified investors have shown a constant growth.

REIFs have some advantages of portfolio diversification, low risk of vacancy and efficient management, tax deduction in comparison to direct investment. The REIFs that sell into the market a portfolio of property already prepared (instead of buying products after the placing of shares) has brought advantages of the allocation of liabilities and tax deduction. REITs introduced, in the real estate market are characterised with more transparency, more efficiency and higher standards.

Despite the advantages of creating a plausible property backed asset, there are a number of factors that have hindered the increase of REITs in Italy. There is a lack of visibility, as in the first stage, the funds issue shares and then buy properties. Thus, the investors invest blind as they don't know the characteristics of the portfolio and the properties included. The secondary market is poorly developed with a lack of liquidity (about 1 % of the market capitalisation) caused by a small number of trades which can have a distorting effect on price formation mechanism, and also led to high discount between market values and net asset values. Exchange is very rare in the market; only investors who need liquidity are trying to sell their units. The market value discounted from the NAV is between 12 % and 77 % and the performance, for 2012 and as reported by Bloomberg, was negative for all funds (Fig. 11.11).

	Funds	Market Cap (€M)	Due date	% Market Cap	Price	Nav/share	Discount	1 month	YTD	1 year	Performance 2012
1	AEDES BPN INVESTIETICO	87,89	2015	4%	1449,00	2534,00	-42,8%	2,36	16,18	12,94	-34%
2	AMUNDI RE EUROPA	89,58	2016	4%	757,00	2116,00	-64,2%	-3,56	20,3	7,69	-27%
3	AMUNDI RE ITALIA	64,99	2016	3%	979,50	2306,00	-57,5%	-1,65	20,07	-1,65	-30%
4	BENI STABILI IMMOBILIUM 2001	39	2017	2%	1533,00	4249,00	-63,9%	1,26	15,29	-11,76	-38%
5	BENI STABILI INVEST REAL SECURITY	56,68	2013	3%	1002,00	2226,00	-55,0%	-1,66	2,34	8,88	-61%
6	BENI STABILI SECURFONDO	68,04	2014	3%	1134,00	2203,00	-48,5%	-6,51	7,34	5,74	-31%
7	BNL ESTENSE GRANDE DISTRIBUZIONE	163,94	2013	8%	1980,00	2656,00	-25,5%	4,71	27,2	14,95	-11%
8	BNL IMMOBILIARE DINAMICO	89,77	2020	4%	61,70	239,00	-74,2%	-3,79	1,67	-28,31	-26%
9	BNL PORTFOLIO IMMOBILIARE	119,25	2013	6%	977,50	1537,00	-36,4%	1,66	21,12	41,63	-45%
10	DB VALORE IMMOBILIARE GLOBALE	45,97	2014	2%	1490,00	3940,00	-62,2%	-0,27	-11,88	-6,09	-26%
11	IDEA FIMIT ATLANTIC 1	127,46	2013	6%	242,00	539,00	-55,1%	1,96	49,03	12,26	-1%
12	IDEA FIMIT ATLANTIC 2 BERENICE	99	2015	5%	165,00	360,00	-54,2%	-5,82	10,97	29,03	-46%
13	IDEA FIMIT FONDO ALPHA IMMOBILIARE	97,95	2015	5%	948,00	3701,00	-74,4%	-8,85	-10,4	-34,62	-30%
14	IDEA FIMIT FONDO BETA IMMOBILIARE	89,94	2015	4%	335,10	548,00	-38,9%	9,91	8,85	24,22	-31%
15	IDEA FIMIT FONDO DELTA IMMOBILIARE	61,71	2014	3%	29,50	97,00	-69,6%	1,63	-1,38	-1,77	-32%
16	INVESTIRE IMMOB OBELISCO	43,69	2015	2%	638,50	1914,00	-66,6%	-6,24	1,27	-2,44	-23%
17	MEDIOLANUM RE A	36,04		2%	3,40	6,00	-43,3%	13,34	7,94	-	0%
18	MEDIOLANUM RE B	202,88		10%	3,18	4,00	-20,5%	-3,61	-13,76	-	0%
19	OLINDA FONDO SHOPS	55,19	2014	3%	105,20	465,00	-77,4%	-3,78	-4,22	-33,21	-4%
20	POLIS FUND	85,33	2015	4%	661,50	2011,00	-67,1%	-1,05	9,26	-3,5	-26%
21	RISPARMIO IMMOB 1 ENERGIA	28,32	2018	1%	5900,00	6753,00	-12,6%	-10,67	-13,87	-29,17	-26%
22	TECLA - FONDO UFFICI	96,34	2014	5%	149,00	356,00	-58,1%	7,77	-4,09	-26,39	-48%
23	UNICREDITO IMMOBILIARE 1	227,04	2014	11%	1419,00	3013,00	-52,9%	-0,21	4,48	-3,37	-22%
24	VEGAGEST EUROPA IMMOBILIARE 1	45,97	2014	2%	430,10	1537,00	-72,0%	-0,27	-11,88	-6,09	-37%

Funds which asked for an extension period
Performance: Bloomberg data

Fig. 11.11 Listed REIFs, capitalisation, NAV, discount, performance

In 2012, income returns have been reduced by a constant growth of maintenance and management costs and introduction of new taxes. From the investor's point of view, there is uncertainty of the returns due to a general reduction of incomes.

REIFs are exposed to different type of risk. Property, economic, and liquidity risks are interconnected and associated with credit market conditions and financial constrains. Hence, the market downturn has affected the performance of REIFs.

Moreover, due to a flat rate transfer regime for funds liquidated before 2011, a certain number of funds have sought to dispose of their portfolio during the downturn of the property market, characterised by small number of transactions, illiquidity and scarcity of financing. During 2013–2015 circa 12 listed funds, owing approximately €2.7 BM of assets, will each reach their maturity and will liquidate a great number of properties. Central and local governments and authorities will sell their assets in the next 5 years in order to reduce the public deficit. Banks will be also disposing in the future, their real estate assets, according to their de-leveraging process. Due to this likely forthcoming over supply in the market, it is possible that the assets of the real estate funds will be re packed in other funds, with longer life, or within new funds or new vehicles.

REIFs still represent an opportunity for institutional and qualified investors, while retail funds for smaller investors are disappearing from the market. Funds could be an interesting opportunity for international investors, but the economic crisis and the uncertainty in the Italian market are not attracting those players. Furthermore, funds and SIIQs, due to the credit crunch and economic crisis, are not investing in new developments. Nevertheless, funds could still be an opportunity for public property disposal in the ownership of public administration and other public bodies.

Despite good performances showed in the first quarter of 2013, as the market is still struggling, investors are not currently seeing any future for SIIQ and for REIFS.

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Chapter 12
Developing Benelux REITs

Dirk Brounen

The REIT regime has had a good home in the Benelux, albeit at different paces and varying scales. In 1969 the Dutch government was second after the U.S. to adopt a REIT-like structure to promote real estate investments, and has successfully done so thereafter. In Belgium the REIT structure was introduced in 1995, and has since fuelled a listed real estate market that today represents a market capitalization of seven billion euro's scattered over 11 different listed firms. For the Lux part of this Benelux introduction the numbers are less compelling. Although Luxembourg has always been a good home for tax efficient investments, real Luxembourg REITs are yet to come.

In this chapter, two stories are told. First, we start with an overview of the Dutch, Belgian, and Luxembourg REIT markets, their institutional settings and evolution. Then, we discuss an issue that is common in these markets – real estate development activities. Over the years, legislators in the Dutch and Belgian markets have changed their minds on the extent to which REITs are allowed to undertake real estate development activities. In the second part of this chapter, we shed some light on this matter, by taking a financial economic point of view and analyzing the risk and return consequences of this matter.

12.1 Development of REITs: The Benelux Tale

From the outset – the signing of the London Customs Convention in 1944 – the Benelux has been positioned as a customs union to promote the free movement of workers, capital, services and goods within this region of three countries. Ever since, these three countries have moved in sync on various matters related to legal and economic affairs. At the same time, each country kept its own independence

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_12, © Springer-Verlag Berlin Heidelberg 2013

and institutional settings. Hence, the tax treatment of real estate investment has always remained a national, rather than a Benelux, concern. Moreover, the three underlying markets differed from the outset as well. The Dutch real estate market services a population of almost 17 million, and has a strong focus on the service industry, while in Belgium and especially within the Southern Wallonian part, the economy relies more on heavy industry. With only around 500,000 inhabitants Luxembourg, would qualify more as a city than a country with respect to the real estate needs and opportunities. These national variations are still at the heart of the evolution and size of the respective REIT markets.

12.1.1 The Netherlands

Today, the Dutch property share market has a market capitalization of nine billion euros, which is among the largest in Europe. This market capitalization is spread over five different publicly listed firms: Corio, Wereldhave, Eurocommercial Properties, Vastned Retail, and Nieuwe Steen Investments, all five with a focus on commercial (retail) properties. From Fig. 12.1, we can read the evolution of the Dutch listed real estate market. At first glance, the number of firms appears to have reverted to the level of 25 years ago, the start of this chart. Back in 1987, the Dutch listed real estate market consisted of four different firms, which in many cases were initiated as spinoffs of institutional property portfolios. By the end of the 1980s big Dutch pension funds and insurance companies preferred to invest their real estate allocations indirectly through liquid and publicly listed vehicles, instead of managing their own portfolio of international real estate assets. During the 1990s, this increased popularity triggered a surge in the number of Dutch REITs as more and more IPO-ed into the financial market.

In these early days, a large fraction of the Dutch REIT market size was clustered in one single firm – Rodamco. This was one of the world's largest REITs at its time, and was set up in 1979 by the Dutch asset manager Robeco, which seeked diversification in their fund supply and wanted to expand into the traditionally more stable real estate market. From the start Rodamco grew into a multinational with a portfolio that soon covered real estate markets all over the world. The 1998 Asian crisis caused significant losses, and convinced Rodamco management to split up the firm into four separate funds with a regional focus. This corporate evolution is still visible in the line graph in Fig. 12.1, as the number of firms increased due to this corporate split. Since the turn of the millennium, consolidation was key in the Dutch REIT market, as the number of firms decreased while market cap continued to build up. By 2007 Rodamco Europe, the last remaining fraction of the old Rodamco empire was acquired by Unibail, which reduced both the figures and numbers in the graph significantly.

Over these past 25 years, the average market cap of a Dutch REIT fourfolded from half to almost two billion euro's a firm. This number closely resembles the overall European average (1.8 billion euros in 2013) and still lags the global

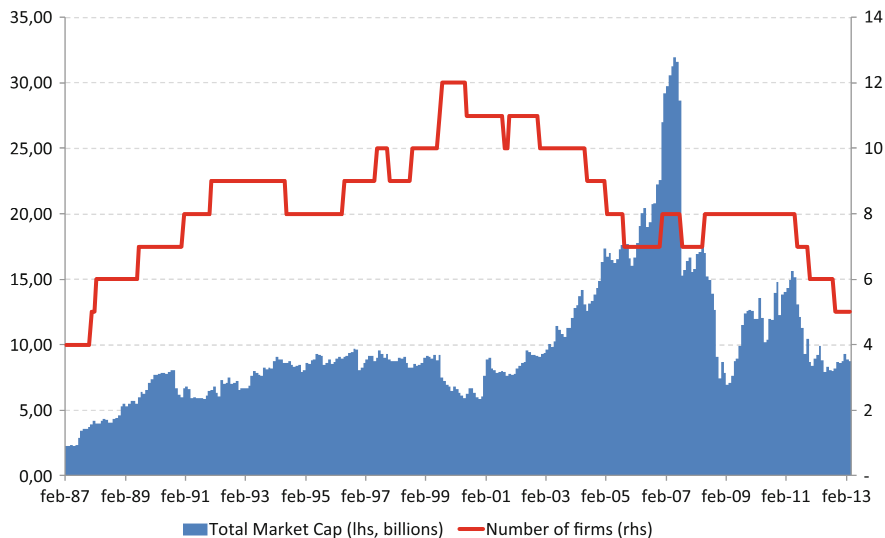

Fig. 12.1 Dutch REIT market development (market caps vs. number of firms)

average of 2.7 billion euros, today. In the Netherlands, property companies with shares traded on the stock exchange are termed NV (a company with a normal residence), a structure that is similar to that of the UK plc. The crucial difference between property companies versus other types of companies is in how they are taxed. Dutch property companies are structured as tax transparent investment vehicles known as “fiscal erkende beleggingsinstellingen (FBI)”. This status provides exemptions from corporate taxes. In order to qualify for this corporate tax-exempt status the company has to comply with certain conditions, the most important being the obligation that the company pays out 95 % of its profits in dividends. In contrast, other Dutch companies are taxed at a rate of 35 % with interest expenses being deductible. Property appears on the balance sheet of Dutch REITs at original cost minus depreciation. If the actual market value lies below this, market value of the property may be stated. Whenever properties are sold, the company is required to pay corporate taxes on any capital gains. However, if a REIT replaces the sold object with the purchase of another property within 4 years time, tax on the capital gains may be avoided. Capital gains made on investments in property shares are not subject to taxation (Fig. 12.2).

Over the past 25 years an investment in the Dutch REIT market yielded an annual average return of 5.5 % at standard deviation (risk) of 15.3 %, this compares rather weak with the global and European REIT equivalents with a returns/risks of 6.8 %/15.5 % and 5.8 %/9.7 %, respectively. This rather high risk profile of Dutch REITs shows clearly since the 2008 crisis, when Dutch REIT prices fell hardest, but also bounced back first. This profile is likely related to the focus on commercial (retail) property among these Dutch REITs, whereas their global peers have also exposure to the more stable residential markets.

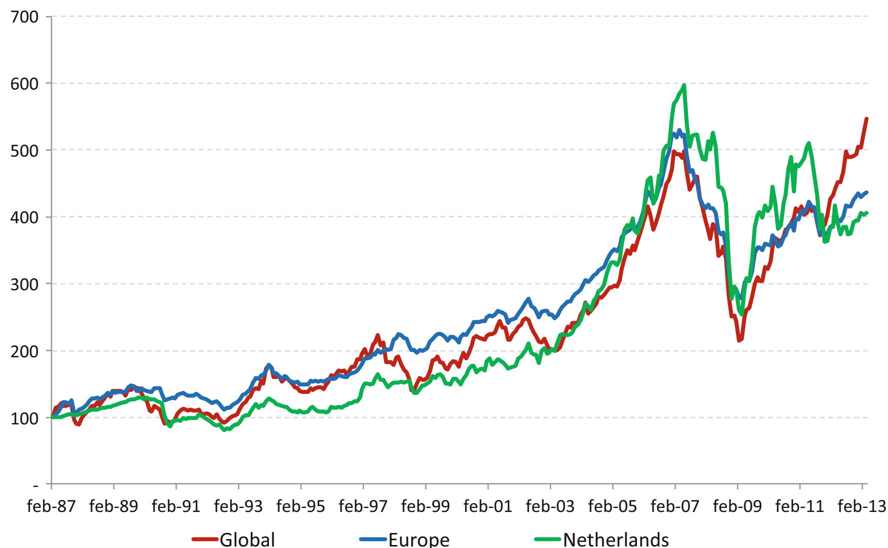

Fig. 12.2 Total return indices of the Global, European and Dutch REITs

12.1.2 Belgium

The current Belgian REIT market consists of no less than 11 different companies, which collectively offer investors a sum market capitalization of seven billion euros. So, the Belgian REITs are more numerous than the Dutch, but at the same time also a lot smaller in size. One reason for this is that Belgian REITs are typically more focused on their home market, whereas Dutch REITs often take a more pan-European perspective and invest in shopping centers across Europe. From the outset, Belgian REITs have been more focused on investments in the Brussels office market, and only gradually moved into other sectors. A good example of this is Cofinimmo, Belgium's largest REIT, which started as a pure office fund, and has made a portfolio shift towards healthcare real estate in recent years. After 2007 this portfolio was extended outside the Belgian borders.

Figure 12.3 depicts the development of the Belgian REIT market, both in numbers and in size. For a long while the Belgian REIT market consisted of one or two firms. In 1995 the Belgian government introduced the company structure 'Societe d'Investissement a Capital Fixe Immobiliere' (SICAFI) to stimulate property share investments. The structure can be compared to that of the American REIT. Property companies have to comply with certain regulations to qualify for a SICAFI. Activity of the company is limited to investment in real estate, with no more than 20 % of total assets invested in one building. Investments are carried at market value, which means there is no depreciation. An independent expert has to value the properties every 3 months and this information must be made available to the shareholders. The net-current result of the company is tax exempt, subject to a

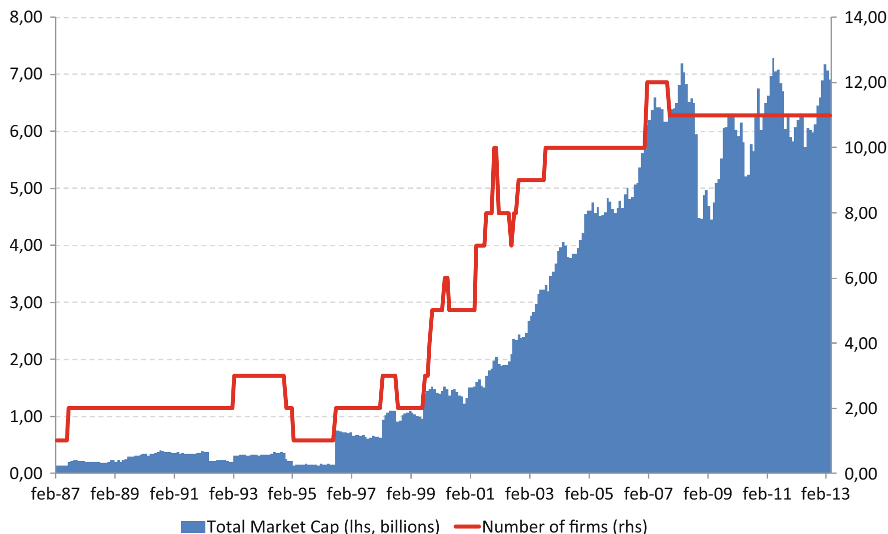

Fig. 12.3 Belgian REIT market development (market caps vs. number of firms)

compulsory dividend distribution of at least 80 %. Borrowing is limited to a maximum of 33 % of total assets and there is withholding tax of 15 % on dividends.

Because of tax regulations, in particular pertaining to the status of a SICAFI (listed property company with fixed share capital), many of the smaller listed property companies in Belgium are only listed for tax reasons. SICAFI's benefit from significant tax advantages, most importantly because a SICAFIcan avoid corporate taxation. Criteria to be granted to the status of a SICAFI are rather easy to meet. The company has to publicly offer 30 % of the shares and the property portfolio must exceed a value of more than 1.25 million euros. Because only a small portion of their market capitalization is floated, liquidity in these companies is very poor. Current legislation prevents the Belgian market from consolidating, becoming more liquid, and achieving overall growth. Until this changes, activity will have to come from new companies or expansion from the larger existing companies (Fig. 12.4).

When it comes to stock performance, Belgian REITs have done remarkably well, both in the long run and in recent turbulent years. Over the past 26 years, Belgian REITs have yielded an annual average total return of 7.2 % at a standard deviation (risk) of 13.6 %. This return risk ratio is strong compared to the return/risk of the Global and European REIT markets over that period (6.8 %/15.5 % Global, and 5.8 %/9.7 % Europe). Also in the past 5 years, after the credit crisis, Belgian REIT held up well by delivering an annual return of 3.3 %, compared to 1.1 % in Europe.

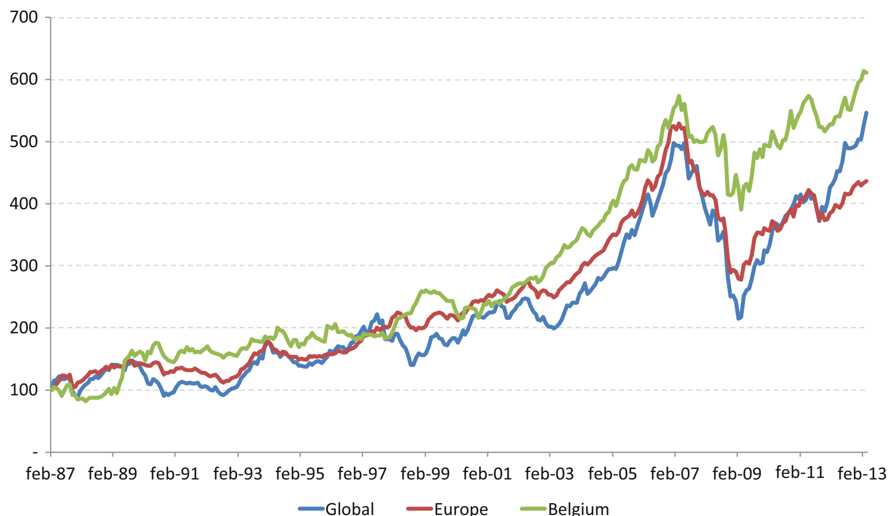

Fig. 12.4 Total return indices of the Global, European and Belgian REIT markets

12.2 Development Within REITs: To Build or Not to Build

The legal framework encompassing United States Real Estate Investment Trusts (REITs) strongly limits the amount of real estate development these companies can participate in. Internationally, however, such limitations are rare, and many property investment companies outside of the United States are involved in property development, either for their own portfolios or for third parties. However, it is not clear whether property development and property investment should be undertaken under the same roof, and real estate professionals do not agree on this matter. Yet, policymakers are keen on designing regulations that direct these development activities away from REITs. Especially within the Benelux REITs, this debate has been very lively over the past decade, with rules and opinions changing over time.

For an investor, it may make sense to start development activities since these grant them access to the most attractive investment opportunities and locations. According to this argument, investors are always last in line when projects come on the market, and adding development activities allows them to advance in that line. For emerging markets, this argument may hold even more than for mature property markets, since the stock of existing properties is relatively small in those markets, and the only way to invest at all is by developing for one's own portfolio.

For a property developer, keeping projects in one's own investment portfolio can be justified by arguing that this can decrease the dependency on the capital market. By combining property investment and development activities within one entity, firm management can use the steady stream of income from an investment portfolio

to finance profitable development projects, even in times when capital markets are not interested in real estate projects.

However, there are also strong arguments against the combination of property investment and development in one company. First, the management expertise necessary for property investment is different from what is needed for property development. Managing both disciplines within one firm may decrease corporate efficiency, causing spills and thereby diminishing firm value. Studies by Capozza and Seguin (1999) and Eichholtz, Op ‘t Veld and Schweitzer (2000) offer evidence that indicates that corporate diversification causes informational asymmetries, which decrease both firm value and stock performance in the United States REIT market. According to both studies firm management should focus its corporate resources on one sector or discipline, enhancing firm value by yielding specialists advantages.

Also, analysts and property share investors generally seem to like focused companies because of their transparency, which may be lost by combining different activities like property investment and development. Development is a very cyclical business and property development companies are associated with relatively high systematic risk, as we will subsequently show. Property investment companies’ shares, on the other hand, are regarded as defensive, with a low systematic risk. Combining the two activities provides the investor with an unclear profile, which may be undesirable.

Despite the relevance for property companies and their investors, the relationship between property development activities and firm performance has not been investigated very deeply. Brounen, Eichholtz and Kanters (1999) have looked into this issue, but only for United States REITs. As we already noted, the extent to which REITs develop their own properties is quite limited. Since the cross-sectional variation in the degree of property development undertaken by listed property companies in most countries is far greater than it is in the United States, we hope to generate new insights by investigating this issue internationally. Besides broadening the sample internationally we also extend the sample period to one full real estate cycle and analyze these samples using more sophisticated methodology.

12.3 Conclusions

The Benelux REIT market has developed swiftly in the past three decades. The Dutch REITs have been around for a long while and have consolidated and matured in vehicles with a market cap of around two billion euro’s. The Belgian REITs are more numerous, but also small in size. Here the maturation process is still progressing, as liquidity is hampered by the REIT structure and market capitalizations. In Luxembourg the tax facilities are ready, but real Luxembourg REITs still need to be developed. In all three markets, legislators have been regulating the extent to which REITs are allowed to engage in real estate development activities.

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Chapter 13
Spanish REITs: The New Regulated SOCIMIs

Paloma Taltavull de La Paz and Irene Peña Cuenca

13.1 Introduction

The financial crisis has resulted in a strong decline of capital flows allocated to the real estate sector. During this period, direct investment moved to other economic activities and, at the same time, mortgage-backed securities lacked demand in capital markets resulting in a sharp decrease of their prices and yields. Within this crisis environment, international REITs have maintained acceptable rates of return and have not suffered a negative shock to the same extent as other real estate funds and securities assets. Real estate financing in Spain follows the traditional structure based on the issuing of mortgage-backed securities and assets (see McGreal and Sotelo 2008). Real estate funds, initially introduced in 1992, were rigidly regulated and had no appreciable tax benefits.

13.2 The History of REITs in Spain

Spanish REITs, as specialized investment vehicles for the real estate sector, were introduced under the name of SOCIMIs (*Sociedades Anónimas Cotizadas de Inversión en el Mercado Inmobiliario*) with the 11/2009 Act of 26 October. This legislation effectively reproduced the international REIT scheme in Spain with a number of restrictions. This was further modified in 2012 (16/2012 Act of 27 December) when SOCIMIs became more attractive from the investment point

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_13, © Springer-Verlag Berlin Heidelberg 2013

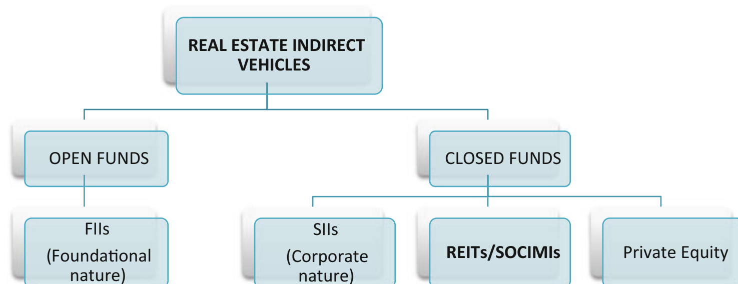

Fig. 13.1 Structure of real estate investment vehicles in Spain (Peña Cuenca 2012, p. 17)

of view because of their great flexibility and fiscal advantages. They constitute a completely new vehicle in Spain entering the marketplace in the early 2013.

International studies have traditionally confused two Spanish real estate indirect vehicles as REITs namely: Real Estate Investment Funds (FIIs) and Real Estate Investment Trusts (SIIs). Both of these form part of the Collective Investment Trust (IIC) created in 1992 and also includes stock investment funds. The characteristics of the two instruments resemble REITs with some restrictions similar to other European finance instruments such as open-ended or closed-ended German funds.

Indirect investment assets could be classified according to their institutional structure (Fig. 13.1). This suggests that a balanced scheme of property funds and trusts exists in Spain combining the previous 1992-regulated corporations (FIIs and SIIs) and the SOCIMIs at the beginning of 2013.

Both SIIs and FIIs were created as indirect vehicles by the 19/1992 Act of 7 July, together with mortgage security funds, seeking to achieve diversification in order to increase capital flows to real estate. The 1992 Act came into being at the start a period of recession (1992–1995) following a real estate and housing market boom and a rise in mortgage activity. The aim was to bring new types of finance that could both diversify the finance structure and provide alternative forms to finance the rental housing market. In this respect, the creation of mortgage security funds introduced a means of diversification for financial institutions and FIIs focused on defining a financial solution for a weak rental market. The Spanish housing market has a traditionally large homeownership rate and consequently a relatively small rental market[1] however difficulties in affording a house for medium-income households since 1989 has provided a stronger focus on the rental market and the possible financing vehicles that could play a major role in the process. Hence, both FIIs and SIIs were restricted to obtain generous tax benefits only if they invested their main resources in housing managed on a rental basis.

The restrictive regulation limited the success of real estate indirect vehicles to some extent and their regulations had to be successively modified during the

[1] The homeownership rate was 89 % according to the 1991 census – the housing rental market consequently being only 11 %.

following two decades. The first adjustment came with the 20/1998 Act of 1 July which introduced a broader perspective of real estate funds along with the assignment of rights. This was followed by the 35/2003 Act of 4 November, which includes the full regulation of Investment Trusts and, lastly, by the Ministerial Command Order EHA/3064/2008 that introduced specific flexibilities for FIIs and SIIs.[2] The specific regulation of Collective Investment Trusts were adapted to EU directives by the 31/211 Act of 4 October, which allowed real estate corporations to undertake financial operations in international markets together with the possibility to participate in other foreign funds. Nevertheless, the legal regime still maintains the obligation to obtain permission from the Supervisory Authority in those cases when a Spanish fund is linked to 'extra-Community' funds.

Real Estate Investment Funds (FIIs) are similar to German Open-Ended Funds under the supervision of the Spanish Stock Exchange Regulation Authority (CNMV[3]). The main goal is to create corporations that can develop the housing rental market through the funds of medium- or small-sized investors. They have an open structure with variable (not limited) capital and free in-out contribution movements whereby participants can disinvest at any time. The advantages regarding fiscal treatment are considerable with a corporate tax of 1 % on returns and a rebate of 95 % of the house transaction tax. The only means to increase capital is through the contributions made by stakeholders, which are regarded as first investments and not quoted in any financial market. An FII has the mandatory requirement to invest 70–90 % of the total equity in real estate in the rental market (including real estate rights, options and participation in developments). The minimum initial capital is nine million ($9 * 10^6$) euros with 100 stakeholders. Leverage restrictions determine a limit of 50 % on total funds; they must have a minimum of 4 real estate projects inside the Fund with none of them being worth more than 35 % of the total assets. An FII has to maintain real estate projects for a minimum period of 3 years managed on a rental basis or 7 years in the case of self-developments.

Real Estate Investment Trusts (SII) are corporations where the Board of Directors is responsible for management and can be defined as a closed-ended structure with a maximum number of shares issued. Shareholders can participate by purchasing the shares when they are issued or directly from the capital market. SIIs could be quoted but it is not mandatory. Their goals are quite similar to that of FIIs, the main difference being that the minimum investment is larger with the possibility of allocating only 10 % to a broad investment portfolio (30 % for FII). With regard to fiscal benefits, a SII closely resembles a FII, with a corporate tax rate of 1 % on

[2] These are the full names of the two Acts and the Ministerial Order mentioned above in Spanish: 'Ley 20/1998 de 1 de julio de Reforma del Régimen Jurídico y Fiscal de las Instituciones de Inversión Colectiva de naturaleza Inmobiliaria y sobre Cesión de Determinados Derechos de Crédito de la Administración General del Estado'; 'Ley 35/2003 del 4 de noviembre que regula las Instituciones de Inversión colectiva (IIC)' and 'Orden EHA/3064/2008 de 28 de octubre que desarrolla aspectos relativos a los fondos y sociedades de inversión inmobiliaria.'

[3] The Spanish initials CNMV stand for 'Comisión Nacional del Mercado de Valores.'

returns and a tax rebate of 95 % in transactions tax (only for housing). Also there is tax exemption when companies (REITs) are set up through change or undertake mergers.

The literature recognizes the SII corporate structure as being the Spanish REITs (Eichholtz and Kok 2007; Just and Feil 2007; Schacht and Wimschulte 2008). Furthermore, the regulation of SOCIMIs established a legal possibility for SIIs to become SOCIMIs through a simple legal formality. The similarity between these two vehicles is the basis of their consideration in this chapter.

Since the 1992 Act at least 50 % of the investment in any of the two funds (SII and FII) has had to be devoted to houses for rent. Such a restriction (which also appears in the 2009 version of SOCIMIs) confirms the policy relevance of combining a financing structure and rental market with the ultimate aim of boosting the development of companies specializing in the housing market. However, the minimum investment requirement in housing (50 % of the total assets) simultaneously prevents FIIs and SIIs from investing a sufficient amount in the commercial real estate segments with higher yields and a more highly developed management. This reduces total corporate returns and also attractiveness of the funds from an investment perspective and largely explains the unsuccessful performance of these vehicles (Peña Cuenca 2012).

SOCIMIs were created in the aftermath of the 2008 financial shock within a framework characterized by a widespread absence of capital flows and the serious liquidity problems experienced by the most relevant real estate companies. The first SOCIMIs were created taking the SII formula as their reference, with new tax incentives strongly focused on channeling funds toward the rental house market, before the state of collapse in the housing market, instead of serving as a vehicle for diversification. The serious liquidity problems experienced between 2008 and 2012 resulted in a large number of bankruptcy processes amongst real estate companies, a situation that was not significantly modified by the appearance of SOCIMIs.

In common with other companies, FIIs suffered liquidity constraints caused by the financial crisis. Such funds offered their stakeholders the possibility to ask for redemption through a quasi-automatic mechanism where the manager must give the funds back within a 2-month period. As the crisis worsened, most stakeholders asked to redeem their contributions and numerous FIIs closed down, while others became single-stakeholder funds. SIIs experienced similar tensions with shareholders massively selling their shares. The existence of legal restrictions on investment, along with the continuity of credit constraints in the market and the low attractiveness for investors led to regulatory change in 2012 which put SOCIMIs on a level with international REITs. The new SOCIMIS fulfill the basic conditions of transparency and fiscal attractiveness that the literature dedicated to REITs identifies as the key features of these investment vehicles.

The Spanish real estate sector has traditionally obtained its financing from banking institutions highly specialized in real estate loans and through the mortgage market (assets and credits), with a regulation adapted to reduce financial risk in real estate operations. Since the 1960s, saving banks have issued the vast majority of mortgages due to their high degree of specialization in development and

homeownership loans. This was an anticipation of the modern mortgage market. Flexibility in mortgage regulation together with the slow development of the capital markets gave the banking system the opportunity to meet most of the real estate demand and generalize 'recourse-to-credit' as the primary way to develop building and property projects.

Financial institutions have historically channelled financing to property markets and obtained funds from the primary capital market through the issue of Mortgage Backed Bonds (MBB). MBBs were the only asset allowed to issue until 1992, at which point the Mortgage-Backed Securities (MBSs) and indirect vehicles (FIIs and SIIs) were created. Developers also resorted to the credit system in seeking to finance building processes and commercial property companies used a combination of their own equity and mortgage loans to finance such projects.

Figure 13.2 shows the relevance of MBBs until the 1990s as well as the diversification of both MBBs and MBSs during the first years of the twenty-first century.[4] Approximately 30 % of the outstanding mortgage credits were financed through MBBs at the beginning of this period. New finance assets started to appear in the late 1990s, but direct finance vehicles (MBBs and MBSs) still maintained their dominance providing real estate with direct access to capital markets, using property as collateral. Figure 13.2 also reflects the size of indirect vehicles, which represent a very small portion of the total compared to the other two components.

Another reason for the prevalence of credit as a real estate financing instrument (and the lower relevance of indirect finance vehicles for the property market) is the Spanish real estate ownership structure. Eichholtz and Kok (2007) highlight ownership structure as one of the reasons behind the limited significance of REITs in Europe, as opposed to the US. In the specific case of Spain, a consequence of the high ownership rate in the housing market is the absence of large companies that could manage the housing market on a rental basis. Similarly, in commercial real estate this is a high ownership level in both the industrial and retail sectors. However, offices, malls, shopping centers and warehouses have a developed rental market that is concentrated in the provinces of Madrid, Barcelona, Valencia, Zaragoza and Seville (Taltavull and Pablo 2013). For these reasons there are relatively few opportunities for real estate diversification through REITs in Spain.

Finally, there is a lack of specialized firms in commercial real estate management.[5] The fragmented nature of real estate professionals and the restrictive regulation formulae applied until the mid-1990s explains the poor development of this market. Real estate management companies started to emerge in Spain as the real estate markets expanded during the 1990s, a period in which the financing system was performing well and market liquidity was good with little incentive to encourage the use REITs.

[4] Both series are represented as a weighting of the total outstanding mortgage credits.

[5] Property management in Spain has traditionally been a regulated economic activity performed by individual professionals. Only those larger companies which own properties have created rental-management institutions in this market.

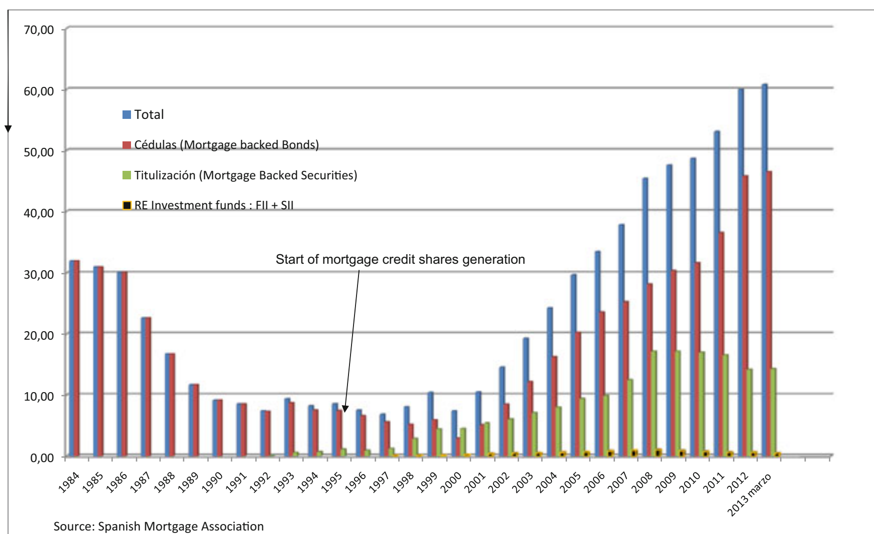

Fig. 13.2 Mortgage finance by instruments: direct and indirect 1984–2013 (In % of total outstanding mortgage credit)

13.3 Regulation Applied to SOCIMIs: Spanish REITs

SOCIMIs are defined as corporations which have as their social goal to acquire and own property in the following categories:

1. Urban properties rented or to rent, which could be self-developed or refurbished; the regulation additionally includes any legal registered rights associated with urban land or buildings owned by the SOCIMI. The society could also own land providing that it is dedicated to develop buildings for rental purposes. There is no specification of a minimum investment level in any property types.
2. SOCIMIs could acquire interest in other societies if they are: (a) other Spanish or international REITs[6] with similar goals and activities; (b) any other Spanish or international corporations that have as their main social goal to purchase urban properties for rent and subject to the same fiscal and pay-out regimes; or (c) own shares of FIIs or other investment trusts. SOCIMIs are also allowed to carry out other activities as long as their income does not exceed 20 % of the total society income.

Therefore, Spanish SOCIMIs could be categorized as an Equity-REIT type as regulation allows them to own properties for rental, sale or purchase purposes. However, they are not allowed to buy mortgage credits. They could develop buildings directly without limits, on condition that they are managed on a rental

[6] The Act admits owning foreign company assets unless they are based in tax havens.

basis, as this would provide an additional source of returns. The transparency and flexibility levels found in SOCIMIs arguably are similar to those shown by most international REITs (Adasmucin 2010).

Following the 36/2012 Act, the design of SOCIMIs was defined through the basic requirements, restrictions and fiscal conditions described below.

1. The minimum capital stock required is five million euros (instead of the 15 million euros laid down in the 11/2009 Act) and shareholders can give in-kind contributions (in the form of properties) to the society. A SOCIMI can own at least one property on a rental basis (a minimum of three has been stipulated in the 11/2009 Act), which means that there are no diversification requirements. These two conditions facilitate the creation of SOCIMIs focused on large real estate projects and those facilitating the participation of small investors, thus favoring the development of the rental housing market.
2. SOCIMIs are authorized to issue one type of share: nominative ones. The word 'SOCIMI' must appear after the Society's registered name in those cases where SOCIMIs are granted by this special fiscal regime.
3. The requirements for investments are: (1) have at least 80 % of the total equity in real estate, land for development or shares from other SOCIMI's societies; (2) at least 80 % of the income has to be obtained from own property rentals plus other REITs' dividends or yields – the income resulting from transactions is excluded from this rule; and (3) properties must remain within the Society's patrimony for at least 3 years or 7 years in the case of self-developments.
4. No leverage restrictions exist: SOCIMIs could obtain external financing for property purchases with no limits (11/2009 Act limited to 70 % of the leverage).

SOCIMIs must observe the following non-tax restrictions:

1. SOCIMIs' shares must be quoted on a regulated continuous or alternative (Spanish or European) Stock Exchange market throughout the tax period. In the case of Spain, the MAB (Alternative Stock Market) acts as a multi-lateral trading system for SOCIMIs with regulation approved by the circular MAB, 2-2013.[7] The mandatory listing for shares means more transparency for SOCIMIs. Such transparency is possible thanks to the public information requested by MAB when the Society enters the market in relation to aspects such as capital structure, ways to market contracts, performing or special conditions which have to be online on the market website as well as public registers. MAB also demands official information about shareholders owning more than 5 % of the SOCIMI's capital and makes public any agreements affecting votes or basic shareholder rights as well as changes in the Society's ownership.[8]

[7] Circular MAB 2-2013 on the Legal Regime for SOCIMIs. See Corrales and Palacín (2012).

[8] See http://www.bolsasymercados.es/mab/

2. It is compulsory to pay out dividends to shareholders within a maximum of 6 months after the end of the fiscal budgetary period. Dividend distribution depends on the source of income. The Society must pay out at least 80 % of the income coming from property rent and 50 % of the returns obtained from property transactions and 100 % of benefits received from other societies in which the SOCIMI participates. Spanish regulation allows SOCIMIs to dedicate 20 % and 50 % (at the most) of non-distributed benefits to investment plans. The resulting amounts have to be re-invested in similar properties or shares with the same business goal and within the following 3 years, thus allowing flexibility to guarantee future investment processes.
3. SOCIMIs cannot transact properties before 3 years from the date on which they were acquired and before 7 years in the case of self-developments.
4. In the event of failure to comply with these requirements, the Society could lose its Fiscal Special Regime (FSR) status.

FSR benefits are exclusively implemented when the Society formally requests its admission into the Special Regime as long as there is fulfillment of both the permanency requirements and those cited above. The fiscal features are described below.

1. FSR has a 0 % corporate tax. SOCIMIs also have a 95 % allowance on transaction taxes (IT, Spanish initials) and Documented Legal Acts (AJD, Spanish initials) related to housing and land (to develop) operations. There is also tax exemption for Society Operations modality.
2. In the case of EU residents, FSR implies that dividends are exempted from paying personal income tax, although a limit should be applied on the income coming either from capital or from property transactions. As for corporations, there is 21 % tax paid on the dividends received when integrated into the earning base (the percentage stipulated in the 11/2009 Act was 30 %). Individuals are not subject to a withholding tax under any circumstances. In the case of non-EU residents, natural persons are exempted from tax payment when they are not established in a tax haven. Corporations are subject to a 21 % withholding tax with the exception of holdings – subsidiary companies which are exempted from tax payment (for instance, when international societies manage hotels or shopping centers).

Should any of the above requirements not be fulfilled, the Tax General Regime will be applied and corporations will not be able to avoid double taxation on their rental income. In short, the above requirements consider SOCIMIs as a flexible investment vehicle for real estate projects and additionally permit the participation of smaller investors attracted by (1) the compulsory pay-out of dividends which gives a stable flow of returns; (2) tax benefits at two levels (corporation and shareholder); (3) holding liquid shares due to the mandatory listing and quoting on the MAB (MAB 2013) –a more flexible regulated market, and (4) the share and corporate transparency guaranteed by the requirements associated with being a quoted company.

Table 13.1 The features of Spanish REITs – SOCIMIs. General structure

Characteristic	Classification	Motivation
Type	Equity REIT	Yes, to expand the housing rent market
	Social purposes?	
Diversification	YES	All types of real estate allowed
		One single RE asset allowed
Transparency	Quoted RE society	Yes
	Regulated market	Spanish MAB (Alternative Stock Exchange Market)
	Information requirements	Yes, published by the regulating authority, website and official register
Taxation (special regime)	Double taxation	No
	Corporate tax	No
	Personal income tax	No
	Transaction cost (real estate)	Tax reduction or tax exempt
	Withholding tax	No, for residents or non-resident individuals
		Yes, for non-resident corporate or tax-haven residents
Operational restrictions	Financial management	Yes, regulator's requests
	Development	Yes, no limit
	Operating costs	No information
Leverage restrictions	No	Indebtedness is allowed

Following Eichholtz and Kok (2007), Table 13.1 summarizes and classifies the characteristics of SOCIMIs.

13.4 The Market Volume in Comparison with Other Financial Vehicles

Spanish REITs and real estate investment societies have acquired relatively little significance. Only one SOCIMI corporation has been registered in Spain after the legal reform introduced in 2012 reform, and regulation is still being developed. The recent (2013) approval of MAB rules (MAB 2-2013 bylaw) means that SOCIMI shares still are not being quoted. Previous real estate funds or societies had only partial success with a maximum of 10 FIIs and 13 SIIs registered throughout the period since 1992, although the value of their capital grew considerably due to the expansion of the real estate sector in Spain during the first decade of the twenty-first century.

The scale of Spanish real estate investment institutions can be evaluated with regard to two indicators. The first is the total asset (patrimony) held by the societies and corporations belonging to the category '*Otros intermediarios financieros*'

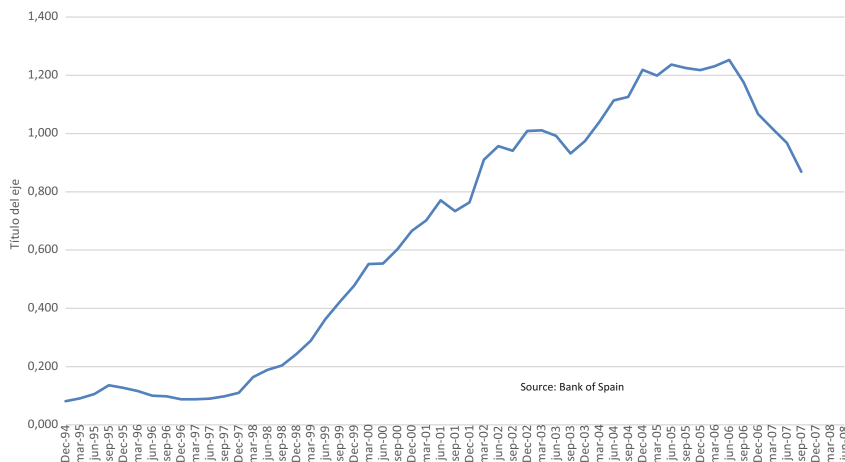

Fig. 13.3 Trends in Spanish real estate investment funds (% of total assets in 'Otros intermediarios financieros' – total investment funds)

[other financial intermediaries][9] such analysis helps assess the capacity of real estate instruments to attract funds from the capital market. The second indicator is the total real estate assets issued by the banking (deposit) institutions to finance their mortgage operations. Total outstanding mortgage backed bonds and securities are used to compare FIIs and SIIs to assess the finance coming from the real estate and construction sectors.

The first ratio is calculated through a comparison between FII patrimony[10] and the total assets accounted for in '*otros intermediarios financieros*' (Fig. 13.3). FII patrimony reached a maximum of 1.2 % of the total indirect investment assets with a sharp growth since 1998 but this figure had started to decline after 2006 and before the start of the financial crisis.

In Table 13.2 two groups of indicators are presented. The first part of the table offers three relative ratios measuring the FII + SII total assets weighted against other variables, thus supporting the perception of relative relevance. The second part of the table shows the features of real estate indirect vehicles. The first column provides the ratio between (FII + CII) patrimony divided by the total outstanding mortgage backed bonds and securities. The values obtained show that real estate vehicles reached between 2.47 % and 4.39 % of total backed outstanding mortgages

[9] This section provides the regular classification for all non-debt funds in financial statistics, including real estate investment funds and trusts. It also includes Investment Trusts the patrimony of which represents ca. 85 % of the total section throughout the period. See Bank of Spain, www.bde.es.

[10] FIIs are used because to the longer time series that they provide. SIIs are not added to avoid interpretation biases.

Table 13.2 Spanish real estate funds. Relevance and characteristics

	Spanish RE FUNDS' Patrimony (FII + SII) weight related to:			FII			SII		
	Mortgage backed bonds + mortgage backed securities	Outstanding credit to Spanish private sector	Outstanding mortgage credits	Number of FIIs (max. in the period)	Number of stake-holders	Total asset values (million euros)	Number of SIIs (max. in the period)	Number of share-holders	Total asset values (million euros)
Average by period	(in %)	(in %)	(in %)			€			€
1995–1999	1.94	0.08	0.27	5	7,137	274.192			
2000–2004	4.39	0.34	1.04	7	50,439	2,181.977	2	94	30.213
2005–2008	2.47	0.55	1.66	10	130,957	7,643.465	9	604	340.908
2009–2011	1.14	0.28	0.59	9	66,081	6,032.977	9	938	436.848
Pro-memory: Dec. 2011	0.9	0.31	0.44	6	29,735	4,494.560	8	944	312.510

Source: CNMV

in the market throughout the period before the crisis. This declines to 1.14 % after 2008 highlighting the redeeming process in FII contributions since 2009 provided by the simultaneous reduction in mortgage backed securities generation due to decreasing demand in capital markets. The fall in indirect instruments was larger than in those capital markets.

In turn, the second column represents the same numerator divided by the total outstanding credit to the private sector. This analysis shows that real estate indirect funds are equivalent to a maximum of 0.55 % of the total credit during the boom period. The third column reflects the same ratio but in relation to mortgage credits, showing that between 1 % and 1.6 % of the total credits having real estate as collateral. All the comparison ratios are consistent and confirm that the role played by real estate indirect instruments in Spanish real estate financing was less important than expected throughout the period compared to the relevance of other direct financing figures. The columns on the right of Table 13.2 show the characteristics of FIIs and SIIs including the number of societies, the number of stake-shareholders and total asset values. It could be argued that both typologies show a small number of societies registered during 15 years, 13 in the case of FIIs (10 active being highest number within any given period) and 9 SIIs. Total FII asset value is larger than that of SIIs; around 22 times during the period 2005–2008. SII assets represent between 4 % and 7 % of the total FII assets suggesting that real estate funds are more popular among Spanish investors. The latter are investment vehicles which attract small savers and have a large number of stakeholders (more than 130,000 on average during the boom period) while SIIs characteristically have a low number of shareholders.

In December 2011, before the enactment of the new SOCIMI regulation, the number of corporations was still falling, down to six FIIs and eight SIIs. The RE corporations operating in the market at the beginning of 2013 are listed in Table 13.3 (Annex).

There is no published information about the returns and cap rates obtained by Spanish real estate funds and trusts on a historical basis. The weighted yield by total assets in FIIs is only available from the Stock Exchange Regulation Authority (CNMV). However, the data offered in Fig. 13.4 show that a positive yield of about 5.5 % remained stable during the period until the crisis. A sharp reduction occurred in 2007 and stayed low reaching negative values in 2009. By December 2011, the negative yield reached −0.93 %, converging to zero after the positive results obtained from one of the funds (Sabadell BS Inmobiliario).

13.5 The Performance of REITs

Both FIIs and SIIs have experienced a strong increase since 1999, when a new flexible regulation concerning real estate funds came into force and SIIs started to develop. Figure 13.5 shows the evolution of FIIs since 1995. The indicators rise sharply throughout the decade until the end of 2007. Since 2008, all variables have

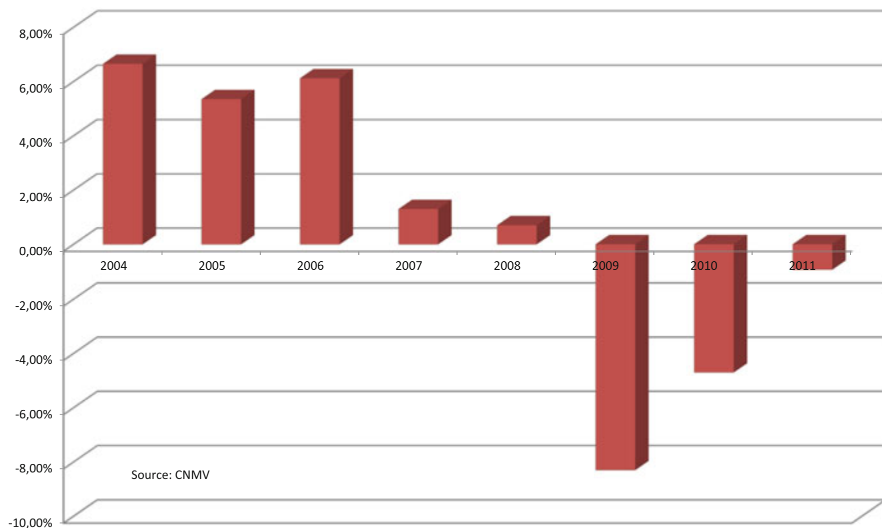

Fig. 13.4 Yield by total assets in Spanish real estate funds (FIIs) (%)

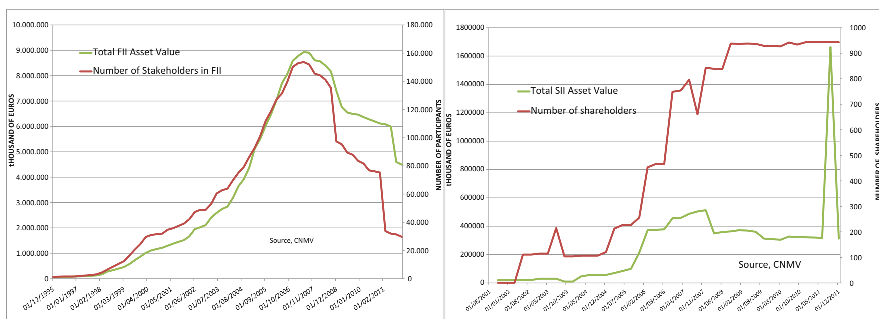

Fig. 13.5 Comparative analysis of Spanish real estate investment funds and real estate investment companies 1995–2011

declined significantly with appreciable loss to their participants. For instance, total FII capitalization lost around 60 % of the total assets (Fig. 13.5).

With regard to Real Estate Investment Trusts, their main indicators show an upward evolution during the period 2004–2007. However, they remained stable after the financial shock until 2011, which seems to suggest that the corporate structure allows the retention of investment positions during a great depression. This is a positive reaction in relation to the future conversion of SIIs into SOCIMIs.

13.6 Lessons for REITs Within a Financial Distress Context

In common with other Spanish investment institutions, the contraction of financial flows through capital markets has stressed liquidity needs for FIIs and SIIs arising from the lack of financing, decreasing yields and increasing requests for redemption payments in FIIs and share sales in SIIs. In 2009, a number of FII funds formally asked the CNMV for a temporary 2-year deferment for redemption payments in 2009 and was reflected in the effective fall in the value of assets in 2011. The crisis led to some funds becoming one-stakeholder societies[11] and promoted the transformation of several FIIs into SIIs.

The financial crisis seems to have had a stronger impact on FII structure, while SIIs remained stable until the end of the period (Fig. 13.6). This suggests that the structure of FIIs is weaker than that of real estate trusts when facing an adverse external shock. The stability of SIIs implies that trust structure could provide a more stable pattern to guarantee permanent financing for real estate unlike open-ended funds (FIIs), the structure of which favours volatility in contributions, thus increasing risk levels within the market. In this sense, the evolution of SIIs supports the idea that SOCIMIs could represent an appropriate vehicle for channeling financial funds into the real estate market.

13.7 Future Challenges for the Market or the Regulation

SOCIMIs were launched with the aim of bringing investment flows back to real estate and have appeal to investors arising from their tax incentives particularly during a period of major crisis for real estate financing in Spain (Orti Vallejo 2009). SOCIMIs actually represent a major challenge in the context of the serious crisis experienced by the Spanish economy, the lack of liquidity which limits credit flows to economic activities, the low activity rate in the construction sector, and commercial real estate showing the effects of the fall in the demand. However, some real estate activities are providing better results with yields between real estate indirect returns, based on rents and financial returns being such as to attract more conservative investment.

The lack of success of real estate vehicles cannot necessarily be extrapolated to the future of SOCIMIs for two main reasons. Firstly, the weaker development of the financial market throughout the period under study contrasts with the previous

[11] Santander Banif Inmobiliario reimbursed up to 93 % of the total patrimony; BBVA Propiedad is put into liquidation, as two examples of this process.

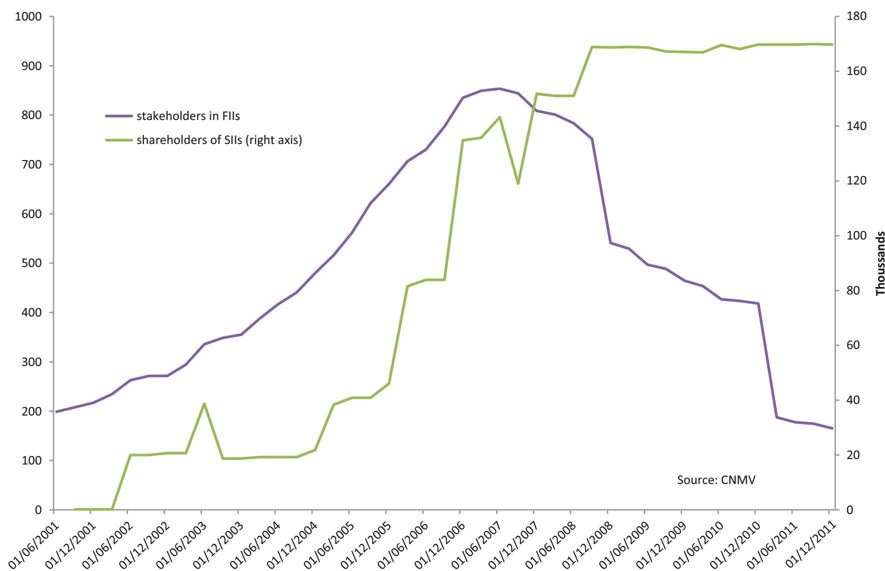

Fig. 13.6 Stakeholders and shareholders in Spanish real estate investment funds (Total number by year). Source: CNMV

strong credit system and excessive liquidity. Direct vehicles were preferred and supported by Spanish monetary regulators for two decades, which led banks and savings banks to create bonds and securities in order to have a more balanced structure to finance real estate. Most savings banks (leaders in the mortgage market with around 60 % of the credit activity prior to the crisis) disappeared in Spain after the financial restructuring. This process distorted the mortgage market during the following years and has opened the door to new financing methods for real estate activities. The second reason concerns the attractive tax structure of SOCIMIs. The corporate tax rate at zero percent together with tax exemption for individuals should have considerable impact in attracting investment flows towards Spanish REITs.

13.8 Conclusions

This chapter has described the structure of Spanish REITs, along with their history and regulation, both focusing on the previous indirect vehicles for real estate financing (FIIs and SIIs) and deepening the knowledge of the new 2012 regulation which equates SOCIMIs to International REITs.

SOCIMIs (the name given to Spanish REITs) could be classified as an Equity REIT with a closed-ended structure. Diversification is not compulsory for real estate activities but requirements include a minimum five-million-euro asset value and holding real estate for rental purposes as a primary requirement with special favorable treatment when managing house-building. SOCIMIs offer an attractive fiscal treatment (for European residents) with dividend exemption for individual investors, zero corporate tax and other tax incentives when returns come from the housing market. SOCIMIs have to be quoted societies allowing more transparency and liquidity for their shares. The regulated financial market available for SOCIMIs' shares in Spain is the MAB (Alternative Financial Stock) and shares will start being quoted during 2013.

SOCIMIs have a minimum yearly pay-out requirement corresponding to 80 % of returns obtained from rents and 50 % of capital gains to be paid as dividends among shareholders. These allow the society to capitalize part of its benefits with the non-distributed income and re-invest between 20 % and 50 % (at the most) in real estate activities. Direct development is allowed (for rent) and leverage is not restricted when the SOCIMI self-develop buildings to rent.

The chapter shows how the previous vehicles (Real Estate Investment Funds – FIIs and Real Estate Investment Trust – SIIs) lacked success. Firstly, the restrictive regulation at the commencement of FII and SII limited their expansion when capital markets started to grow. Secondly, the traditional financial structure of the Spanish real estate market, based on the banking system than in capital markets, and the tradition to issue direct vehicles (like mortgage backed bonds and securities) to finance mortgage credits restricted the development of FIIs and SIIs. Thirdly, the real estate service management system in the Spanish market was regulated around professional real estate managers thereby not allowing management companies to compete in the market until the late 1990s. Such a structure could affect the capacities and skills to manage larger real estate portfolios on a rental basis.

The chapter shows how changes in the Spanish financial system and in real estate markets, along with the need for financing and the provision of real estate management services could give an additional chance for SOCIMIs to develop as financial vehicles for the real estate market. It is argued that SOCIMIs could play a role developing the housing rental market but it needs a specialized and high-skill management system and does not always produce competitive return rates.

Annex

Table 13.3 Spanish indirect real estate investment companies in April 2013

	Registration date
Real estate funds – FIIs	
SANTANDER BANIF INMOBILIARIO, FII	21/02/1995
SEGURFONDO INVERSION, FII (in closure)	21/02/1995
BANKIA INMOBILIARIO, FII	14/03/2003
SABADELL BS INMOBILIARIO, FII	13/01/2004
AHORRO CORPORACION PATRIMONIO INMOBILIARIO, FII	07/09/2004
CX PROPIETAT, FII	24/05/2006
Real Estate Investment Company – SIIs	
PROMOCIONES LLADERO, S.I.I., S.A.	11/12/2002
REAL ESTATE DEAL, S.I.I., S.A.	24/02/2004
INMOASSETS, SII, S.A.	12/05/2005
SANTANDER AHORRO INMOBILIARIO 1, S.I.I., S.A.	23/12/2005
INMO FAREAL 2006 SOCIEDAD DE INVERSION INMOBILIARIA, S.A.	14/12/2006
SANTANDER AHORRO INMOBILIARIO 2, SII, S.A.	19/12/2006
INVERSIONES BINEXPO 2006, SII, S.A.	13/07/2007
VENTAFARINAS IMMOBLES, SII, SA	12/12/2008
LAZORA, SII, S.A.	18/01/2013

Source: CNMV

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Ley 11/2009, de 26 de octubre, por la que se regulan las Sociedades Anónimas Cotizadas de Inversión en el Mercado Inmobiliario. BOE (Boletín Oficial del Estado) del 26 de octubre, No. 259, pp. 89693–89723.

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Chapter 14
REITs: The Bulgarian Perspective

Kamena Valcheva

In 2003, in order to stimulate the further growth of the real estate market and the development of the capital market in Bulgaria, the Bulgarian Parliament adopted a new law – the Special Purpose Investment Companies Act[1] (the "SPIC Act"). The stated intent of the authors of the bill and of the Parliament is the encouragement, through this new law, of small and medium investors by allowing them to participate in large and profitable projects in the real estate sector. The SPIC Act regulates the regime governing the incorporation and the activity of real estate investment trusts (the "REITs").

In addition to REITs, the SPIC Act regulates special purpose investment companies investing in accounts receivables, i.e. claims (of whatever nature, provided the obligor is a Bulgarian person or entity, and excluding claims that are being the subject of a legal dispute). The legal and tax framework of the REITs and of the special purpose investment companies securitizing receivables is the same. By April 2013 there are 58 REITs and 7 special purpose investment companies investing in accounts receivables in Bulgaria. This material only focuses on REITs.

14.1 Legal Nature of REITs Under Bulgarian Law

Under Bulgarian law REITs are public closed-end joint-stock companies. In order to raise money for their investments, REITs issue securities. The money received from the shareholders who have bought the securities is used for investments in real estate properties. REITs are not entitled to reorganize into another type of

[1] This law was first published in this country's official gazette, "State Gazette" volume 46/2003 dated 20 May 2003. The last amendment was published in volume 77/2011.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_14, © Springer-Verlag Berlin Heidelberg 2013

companies or to change their scope of business. Moreover, under the Act on the Activity of the Collective Investment Schemes and of the Other Undertakings for Collective Investments, adopted in 2011 in order to transpose into Bulgarian law the UCITS IV Directive, REITs are treated as undertakings for collective investments. It is worth pointing out that all Bulgarian REITs are public companies listed on the Bulgarian Stock Exchange – Sofia (the "BSE"). The listing on a stock exchange is a mandatory requirement under the SPIC Act.

14.2 Bulgarian REITs in Figures

14.2.1 Number of REITs

By the beginning of April 2013, 58 REITs are listed on the Bulgarian Stock Exchange.[2] Most of them were licensed by the Bulgarian Financial Supervision Commission (the "FSC", the "Commission") and listed on the BSE between 2005 and 2008. The crisis put a hold on the development of the Bulgarian real estate sector, as well of Bulgarian REITs. From 2011 until mid-2013 only one new REIT was registered.

Currently the securities of 13 REITs are traded on the regulated market of the BSE. The remaining 46 REITs are traded on the Bulgarian Alternative Stock Market, called the BaSE Market. The BaSE Market is intended for share issues of public companies (inclusive REITs) that do not meet the minimum requirements for admission to trading on the main market of BSE; BaSE securities are generally less liquid then these on the main market.

14.2.2 Market Capitalisation

The total market capitalisation of the Bulgarian REITs market at the beginning of April 2013 was about BGN 1,970,000,000 (approx. EUR 1,007,245,000). In the first days of April 2013 the market capitalisation of the 13 REITs traded on the main market of the BSE was approx. BGN 520,000,000, whereas the market capitalisation of the same REITs at the end of December 2012 was about BGN 471,000,000.

[2] Statistical data is primarily taken from the Bulgarian Stock Exchange – Sofia, and the Bulgarian Financial Supervision Commission and is available on their websites: www.bse-sofia.bg, www.fsc.bg.

14.2.3 BG REIT: The Specialised Stock Exchange Index for REITs in Bulgaria

In 2007 the BSE launched a specialised stock exchange index for REITs called BG REIT. BG REIT is an index based on the free-float-adjusted market capitalisation and covers seven issues of common shares of REITs, with the greatest market value of the free-float and the highest median value of the weekly turnover occurring in a preceding 6-month period. These two criteria have equal weight.

Beside the general requirements an issue included in the index base of BG REIT has to meet the following criteria:

- To have been traded on a market, organised by BSE, for at least 3 months before its introduction into the BG REIT portfolio;
- The market capitalisation of the issue shall not be less than BGN 5,000,000;
- The free-float shall not be less than 25 % of the total volume of the issue.

According to the statistical information published on the website of the BSE BG REIT index rose by 55.36 % between 30 December 2011 and 28 December 2012. In the first quarter of 2013 the BG REIT index continued its growth and reported an increase of 9.43 % between 1 January 2013 and 28 March 2013.

14.3 Establishing and Licensing of REITs Under Bulgarian Law

14.3.1 Founders

The founders of a REIT (which may not exceed 50 individuals and/or legal entities in accordance with the requirements of the SPIC Act) have to convene a constituent meeting on which the REIT will be incorporated. There is no statutory requirement for a minimum number of shareholders in a REIT. The subscription of the shares of the REIT has to be performed at the constituent meeting. The constituent meeting must be attended by at least one institutional investor (a bank, a collective investment scheme, a closed-end investment company, an insurance company, a pension fund or other company the scope of activity of which includes the acquisition, the holding and the transfer of securities). The institutional investor has to subscribe not less than 30 % of the shares of the incorporated REIT. The requirement for participation of institutional investors in the establishment of the REIT guarantees to a certain extent the interests of small investors – such participation could be considered as positive external evaluation of the suitability of the REIT provided by a legal entity experienced in the financial sector.

14.3.2 Setting Up and Entering into the Bulgarian Commercial Register

As already mentioned, a REIT has to be established at a constituent meeting at which its shares are subscribed. The minimum registered capital required for the formation of joint-stock company under Bulgarian Commerce Act[3] is BGN 50,000 (approximately 26,000 Euros). For REITs, higher initial registered capital is required – it must amount to at least BGN 500,000. Full payment of the registered issued capital is required before a REIT is entered into the Commercial Register. Contributions in kind are not allowed. Upon the incorporation of a REIT, the constituent meeting is required to pass a resolution for an "initial capital increase". In accordance with the requirements of the SPIC Act the increase ought to amount to at least 30 % of the initial share capital (e.g., if a REIT is incorporated with the minimum initial capital of BGN 500,000, after the increase its capital has to be at least BGN 650,000). REITs could be established either for an indefinite period of time or as term funds.

The Articles of Association of a REIT have to contain some REIT specific provisions, e.g. investment objectives, restrictions for the type of real estate properties in which the company may invest (if any), the maximum size of the expenses for management of the company as a ratio to the book value of the assets of the company, the rules for determining the remuneration of the members of the board of directors of the company, as well as of the remuneration of the servicing companies, the rights and obligations of the servicing companies, etc.

The corporate name of each REIT consists of two parts – the name chosen by its founders at the constituent meeting and the indication "joint-stock special purpose investment company" or the abbreviation "JSSPIC".

A REIT is considered valid and existing only after it is entered into the Commercial Register administered by the Registry Agency with the Ministry of Justice. This is a one-stop shop registration upon which the REIT obtains a unified identification code which serves for all commercial, tax, social security, statistics and other public purposes.

[3] This law was first published in "State Gazette" volume 48/1991 dated 18 June 1991. The last amendment was published in volume 20/2013.

14.3.3 Licence and Authorisation Issued by the Bulgarian FSC

14.3.3.1 Powers of the FSC and Licensing Procedure for the REITs

A REIT can carry out its activities lawfully only if licensed by the Bulgarian Financial Supervision Commission. This is an oversight authority independent of the government, which supervises the financial markets, except for the banking sector (which is under the supervision of the Bulgarian National Bank). Within the supervision powers of the FSC lies the powers to grant a licence to a REIT, to authorize its prospectus, and the supervision of the activities of a REIT, as well as the power to grant permission for a number of changes related to the functioning of a REIT, e.g. permission for amendments to the Articles of Association of a REIT, for changes of the depository bank and of the service company, for reorganisation and termination of a REIT. The FSC supervises not only the REITs, but also their service companies.

REITS are obliged to notify the Financial Supervision Commission about their entry in the Commercial Register within 7 days from entry.

In order to perform activities as a REIT, a joint-stock company must submit to the FSC an application for the issuance of a licence within 6 months as of the date of the entry into the Commercial Register. A prospectus for the initial capital increase through public offering of shares is to accompany the licensing application. The FSC reviews the application and the enclosed documents within 1 month from their receipt and must either issue a licence and authorise the prospectus for publication, or issue a motivated refusal. If the Commission needs additional information and documents in the licensing procedure, it can require such documents from the REIT. In this case the FSC has to issue a decision on the licence and the prospectus within 14 days from the receipt of the additional documents. Upon granting the licence, the FSC enters the REITs into the register for public companies and other issuers of securities kept by the Commission.

If the statutory requirements regarding the REIT, the prospectus, the members of the Board of Directors, etc. are not met, the FSC will refuse to issue a licence and will send to the Registry Agency the refusal, upon exhaustion of the right to appeal. Upon receipt of the refusal the Registry Agency enters ex-officio amendment to the trade name of the REIT and the indication “joint-stock special purpose investment company” or the abbreviation “JSSPIC” shall be replaced by the general “joint-stock company”, respectively “АД” in Bulgarian.

If a REIT does not commence operations within 12 months of issuing the licence, its licence would be revoked.

14.3.3.2 Authorisation of the Initial Capital Increase

In order to perform the obligatory initial capital increase, a REIT has to prepare and submit a prospectus to the FSC. The prospectus for public offering of securities by a REIT must contain, among others, data about the company, its activity and the offered shares, as well as information about the investment purposes and the restrictions of the investment policy, description of the criteria to which the real properties correspond and the characteristics of the acquired real estate, data about the depository bank and the requirements to be met by the servicing companies, the maximum admissible size of the expenses related to the management of the REIT, etc. The prospectus has to comply with the contents (information) and other requirements provided for by the Public Offering of Securities Act and by the SPIC Act.

The FSC approves the prospectus within 1 month from the receipt of the application of the REIT (if the FSC has required additional information and documents – within 14 days from their receipt).

14.3.4 Listing on a Regulated Market

In order to perform the obligatory share capital increase, a REIT has to obtain a listing on a regulated market. The increase is to be effected through the issuance of rights. The rights entitle the holders to participate in the subscription. In order to buy one share, the investor needs to hold one right. Founding shareholders are deprived of pre-emption rights for the purposes of the initial capital increase. The whole rights issue must be offered by an investment firm for public trading on a regulated market (currently, only the BSE is a regulated market in Bulgaria).

It is the rights related to the capital increase that must be listed first on the regulated market. The regulated market has to be notified by the managers of the REIT about the initial date on which the offering of rights is scheduled to begin, the terms of its fulfilment, the number and the par and issued value of the shares to be registered. For this purpose, the REIT must submit a notification to the regulated market on which its shares will be offered within 30 working days from the date of the authorisation of the prospectus for the initial capital increase by the FSC. The regulated market is obliged to accept for trading the rights issued by the REIT.

The time limit for registration of shares for the capital increase is at least 30 days. The initial increase is made up to the size of the registered shares. The shares of a REIT are issued only as book-entry securities. The issuance of preferred shares with multiple votes is not allowed by the law. The shares of a REIT are without any exception non-redeemable – the statutory right of redemption of shares under the Bulgarian Commerce Act is not applicable to REITs.

14.4 Management

Bulgarian REITs are managed and represented by a Board of Directors. Management of a REIT under the two-tier system of management is not possible under Bulgarian law. The corporate governance structure of the REIT consists of:

- General meeting of shareholders;
- Board of directors

There are no restrictions for foreigners to be appointed managers of a REIT. The management of the assets of a REIT shall be carried out conscientiously and with due care, giving priority to the interest of the shareholders to own interest and maintaining an optimal balance between reliability and profitability.

The persons, managing and representing a REIT are obliged to avoid conflicts between their interests and the interest of the REIT and, should such conflicts occur, to disclose them in due time, in a way accessible to the investors, and not participate in taking decisions in these cases. The managers of the REIT must keep details of the company confidential until the public disclosure of the respective circumstances.

Recently, a remuneration policy requirement has been imposed on REITs with regard to the remuneration of the members of their Boards of Directors. In March 2003 the FSC enacted the Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies.

14.5 Depository Bank

The funds and securities of the REIT shall be kept in a depository bank. The funds raised from issue of securities shall be deposited by the persons having purchased the securities to a bank account specially opened at the depository bank by the REIT. The depository bank makes all payments for the account of the REIT in observance of the terms stipulated by its Articles of Association and prospectus for public offering of securities.

REITs notify the FSC about the chosen depository bank in the licensing procedure and need the permission of the Commission in order to change the depository bank.

14.6 Investments, Financing and Restrictions

14.6.1 Investments

In accordance with the SPIC Act, REITs are entitled to invest in three different types of assets – (1) real estate related property rights; (2) securities and (3) bank deposits.

Concerning properties REITs could invest in real estate and limited property rights in real estate, construction works and improvements, with the purpose of providing the property for management, letting out, leasing and selling. The majority of the Bulgarian REITs invest in a wide variety of real estate properties. However, there are also REITs investing only in agricultural land.

With regard to the securities, the securities issued or guaranteed by the Bulgarian government are eligible investments for REITs. The same is applicable to bank deposits.

To a certain limits REITs can also invest in mortgage-backed bonds (up to 10 % of their own funds), as well as in service companies for their own needs (management and maintenance of acquired real properties, performance of construction). The investment in service companies also must not exceed 10 % of the own funds of each REIT.

14.6.2 Financing

For the purposes of financing their activities, REITs are entitled to:

- Issue debt securities registered for trade on a regulated market;
- Draw bank loans for acquisition and commissioning of the assets subject to securitisation;
- Draw bank loans amounting to 20 % of the book value of the assets which are used for the payment of interest, if the term of the loan is not more than 12 months.

14.6.3 Restrictions

REITs cannot invest in real estate located outside the territory of Bulgaria. Real estate properties which are the subject of a legal dispute are not eligible investments for REITs in accordance with the provisions of the SPIC Act.

A REIT may not participate on the capital market by investing in assets other than securities, issued or guaranteed by the Bulgarian government, and mortgage-backed bonds.

REITs may not acquire shares in other companies except for service companies.

In addition, REITs are not entitled to guarantee obligations of other persons or to provide loans.

Furthermore, all activities relating to management and maintenance of acquired real properties, as well as construction and improvements have to be outsourced to service companies. Direct performance of such activities by a REIT is not allowed by the law. As mentioned above, the eligible investment amount in service companies is up to 10 % of the own funds of a REIT.

14.7 Acquiring, Use and Maintenance of Real Estate Properties

14.7.1 Acquiring of Real Estate Properties

A mandatory prerequisite for the acquisition of real properties by a REIT is their valuation. The Board of Directors of a REIT is not entitled to perform such valuation on its own. REITs assign the valuation of the real estate properties subject to acquisition to one or more experts with qualification and experience in the relevant field. With the aim of preventing abuses, the SPIC Act provides for certain incompatibilities with regard to the choice of an expert who will carry out the valuation of the real estate. For example, the valuation may not be assigned to a person who holds directly or indirectly shares in the REIT or who is a member of the board of directors of the REIT. The expert who will value the real estate should not be the seller of the real estate, a member of a managing or control body, a partner or shareholder of the seller, etc.

The prices at which the REIT acquires real estate properties must be consistent with the valuation provided by the experts. The price may not differ considerably from the valuation. Non-compliance with this rule is acceptable only in exceptional circumstances. In such cases managers of the REIT must explain in the next regular report why they have bought a real estate at a considerably higher price or have sold a real estate at a price that is considerably lower than the valuation.

The real properties held by the REIT are valued at the end of each financial year. In addition, if the index of the prices of real estate properties or the inflation index determined by the National Statistical Institute changes by more than 5 %, the performance of a valuation of all real properties held by a REIT is mandatory. These valuations have to be presented in the annual and quarterly financial reports prepared by the REIT.

A REIT may acquire a new asset or assets for securitisation only if this has been stipulated by the Articles of Association of the securities.

The members of the board of directors of a REIT are obliged, immediately upon acquisition of a real estate, to have it insured.

14.7.2 Use and Maintenance of the Acquired Real Estate Properties

The REIT may not carry out directly the activities on using and maintenance of the acquired real estate properties. The REIT must assign to one or more commercial companies, having the necessary organisation and resources ("servicing company"), the servicing and maintenance of the acquired real estate properties, the construction and improvements, the keeping and safeguarding of accounting and other reporting correspondence, as well as any other necessary activities. The FSC supervises also the servicing companies.

A servicing company may not offset funds of the REIT against its remuneration.

14.8 Distribution of Dividends and Distributable Profit of REITs

14.8.1 Distribution of Dividends

The distribution of at least 90 % of the adjusted accounting profits of a REIT for a respective financial year is mandatory under the SPIC Act. The payment of the dividends to the shareholders of a REIT must be performed within 12 months as from the end of the financial year.

For committing or admitting the commitment of the violation of this rule, individuals are subject to a fine amounting from BGN 5,000 to BGN 10,000 (approx. EUR 2,550–EUR 5,100) and legal entities are subject to a property sanctions in the range from BGN 10,000 to BGN 20,000 (approx. EUR 5,100–EUR 10,200). For repeated violations higher penalties are imposed by the chairman of the FSC.

14.8.2 Distributable Profit of REITs

The distributable profit of the REIT is the financial result (accounting profit or loss), adjusted as follows:

1. Credited/debited with the expenses/income from subsequent valuations of real estate properties;
2. Credited/debited with the losses/profits on transactions for transfer of ownership of real properties;
3. Credited/debited, in the year of transfer of ownership of real estate properties, with the positive/negative difference between the selling price of the real estate,

and the sum total of the historical cost of the real estate and the subsequent expenditures which have led to an increase of the net book value thereof;

4. Credited/debited with the losses/profits on sales reported in the year of conclusion of financial leases;
5. Credited/debited, in the year of expiry of the term of validity of the financial lease, with the positive/negative difference between the income from the sale of the real estate recorded at the commencement of the term of validity of the financial lease, and the sum total of the historical cost of the real estate and the subsequent costs which have led to an increase of the net book value thereof.

The purpose of the adjustments described above is elimination of the effects of accounting entries which are not related to cash flows.

REITs are not entitled to increase their capital through capitalisation of distributable earnings. REITs must maintain a reserve fund in accordance with the provisions of the Commercial Act. This requirement is applicable to all joint-stock companies in Bulgaria.

14.9 Reporting Obligations

REITs, as undertakings for collective investments and listed companies, have to comply with numerous reporting requirements. These requirements concern the content of the quarterly and annual reports prepared by REITs. The reports have to include, among others, information on the share of assets assigned by the REIT to third persons for use against consideration compared to the total amount of securitised assets, as well as details about the sale and/or the purchase of new assets whose value exceeds 5 % of the value of the securitized assets. Moreover, if during the reporting period the representatives and managers of a REIT have executed transactions on considerably lower/higher prices than the expert valuation, they must explain them in the report for the relevant period. REITs have to present in their reports data about the activities of the service companies in which they hold an interest. Other information explicitly specified in the regulations issued by the Commission must also be included in the reports of REITs. The reports of REITs must be prepared in accordance with the International Financial Reporting Standards.

14.10 Reorganisation and Termination of a REIT

14.10.1 Reorganisation of a REIT

Reorganisation of a REIT into another type of commercial company is not allowed under the SPIC Act. A REIT may not be reorganised into another type of

commercial company. The reorganisation through merger by the formation of new company or merger by acquisition must be carried out, upon permit of the FSC only between REITs. Reorganisation through division by the formation of new companies or separation has to be carried out also upon permit of the FSC, and the newly established company(s) must also be REITs. The Commission has to take a decision on the application for issuance of permit for transformation within 14 days from its filing, and if the Commission has required additional reference and documents – within 7 days from their receipt. The Commission must grant the authorisation for reorganisation along with the granting of a licence to carry out activity as a REIT. The FSC will refuse to issue permit for reorganisation if the interests of the investors are not protected.

14.10.2 Termination of a REIT

The REIT has to be terminated upon expiration of the term stipulated by its Articles of Association or by a decision of the general meeting only on grounds stipulated by the Articles of Association and by the prospectus for issuance of securities. A permit shall be issued by the Commission for termination of the company. The persons appointed as liquidators or trustees in bankruptcy of a REIT have to be approved by the Commission. The FSC must take a decision on the application for issuance of permit for termination within 14 days from its filing, and when additional reference and documents have been required by the FSC – within 7 days from their receipt. The Commission will refuse to issue permit for termination if the interests of the investors are not protected.

14.11 The Association of Bulgarian REITs

In 2011, ten Bulgarian REITs founded the Special Investment Purpose Companies Association (SIPCA), a non-profit organisation with a seat and registered address in Sofia.

Some of the goals of SIPCA are to:

- Protect the professional and economical interests of its members;
- Increase knowledge and understanding of all the questions towards the investments in real estate and in accounts receivables;
- Initiate and maintain to the competent Bulgarian authorities projects for amendments in the legal regulation of the special purpose investment companies;
- Improve the relations between the special purpose investment companies – members of the Association;

- Create informational environment for the problems of the special purpose investment companies and the investment process, etc.

Currently SIPCA has 12 members – 11 REITs and 1 special purpose investment company investing in accounts receivables.

14.12 Conclusion

Generally speaking, the legislative regulation of REITs in Bulgaria is fairly advanced, although there are some minor practical issues that remain not clearly regulated. REITs are attractive investment vehicles for both the retail and the institutional investors in Bulgaria, even during the financial crisis which has an extremely strong impact on the real estate sector in Bulgaria. Proof of the attractiveness of REITs for investors is the better performance of BG REIT, the specialised stock exchange index for REITs, in comparison with other exchange indices on the BSE, a trend which is stable e.g. throughout the period June 2010–June 2013, as well as the relatively high market capitalisation of REITs compared to other public companies listed on the BSE. The aim of the SPIC Act, to encourage small and medium investors by allowing them to participate in large and profitable projects in the real estate sector, has been achieved to a significant extent.

Chapter 15
The Greek REIT Industry: Current State and Its Post Crisis Evolution

Theodore Mitrakos, Vasiliki Vlachostergiou, and Sotiris Tsolacos

15.1 Introduction

The Greek property market has heavily been affected by the long lasting debt crisis as the Greek economy entered its 6th year of negative growth in 2013. In contrast to what happened in other economies, the real estate market and construction sectors were not the primary causes of the Greek debt crisis although the market was certainly overheated. The Greek real estate market has reflected the economic calamities and credit crunch, and has entered a protracted period of sluggishness characterized by low occupier activity and stalled investment transactions. All property sectors have been affected, both in Athens and the periphery. Arguably the only exception is selected tourism-related real estate which attracts international interest looking for assets on an opportunistic basis in prime locations at bargain prices.

The history of Real Estate Investment Trusts (REITs) in Greece has been relatively brief, they first appeared in 2006, and one might argue that this is a sector too young to withstand shocks such as those that the debt crisis has caused. However, Greek REITs have been relatively resilient to the economic woes. Their portfolios consist of prime property with a good mix of defensive tenants and strong covenants that have safeguarded income and provided a cushion against

The views expressed herein are those of the authors and do not necessarily reflect the views of the institutions the authors represent.

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_15, © Springer-Verlag Berlin Heidelberg 2013

the deep recession. As a result the REIT sector has been the best performing sector in the Greek stock market and it is gradually emerging as a standard investment vehicle in Greek real estate.

This chapter has a twofold objective. First, it provides an overview of the emerging REIT sector in Greece amid the economic crisis and the environment within which the REIT industry operates. Second, it discusses developments that are expected to impact on the growth and appeal of the Greek REIT sector going forward.

The remainder of the chapter is organized in four sections. Section 15.2 presents the conditions of the underlying commercial real estate market. In Sect. 15.3 the characteristics of the Greek REITs are presented. An assessment of the developments that will affect the sector is given in Sect. 15.4 which is followed by the conclusions section.

15.2 The Severity of the Crisis on the Greek Commercial Market

There is a view in the literature that REIT performance reflects the stock market in the short-run and the underlying real estate market as the time horizon lengthens. In the case of Greece in crisis, any REIT analysis should certainly take stock of the present conditions in the underlying market.[1] The slump in the commercial real estate market resembles that of the economy and reflects the historically low levels of confidence in all aspects of economic life. The economic crisis and the significant reduction in the level of economic activity have brought about business failures well above the long-term trend. Moreover, restricted financing, coupled with the overall uncertainty about the economic environment have just made business planning difficult. Firms are ultra-cautious about operating costs and they are of course keen to economize on accommodation costs too.

The suppressed delivery of new office premises has not offset the notable reduction in office demand. A significant increase in the volume of space from existing buildings has led to major rises in availability. The supply of small office units is high, central areas included. Vacancy rates have increased to approximately 10 % in the CBD with availability rates being much higher in secondary office sub-markets. Rents are on a declining path. Prime rents fell by about 30 % in the period 2009–2012. Rent falls are more severe in non-prime areas. Figure 15.1

[1] For the main characteristics and recent developments in the Greek real estate market see the studies included in the collective volumes edited by the Bank of Greece (2009, 2012), as well as Karamouzis and Hardouvelis (2007). See also, Brissimis and Vlassopoulos (2009), Brissimis et al. (2012), Deutsche Bank (2012), Eurobank Property Services (2013), Fitch Ratings (2013), Mitrakos (2009, 2011), OECD (2011), Sampaniotis (2013), and the recent Bank of Greece Governor's Reports (Monetary Policy – Interim Report 2011 and 2012, Annual Report 2011 and 2012, Monetary Policy 2011–2012).

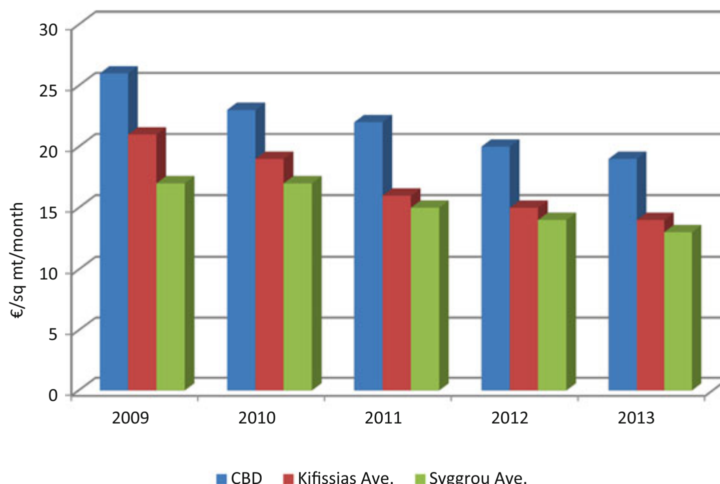

Fig. 15.1 Prime office rents (Source: Eurobank Property Services)

illustrates the rent declines in the key office districts in Athens. There has been an evident trend among office occupiers rationalizing and shifting towards cheaper premises. As the crisis progressed demand was restricted to premises up to 2,000 sq. m with this demand coming from tenants seeking to lower their rent or move to better quality accommodation at the same rent.

Lack of demand for purchasing new property has led to very low levels of investment transactions since 2010. Limited deals were recorded in 2012 and they were dominated by renegotiations of existing lease agreements or relocations to smaller office units. Office yields moved out by 200 basis points at the prime end to 8.25 % at the end of 2012 from the pre-crisis levels of 6.5 % in 2008. Office values have dropped by over 30 % since 2009.

The retail market has been heavily affected too by the debt crisis. Demand for high street retail is limited and values are rapidly falling. Secondary locations are now characterized by a high percentage of vacant space. Shopping malls appear less affected than high street retail, however they started feeling the pinch of the crisis in 2012 and risks to their turnover are rising. Rental values in the main high street in Athens range from 100 to 150€/sq.m/month., whereas in less prime locations rents have dipped below 90€/sq.m/month. Prime yields were about 7.5 % at the end of 2012 according to Eurobank Property Services.

A similar picture is observed in the warehouse market. Both demand and supply of new prime space remain at depressed levels with rents and prices constantly falling. According to Eurobank Property Services prime rents are in the region of 3–4€/sq.m/month. Prime yields in this sector are estimated to be over 10.5 %, whereas yields on secondary assets exceed 12 %.

It is worth noting that the rent and value adjustments this market is experiencing are to a good extent corrections from previously irrational levels. Further a

convergence of prices in areas with similar characteristics is now being achieved rectifying previously unjustifiable discrepancies.

This brief overview of the underlying market illustrates the challenges for REITs and their NAVs in Greece. The underlying market environment will continue to be gloomy until the macroeconomic conditions show signs of stabilization. Fortunately, the focus of REITs in their first few years of operation on prime assets has shielded performance from income voids and the major drop in values of non-prime assets.

15.3 The Greek REIT Industry: Characteristics and Performance

15.3.1 Characteristics

The legal framework for Greek REITs was first introduced in 1999 and the authorities have implemented changes and attempted to improve it three times since. The most recent amendments, which were finalized and endorsed by the Greek parliament in March 2013, are very much in accordance with the practices in other European countries. Overall these amendments provide Greek REITs with additional flexibility preserving at the same time their existing tax advantages.

The need for large property portfolio owners, mainly commercial banks, to realize liquidity from their otherwise illiquid assets, along with the tax incentives offered by the REIT status, triggered the establishment of the first two REITs in 2006. Moreover, the economic environment at the time was favourable for investment in real estate, with prices constantly increasing, yields dropping and commercial activity being at its highest level. The main shareholders of all five REITs are major commercial banks. Three REITs are listed on the Athens Exchange.

15.3.1.1 Size

The list of all five Greek REITs with their main income and value figures (as of end of 2012) is presented in Table 15.1. The total Net Asset Value of the Greek REITs reached €1.75 billion at the end of 2012 while the value of the property portfolio reached €1.48 billion.

15.3.1.2 Institutional Framework and Regulation

While the exact structure of REIT vehicles does differ globally, there are broad similarities in the rationale behind the introduction of REITs which are broadly tax

Table 15.1 Market and portfolio values for Greek REITs (end of 2012)

	NAV (€ m.)	Funds from operation (€ m.)	Property portfolio value (€ m.)
Pangaia	939.3	70.2	771.8
MIG	36.9	4.5	47.8
Eurobank Properties	627.0	37.6	547.8
Trastor	85.8	85.8	68.8
Intercontinental	64.5	64.5	45.6
Total	**1,753.5**	**262.6**	**1,481.8**

Source: Bank of Greece (BoG), data from REITs

Under decision 9/10.01.2013 of the Bank of Greece Executive Board, the existing five Greek REITs are required to report detailed data concerning the income-generating assets they hold and manage. REITs were considered as an excellent initial source of data on commercial property, as they offer several advantages in terms of data availability. Specifically, the existing legal framework imposes transparency of transactions; biannual valuations of all assets by the Greek Body of Chartered Surveyors (S.O.E.); publication of financial statements and portfolio status; as well as professional management of portfolio and properties separately. These requirements ensure the availability of high-quality data from extended portfolios – "baskets" – the contents of which remain more or less unchanged, enabling also the monitoring of commercial property market fluctuations, including the evolution of valuations over time and rent reviews of the investment assets. Hence, data from Greek REITs are reported to the Bank of Greece Real Estate Market Analysis Department on a biannual basis. Among other information, such data include rental and open market values, rent reviews, portfolio total returns and capital growth, vacancy rates, distribution and allocation of assets, etc.

transparent closed-ended funds. Notwithstanding these similarities, each country imposes its own set of conditions and limitations (Hughes and Lewis 2008).

The regulatory framework for Greek REITs was first released in 1999. Following amendments drawing on international experience the most important changes in the institutional framework of the Greek REITs took place in March 2013. It provides additional flexibility in the investment strategy of REITs while maintaining the existing tax advantages.

Greek REITs have been operating under the following principal regulations (or at least until March 2013)[2]:

- *Legal form:* Open ended property companies, with a minimum share capital of €29.3million. Within 1 year from their establishment REITs are obliged to apply for listing at the Athens Stock Exchange.
- *Tax treatment*: Greek REITs are covered by a tax efficient regime compared with ordinary corporate taxation. A 0.1 % duty on the "taxable value" of the properties is imposed as well as an annual tax of 10 % of the main refinancing operations minimum bid rate of the European Central Bank (reference rate) plus 1 % of the average investments and any available funds at their current value. No

[2] For a detail analysis of the operational framework of Greek REITs comparing with other countries, see Karytinos (2009) as well as McGreal and Sotelo (2008).

additional tax on rental income is imposed and no property transfer tax is applied. Furthermore REITs are exempt from capital gains and dividend taxes.

- *Leverage limit:* A leverage of up to 50 % of the total asset value is permitted for the acquisition and development of property assets.
- *Development option:* Refurbishment and completion of properties are allowed as long as development costs do not exceed 25 % of the open market value of the property (after completion).
- *Diversification:* Portfolio asset allocation is limited to commercial properties, excluding all residential uses. Furthermore, a single asset value cannot exceed 25 % of the total portfolio Value.
- *Dividend distribution:* Dividend distribution is at 35 % of net profits and this income is tax free.
- *International Investments:* Investment in properties within the European Economic Area (EEA) is unlimited, whereas investment outside EEA is subject to a 10 %, of the REITs total asset value, restriction.

15.3.1.3 Sectoral Allocation

Due to complications arising from investing in residential property, REIT allocations have solely focused on commercial property. In particular retail and office properties dominate portfolios with bank branches well represented. REIT portfolios comprise a total of 450 commercial properties in prime locations across Greece. The representation of these sectors in the portfolios is as high 94 %. The rest 6 % is made up of warehouses, supermarkets and several petrol stations held by a single REIT (Trastor). Figure 15.2 illustrates the allocations.

On a year by year basis, the portfolio synthesis, and thus asset allocation, has been pretty stable, with companies holding onto properties and engaging in just very few new purchases. This trend has lasted for 3 years (to end of 2012) and will through 2013. The adverse economic circumstances that first emerged in 2009 and aggravated since, have deterred new investments. Moreover, recurrent negative capital value growth did not justify sales of existing assets, which on the other hand provided stable operating income.

15.3.1.4 Geographical Allocation

Until the end of 2012, with the exception of one REIT (Eurobank Properties), Greek REITs included assets from solely within Greece (see Fig. 15.3). The greater Athens area (prefecture of Attica) was the main focus and assets from this region make up about 65 % of REIT holdings.

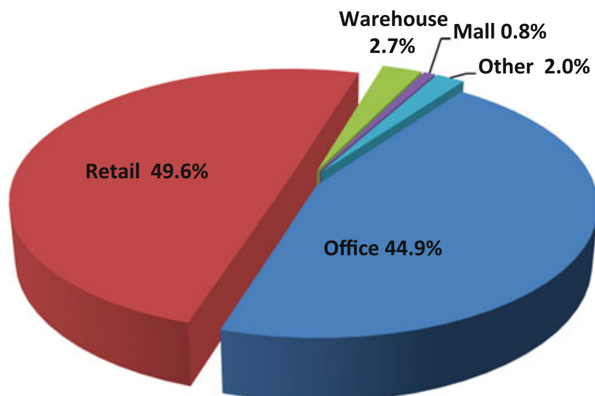

Fig. 15.2 Asset allocation from sector (Source: Bank of Greece, data collected by REITs)

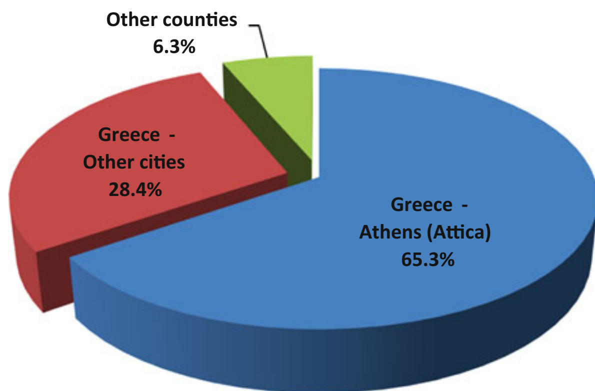

Fig. 15.3 Asset allocation of Greek REITs from geography (Source: Bank of Greece, data collected by REITs)

The REIT Eurobank Properties holds assets outside the Greek territory, located in eastern European countries and more specifically in Romania, Serbia and Ukraine. These account for approximately 17 % of the company's entire portfolio asset value. In 2012 MIG REIT purchased two new investment properties in Romania (retail and offices), thus being the second Greek REIT expanding its portfolio with the inclusion of international assets.[3]

15.3.1.5 Portfolio Rent and Yields

By the end of 2012, the average rental value for prime office property in REIT portfolios was €15.6/sq.m/month, with the maximum value recorded €40/sq.m/month. Respectively, average prime retail property rent was approximately €21/sq.m/month with the maximum rental value at €133.6/sq.m/month.

[3] This purchase is not completed and therefore it is not represented in the figures presented here.

Table 15.2 REITs portfolio rents and yields

	Average rents (€/sq.m/month)	Average yields
Offices	15.6	8.8 %
Retail	20.9	8.6 %
Warehouse	4.6	10.9 %

Source: Bank of Greece, data collected from REITs

Average yields for both offices and retail property exceeded 8.5 %, with average yields closer to 9 % for office and 11 % for warehouses (Table 15.2).

15.3.2 Performance

The sector's asset values began to decline in 2010 and this trend has intensified since mid-2011 (Fig. 15.4). From 2006 to 2009, the total asset value of all REITs increased, owing to a combination of higher valuations (including post-Lehman in 2008 and in 2009) and new additions to existing portfolios. In 2009 rising valuations pushed asset values up by 6.5 % compared to 2008. In 2010 a major REIT (Pangaia), with a total portfolio worth of €884million, was formed which explains the boost to the industry's total asset value. Nevertheless, from that point on, a constant reduction in values took place and by the end of 2012 asset values were down 11 %[4] from their 2009 level.

This is good performance by REITs in the Greek context. The sector certainly performed better (or rather less badly) than the direct segments of the market. Characteristically, the cumulative decrease in residential property values is estimated to 29 % since mid-2008, whereas the respective decrease in commercial direct prime property is estimated to exceed 30 %, with secondary property being far more severely affected. Portfolio diversification, lack of new supply for prime assets, a robust mix of tenants – which in certain cases were affiliated to the company – and beneficial tax treatment are among the reasons for the resistance that REITs showed in a depressed environment.

The performance of REIT shares has remained consistently better than the general index of the Athens Stock Exchange, over the past 4 years, as Fig. 15.5 depicts. However this observation should be made in the context of significant falls across the board, or a crash situation, of the Athens Stock Exchange. REIT asset values and share prices will remain under pressure from risks on income growth. Renegotiations with tenants led to significant rent reductions in 2012 (varying from 10 % to 30 %). Moreover, new lease contracts tend to start from significantly lower base rents and include terms of participation to the tenant's investment turnover. The effect of the downward rent reviews and new lease patterns will be captured by the REIT financial results in 2013.

[4] Cumulative percentage adjusted for new REIT entries, i.e. calculates changes between asset values of REITs existing in both consecutive years of reference.

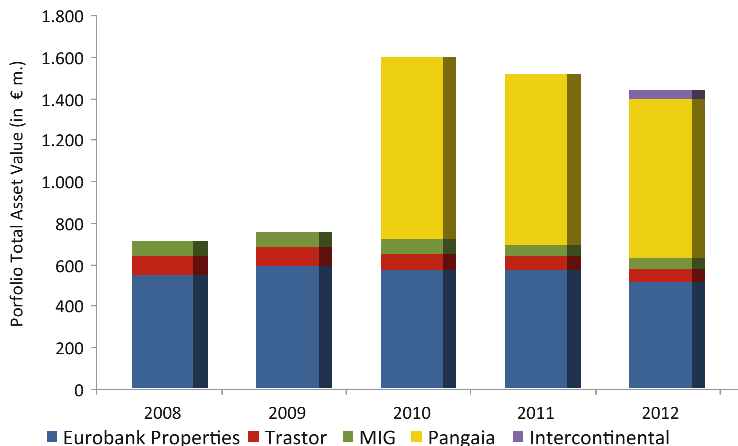

Fig. 15.4 Greek REITs total asset value (*as end of year*) (Source: Bank of Greece, data collected from REITs)

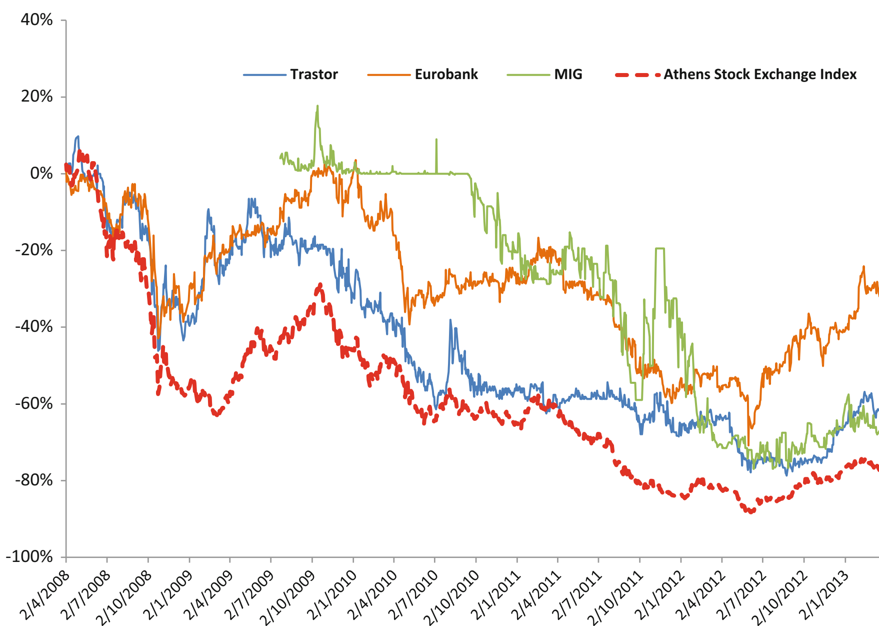

Fig. 15.5 Listed REITs share prices (*Cumulative change in share prices, 2/4/2008–2/4/2013*) (Source: Athens Stock Exchange)

NAV per share has significantly dropped during the past few years (Fig. 15.6), reflecting the continuous reduction in property values. With share prices plummeting ahead of NAV adjustments a significant discount to NAV has emerged

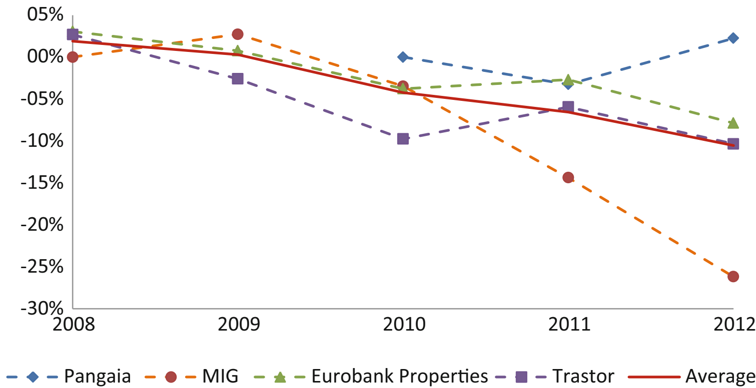

Fig. 15.6 REITs NAV per share annual change (Source: Bank of Greece, data collected from REITs)

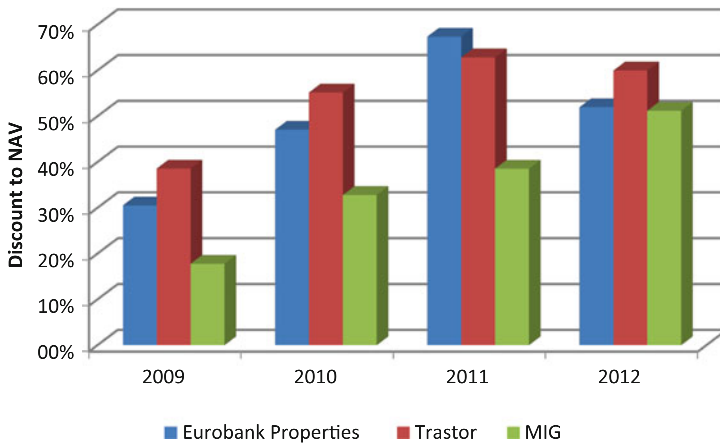

Fig. 15.7 Greek REITs discount to NAV (Source: Bank of Greece, Athens Stock Exchange)

(Fig. 15.7). It stood at over 50 % for all listed REITs at the end of 2012 having eased from the previous year.

Listed REITs tend to pay out higher dividends than non-REITs listed companies because of their legislative obligations to distribute a significant percentage (35 % – will rise up to 50 % under new legislation) of earnings to shareholders. The listed REITs were able to pay out dividends even during the financial crisis. As Fig. 15.8 shows, REIT dividend yields gradually increased during the crisis, the result of falling prices and ability to maintain income. Between 2009 and 2011, Greek REITs offered an average dividend yield of 9.3 %, well above other REITs in Europe, however in a much more risky environment.[5]

[5] See, http://www.epra.com/main-news-tree/pr-template7.

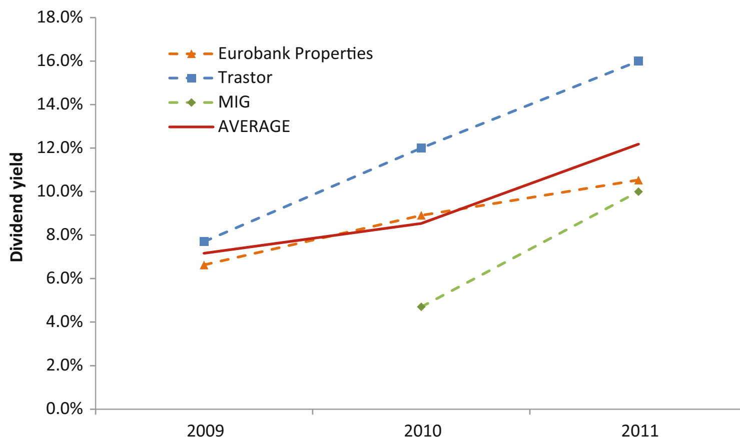

Fig. 15.8 Greek REITs dividend yields (Source: Bank of Greece, data collected from REITs)

15.4 What Are the Prospects?

There are three areas that will determine the future of Greek REITs. Legislation, to start with, introduced in March 2013, is a step towards the right direction, as certain limitations that were holding back a more active investment strategy are now removed. The amendments and new provisions will increase REITs' flexibility to structure their portfolios with assets from a much broader pool. The most important changes include:

- *Legal form:* Open ended property companies, with a minimum share capital of €25million. The minimum required share capital has been reduced in order to facilitate investment under the current adverse economic circumstances. Furthermore the period for new REITs applying for listing on the Athens Exchange is prolonged from 1 to 2 years, with the option of an extension for another 18 months.
- *Taxation:* The favourable tax framework remains stable.
- *Leverage limit:* Increase the maximum leverage (debt) into 75 % of the REIT's assets instead of up to 50 %.
- *Portfolio assets:* Portfolio asset allocation is no longer limited to commercial properties. Investment in residential property is also allowed, including holiday residences and tourism-related accommodation, property under development, plots of land with existing building permit, provided that the remaining development period does not exceed 36 months. REITs are also allowed to invest in long-term public property concession schemes. It is expected that this provision will increase the scope for diversification.
- *International investments:* Investment outside EEA is allowed up to a percentage of 20 % of the REIT total asset value.

- *Dividend distribution:* Under the new legislation dividend distributions are set to 50 % of REITs' net profits, thus strengthening their attractiveness to investors, under the current adverse economic circumstances. This amendment is in accordance with the practices in most European countries.

A second factor we should highlight is the privatization program of state owned assets. Will REITs benefit from this ambitious privatization agenda which will bring an assortment of assets with relatively safe income to the market? The Hellenic Republic Asset Development Fund has identified a pool of 3,150 properties with an estimated market value of €10 bn that can be sold in the next 2–3 years and is proceeding with clearing up regulatory provisions. These real estate assets could help boost property investment and REITs should play a dominant role in this regard. A number of potential important opportunities lie ahead for Greek REITs as long as this program is fully or partly implemented.[6]

But really the key risk to the outlook for this industry remains the macro economy and the unresolved macroeconomic uncertainties. Although legislation, privatization and the performance of REITs during the crisis all point to a sector that should attract the attention of domestic and foreign investors looking into Greek real estate, it is the economic fortunes and the well-being of the underlying real estate market that will determine whether any potentially good prospects for Greek REITs will be realized. The downside risks to rents and capital values will remain and such risks are illustrated in the negotiations for lower rents by public sector tenants, the group of assets REITs are likely to target.[7]

We should also consider the fact that REITs, apart from their apparent liquidity advantage, could provide access to what is an immature and non-transparent direct market in Greece. Direct investment in real estate has never been that attractive to foreign investors, as a significant number of disincentives exist. These arise from a range of factors including bureaucracy, lack of transparency in transactions, a

[6] For additional information and assessments about the utilization of public property in Greece see also, Hellenic Public Asset Development Fund (2013), and the Bank of Greece Governor' Annual Report for 2011 (Section V.2) and Monetary Policy Interim Report 2010 (Special Feature 3). See also the reports of the Hellenic Public Asset Development Fund which has taken up the Greek privatisation programme since August 2011 (http://www.hradf.com).

[7] The fall in rent values and the renegotiation of lease contracts for commercial properties have contributed to the decrease in rent paid by the State for the accommodation of its departments. According to Ministry of Finance estimates, a total of €155.8 million was spent in 2011 for 2,639 lease contracts, while this expenditure came to €169.7 million in 2010 and €178.1 million in 2009 (declining by 8.2 % in 2011 and 4.7 % in 2010). This decline was also driven by the legislative intervention (Law 4002/2011), stipulating that the rent paid by the Greek State and public sector bodies for the lease of properties to accommodate their departments is reduced by 20 % (on the basis of rent levels in July 2010). A further reduction of accommodation costs is pursued for 2012 and the following years, since a provision of Law 4081/2012 further reduces the rent the State tenants should pay. This reduction amounts to 10 % for properties with a monthly rent of less than €1,000, 15 % for properties with a monthly rent of €1,000–€2,000, 20% for properties with monthly rent of €2,000–€3,000 and 25 % for properties with monthly rent of over €3,000.

changing tax environment, complicated licensing procedures, limited size and fragmented ownership.

New investment funds, expected to be formed under the new REITs regime, are on the lookout for the right time to enter the market. For the time being, these funds originate in Greece (property development companies and private funds). It is not unlikely that a change in sentiment in conjunction with the high yields could attract international funds, initially on an opportunistic basis. The next wave of investments, when it happens, will be in growth areas exposed to international demand such as tourism, leisure and holiday residential development projects, and in state owned assets. All these represent now investment options for Greek REITs.

15.5 Conclusions

The REIT sector in Greece is young and trying to cope with the economic repercussions of the debt crisis in the country. Reductions in the asset values of REITs have occurred and share prices are trading at a significant discount to NAV. REITs have showed resilience in this crisis in the sense that they have performed better than the overall stock market and have been able to generate and distribute income to shareholders. The portfolios of REITs comprising prime properties with good covenants have mitigated the steep reductions in rents and values witnessed in the underlying market. Moreover, companies have endeavored to compress operating costs and support cash flows.

A key objective of this chapter is to assess the outlook for REITs in Greece, highlight challenges and any opportunities. At the time of writing the single most important factor affecting the whole economic and investment life in Greece is the continuous recession as the country struggles to recover from the debt crisis and the need to implement much needed structural reforms.

It is argued in this chapter that under conditions of a more ordinary economic environment two developments should benefit the REIT industry. The legislation passed in March 2013 introduces more flexibility and provides a platform for an enlargement of the industry. REIT companies will have more options to invest and diversify their portfolios. The implementation of a substantial, for the standards of Greece, privatization program is expected to bring properties to the market of institutional grade. Some of the problems that stand in the way of the effort to develop public property remain, with delays recorded in the execution of the necessary administrative decisions until recently. It has now become imperative to intensify the necessary actions and accelerate the resolution of legal and technical issues relating to the commercial exploitation of state property. Should this plan put into action we expect REITs to become active buyers of these assets.

Direct investment in the Greek real estate market is hindered by a host of impediments that the industry has lobbied against. REITs can be seen as a vehicle offering access to this immature market. However, the health of the REIT industry is supported by a better functioning of the underlying market which will make the

market more liquid. The tax treatment of real estate remains a hot issue. The decline in property market activity is magnified by the growing uncertainty regarding the future tax treatment of real estate transactions and ownership, the frequent references to additional but not specified tax measures as well as the high transaction costs (about 14 %, Caldera Sánchez and Andrews 2011). These uncertainties discourage demand despite the large fall in prices and in general they are an impediment on liquidity.

In a more stable and secure national economic environment, which has now to be the key assumption and prerequisite for any assessment in Greece, we expect the gap in dividend yields between Greek and other European REITs as well as the magnitude of the discount to NAV to attract interest from investors who would be keen to move up the risk curve.

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Chapter 16
Turkish REICs: Real Estate Investment or Real Estate Development Companies?

Dilek Pekdemir

Abbreviations

CMBT	Capital Market Board of Turkey (*SPK*)
IREICs	Infrastructure Real Estate Development Companies (*Altyapı Gayrimenkul Yatırım Ortaklıkları*)
ISE	Istanbul Stock Exchange (*İMKB*)
REICs	Real Estate Development Companies (*Gayrimenkul Yatırım Ortaklığı*)

16.1 Background

REICs have played an important role in the institutionalisation of the Turkish real estate market. They have promoted legalisation of the real estate industry. The legal framework makes REICs more transparent by providing reliable and quality information. Furthermore, their structure brought international standards and professionalism to the broader real estate industry and fostered foreign investments in Turkey, especially on an institutional scale (Erol and Tırtıroglu 2008).

REITs are key investment tools, in order to bring savings of both individual and corporate investors into a common pool to be used in the resource-starved industry. REITs also offer an alternative to direct-asset investment for investors as well as eliminating the liquidity problem, which is the most fundamental challenge facing investment in the real estate industry (Aktan and Ozturk 2009; Kıyılar and Hepşen 2010). Turkish REITs present an alternative investment vehicle for both individual and institutional investors.

REITs were introduced as a capital market institution in Turkey several years ahead of many developed countries, including Germany, France, UK, Japan,

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R. Sotelo and S. McGreal (eds.), *Real Estate Investment Trusts in Europe*,
DOI 10.1007/978-3-642-36856-1_16, © Springer-Verlag Berlin Heidelberg 2013

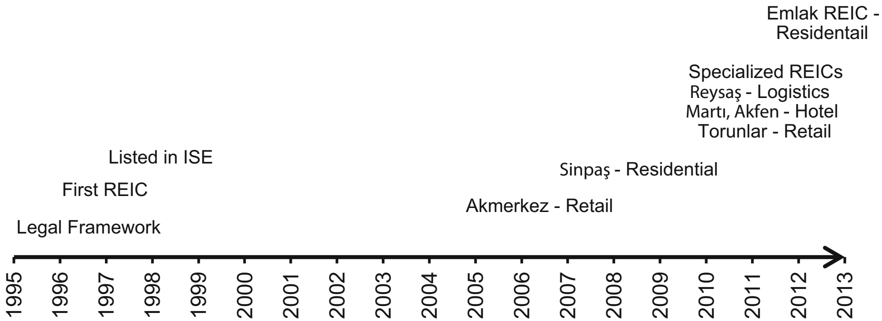

Fig. 16.1 Historical background of Turkish REICs

Singapore and Hong Kong. The legal framework for Turkish Real Estate Investment Companies (REICs) – *Gayrimenkul Yatırım Ortaklıkları (GYO)* – was prepared by the Capital Markets Board of Turkey (CMBT) in 1995. The first REIC was established in 1996 and REICs became publicly listed on the İstanbul Stock Exchange (ISE) starting from 1997.

The Turkish economy went through a severe restructuring after the financial crisis in 2001, and reached a remarkable growth performance with an average annual growth of 5.5 % between 2004and 2011, supported by the EU accession process. The Turkish real estate market has entered an upward trend, especially from 2004 onwards, following political stabilization, economic improvements and declining interest rates. As illustrated in Fig. 16.1, the number of REICs increased in line with these developments, and their portfolios specialized in certain sectors, as well.

Based on the number of REIC IPOs, the market can be divided into three phases (Fig. 16.2). The first "hot" market occurred between 1997 and 1999 when eight REICs entered the market. The period from 2000 to 2006, when very few REICs came to the market, could be classified as a "cold" market, and was then followed by a new "hot" market from 2007 onward (Arslanlı et al. 2011). The specialized REICs occurred in the later hot period, particularly in 2010.

Turkish REICs have growth potential, although total REIC market capitalization is relatively small with a share of 3 % of total stock market capitalisation, compared with REITs in developed capital markets. As of the end of 2012Q3, 24 REICs were listed on the ISE with a total net asset value of USD 7.48 billion, while market capitalization was USD 12.59 billion.

Twenty-four REICs were listed on the ISE, by the end of 2012. Three REICs started to be traded on the ISE in the first quarter of 2013, while four new REICs have been authorized for public offering, and their shares are expected to be traded on the ISE in the years ahead.

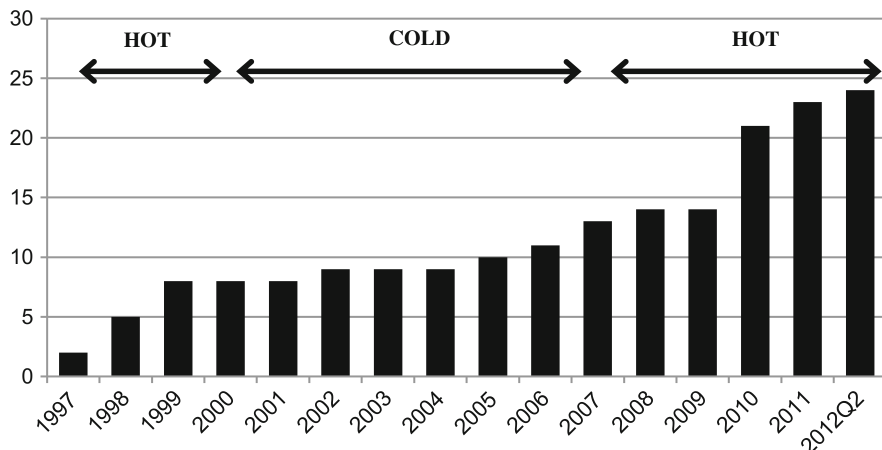

Fig. 16.2 Development of Turkish REICs (Data compiled from CMBT)

16.2 Regulations

The REIC regime is regulated by Capital Market Law and in the related Communiqué (Principles regarding REICs Serial VI, No.11). The regulations took place initially with the modification of the Capital Market Law in 1992, and then detailed arrangement was made in the related Communiqué in 1995.

Turkish Real Estate Investment Companies are established in the form of joint-stock corporations and they are legal entities. They don't have a trust status and are not managed by a board of trustees (EPRA 2012).

REICs may be constituted by establishing new joint stock companies, or existing joint stock companies can convert into REICs by amending their articles of association in accordance with the procedures of the Communiqué and Capital Market Law. For either the establishment or the conversion of a company into an REIC, CMBT approval must be obtained. The company's name must include "real estate investment company".

REICs are required to float at least 25 % of their shares to the public. REICs are obligated to apply to CMBT for offering share certificates representing 25 % of their capital to the public within 3 months after establishment. There are no restrictions on foreign shareholders.

A REIC can be established for a specific period to realize a certain project, for a specific or unlimited period to invest in certain areas and for a specific or unlimited period without any limitation of objectives.

Like REITs around the world, Turkish REICs must deal primarily with portfolio management. The portfolio of a general purpose REIC is required to be diversified based on industry, region and real estate and to be managed with a long-term investment purpose. In case a REIC is established with the purpose of operating

in certain areas or investing in certain projects, at least 75 % of the REIC's portfolio must consist of assets mentioned in its title and/or articles of association.

REIC's are required to invest in real estate, rights supported by real estate and real estate projects at a minimum rate of 50 % of their portfolio values. They can invest in time deposit and demand deposits in TRY or any foreign currency for investment purposes at a maximum rate of 10 % of their portfolio values. Investments in foreign real estate and capital market instruments may only constitute no more than 49 % of the REICs portfolio value.

Any vacant land and lots in the portfolio of the REIC, on which any project has not been realized for 5 years as of the acquisition date, should not exceed 10 % of its portfolio value.

In order to meet the short-term fund demands or costs related to the portfolio, a REIC can obtain credit at a rate of five times the net asset value. A REIC can issue debt instruments within the restrictions of the capital market legislation.

There are restrictions on the activities of REICs; they cannot be involved in the construction of real estate as a contractor. Additionally, they cannot commercially operate any hotel, hospital, shopping centre, business centre, commercial parks, commercial warehouses, residential sites, supermarkets and similar types of real estate nor can they employ any personnel for this purpose. If any real estate exists in the portfolio for the purpose of generating rental revenue, companies can provide the security, cleaning, general management and similar services to tenants for such real estates.

In order to promote the growth of the Turkish REIC industry, significant tax incentives have been granted to REICs. Profits generated from the portfolio management activities of REICs are exempt from the general applicable 20 % corporate tax. In addition, although an official exemption has not been granted, the income tax rate has been determined to be "zero" for REICs. Aside from these two incentives, REICs are subject to all other applicable taxes, such as VAT, title deed fee, except stamp duty.

An important difference of Turkish REICs from other REITs in more developed economies is that Turkish REICs do not have to pay out dividends to the shareholders on an annual basis.

The profit distributions of REICs are subject to the general regulations of the CMBT with respect to the timing, procedures and limits of profit distributions of public companies. According to the communiqués regarding dividend distributions, public companies are required to distribute at least 20 % of their annual profits after the deduction of tax provisions, legal reserves and accumulated losses.

However, based on the Communiqué public companies may freely decide to distribute dividends; (1) entirely in cash, (2) entirely as shares, (3) partially in cash and partially as shares and keep the remaining as reserves, (4) keep all the profits as reserves.

A dividend withholding tax rate of 15 % is applicable to dividends distributed to individual and foreign corporate shareholders. For REICs however, the Council of Ministers has determined a withholding tax rate of 0 %, therefore dividend

distributions to individual and non-resident shareholders of REICs create no dividend withholding tax burden.

The CMBT announced another type of CMBT-regulated company as Infrastructure Real Estate Investment Companies (IREIC) in the beginning of 2009. IREICs are closed-end, corporate tax exempt, investment companies managing portfolios composed of properties, companies, projects and capital market instruments based on infrastructure investments and services, and other capital market instruments.

As a capital market instrument, IREICs will help securitization and will provide transparency in the market. Although no IREIC has been established yet, this framework can be considering as an embryonic stage for infrastructure REITs in Turkey and will be an alternative asset class for investors (Pekdemir 2010).

16.3 Asset Allocation of Turkish REICs

There is a requirement that Turkish REICs are diversified based on industry, region and real estate and to be managed with a long-term investment purpose. REICs can engage in the following activities:

- Investing in real estate
- Investing in real-estate backed securities
- Generating rental income from their portfolios
- Real estate sales
- Purchase land to realise capital gains or to develop projects.

The proportion of property assets in their portfolio changes depending on Turkish economic conditions. During the recession period in the late 1990s, the REICs preferred to maintain liquid portfolios and took advantage of the high real interest rates in those years. Following the economic recovery, new development projects have been started and the share of property assets increased gradually. The first wave of "project development oriented" REICs adopted "develop-hold" strategies and developed their assets, mainly due to the lack of investment grade products in Turkey. On the other hand, the second wave of "project development oriented" REICs adopted "develop-sell" strategies and focused on "developer's profit" instead of "rental income & capital gain" (Fig. 16.3).

In the early stages of their development, the core business area of the major shareholders was either banking (Garanti, İş, Vakıf, Yapı Kredi Koray) or the construction/development business (Alarko, Yeşil, Nurol). Later, REICs became specialized in certain markets, especially since 2010 (Pekdemir and Soyuer 2012; DTZ Pamir & Soyuer 2007, 2012):

- Retail (Akmerkez 2005; Torunlar 2010)
- Residential (Sinpaş 2007; İdealist 2010; Emlak Konut 2010)
- Logistics (Reysaş 2010)
- Hotel (Martı 2010; Akfen 2011)

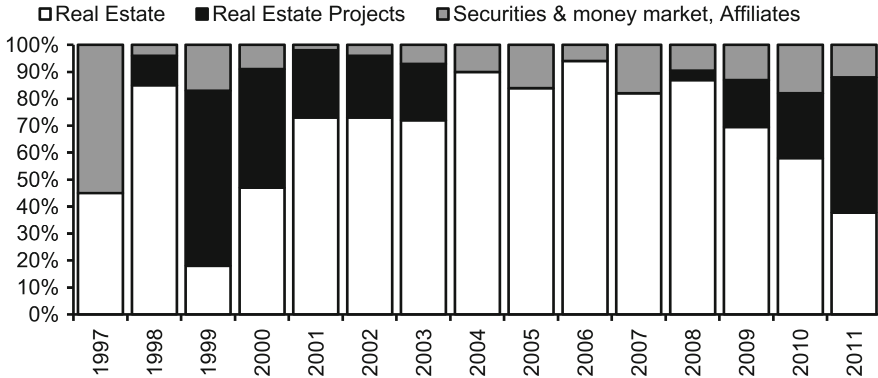

Fig. 16.3 Portfolio composition of Turkish REICs (CMBT 2013)

The REICs portfolio composition, which came on the market in different stages, displays a notable difference (Fig. 16.4). The REICs that first entered the market in the early stages, following introduction of the Communiqué, were more evenly spread across the traditional real estate sectors than the REICs that came later. In contrast, the later REICs in comparison are much more diverse, with relatively large holdings in hotels, logistics and warehouse properties as well as in the traditional sectors, with very few interests in securities (Arslanlı et al. 2011).

Another difference in Turkish REICs' portfolio composition is the significant increase of land and development projects in the total asset value. Compared with the earlier stages, their share increased almost twofold in the latest stage. In the first half of 2000s, the share of land and development projects was around 15–30 % in total asset value while the market dominated by REICs with large commercial portfolios represented around 55–70 % of total asset value. By the end of 2010, almost 50 % of the total portfolio was composed of land and development projects, while only 14 % of the total portfolio was invested in commercial assets.

As of the second quarter of 2012, land and development projects have the major shares with 25 % and 21 % in total asset value, respectively, followed by retail, residential and office properties with shares of 16 %, 9 % and 5 %. Newer sectors, such as hotel and logistics properties have only 3 % and 2 %, respectively (Fig. 16.5).

The current asset composition of Turkish REICs emphasizes development of their own assets, due to the lack of investment grade property portfolios in Turkey. REICs have become a "developer's vehicle" for construction companies and contractors. They act like "developer" instead of "investor" and also focus on "developer's profit" instead of "rental income and capital gains". Their behaviour indicates the unique characteristics of Turkish REICs, and therefore may called "Real Estate Development Companies – REDCs".

Turkish REICs can be categorized into three types by investor type, investment product and strategy, as given in the Table 16.1 and Fig. 16.6:

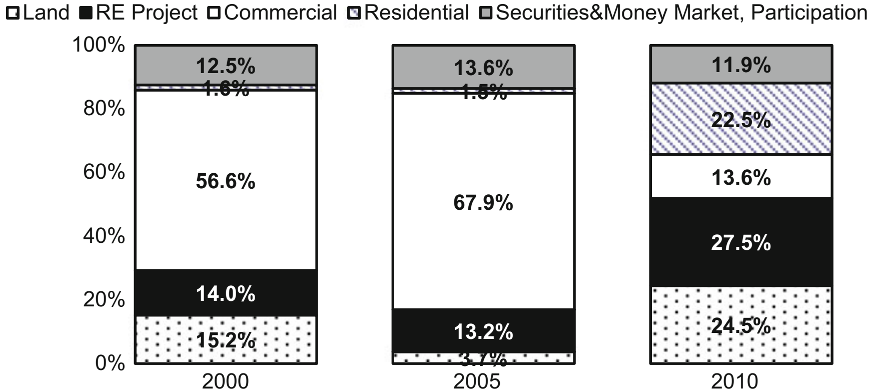

Fig. 16.4 Asset allocation of Turkish REICs in different stages (Pekdemir and Soyuer 2012)

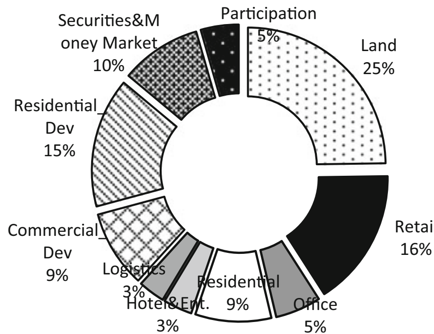

Fig. 16.5 Turkish REICs asset allocation (CMBT 2013)

Table 16.1 Turkish REICs characteristics (Pekdemir and Soyuer 2012)

Characteristics	Type I	Type II	Type III
Investor type	Investor	Developer/investor	Developer
Investment strategy	Buy/hold	Develop/hold	Develop/sell
Investment product	Income producing assets	Income producing assets	Residential sales
REICs	Akmerkez	İş	Emlak Konut, Sinpaş

Type I and Type II REICs are focused on commercial assets, which are income producing assets. They have conservative strategies and take less risk. In contrast, Type III REICs are focused on residential sales, which force them to apply aggressive strategies with higher risk. The total net asset value and distinctive characteristics of the selected REICs regarded by type are illustrated in Fig. 16.6.

The aforementioned characteristics of Turkish REICs may be attributed to a number of factors.

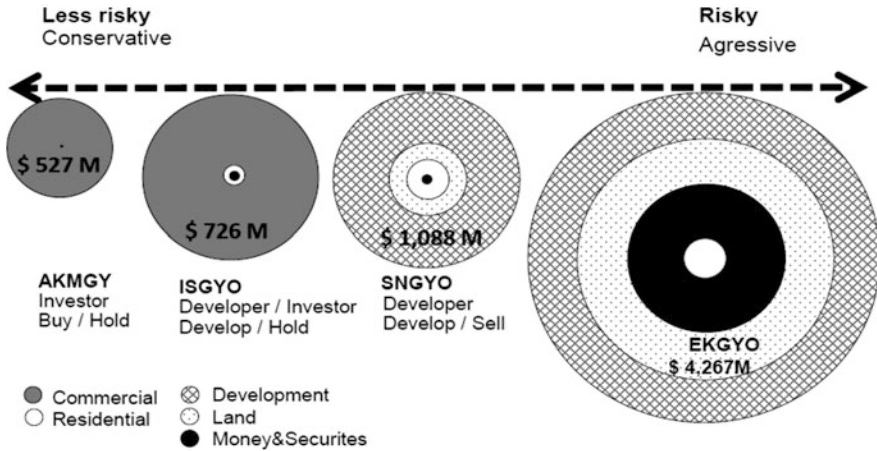

Fig. 16.6 The selected Turkish REICs characteristics (Pekdemir and Soyuer 2012)

First, the lack of investment grade products has become a chronic problem especially for corporate investors. For this reason, REICs prefer to develop their own assets, which force them to act like a developer instead of like an investor.

The second reason is difficulties in providing financing. Especially, residential assets are able to create a source for financing by the pre-sale of residential units. Thus, a developer / investor can finance the remaining developments or buy land for new projects. It should be noted that as a unique investment characteristic in Turkey, residential assets are considered for their sale instead of as income producing assets, compared with mature markets. No large companies invest in residential portfolios for leasing purposes, because residential properties provide much more return from capital gains and less income yield. Therefore, both individual and corporate investors prefer to take advantage of capital gains by residential sale.

Thirdly, REICs provide tax advantages and especially construction companies can benefit from this advantage.

16.4 Performance of Turkish REICs

Between 1996 and 1999, the aggregate net asset value of Turkish REICs increased from USD 50 million to USD 75 million while the aggregate market value increased from USD 55 million to USD 780 million. This was followed by a drop until 2002. The market value decreased to USD 207 million, resulting in approximately 70 % discount to NAV. In line with the tight monetary policy and restructuring implementation following the Turkish banking crisis in 2001, the market started to recover and reached USD 3.3 billion net asset value, until the 2008 global financial crisis. The market returned to the pre-crisis level in 2009; moreover, a huge step occurred in 2010 exceeding USD 11.2 billion net asset value.

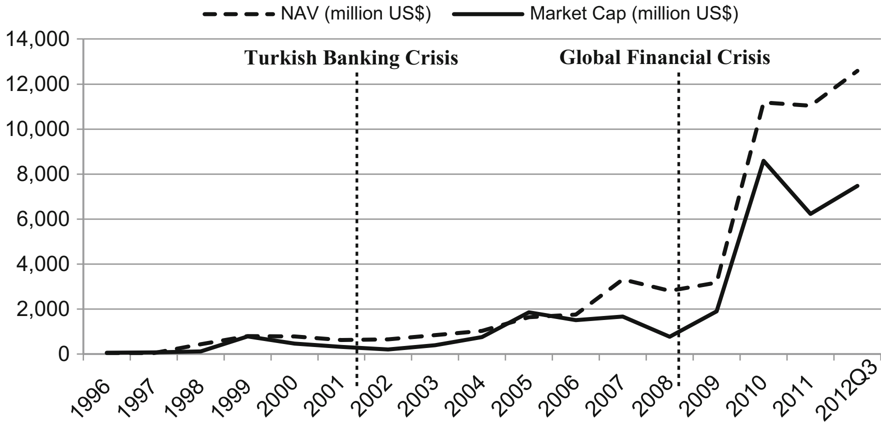

Fig. 16.7 Historical performance of Turkish REICs (Data is compiled from CMBT)

The historical net asset value and market capitalization of the Turkish REIC market is given in Fig. 16.7.

The gap between the total NAV and market capitalization of the REIC market increased significantly after 2010. As explained in the previous section, this can be attributed to the changing strategies of the large REICs which implement "develop/sell" strategies and focus on residential sales. Most notably, the entrance of Emlak Konut REIC, representing almost half of the total market NAV, changed the balance in the market. The government-oriented structure and large share of land and development projects in its portfolio may create a high risk perception in the market.

As of September 2012, the 24 listed REICs' total net asset value reached a level of USD 12.59 billion while market capitalization was only USD 7.48 billion. Emlak REIC is the industry leader both in terms of net asset value and market capitalization with a share of 46.2 % of total market capitalization. The second largest REIC, Torunlar has a share of 10.5 % of the total market capitalization, followed by Sinpaş with a share of 5.7 %. The largest three REICs represent approximately 62 % of both total NAV and market capitalization. Market capitalization and net asset value of REICs are given in Table 16.2.

As illustrated in Fig. 16.8, REICs are traded at a discounted value on the stock exchange. Possible causes of the discount may be the high ratio of land and development assets which creates a high risk perception in their portfolios and/or a low dividend payout ratio.

The return of Turkish REICs has displayed volatile performance throughout the different stages of its development (Fig. 16.9). After the enactment of the legislation, REICs were a new and untested vehicle by investors, which suggests high information asymmetry between the REICs and investors, which led to relatively high return performance in the earlier stage. Then, a strong fall in return followed, partly due to the Turkish banking crisis in 2001. The following stage was dominated

Table 16.2 Market capitalization and NAV, 2012Q3 (CMBT September 2012)

REIC	NAV (million USD)	Market cap (million USD)	Premium/discount (%)
AKFEN	611.3	164.3	−73.1
AKMERKEZ	527.1	384.4	−27.1
ALARKO	128.1	110.4	−13.8
ATAKULE	126.6	54.8	−56.7
AVRASYA	44.8	22.5	−49.8
DOĞUŞ-GE	110.9	82.7	−25.5
EGS	75.8	6.1	−91.9
EMLAK KONUT	4,266.5	3,459.3	−18.9
İDEALİST	5.2	16.2	213.4
İŞ	725.7	448.6	−38.2
KİLER	265.3	121.1	−54.4
MARTI	119.9	32.5	−72.9
NUROL	276.5	184.6	−33.3
ÖZAK	450.5	197.1	−56.2
ÖZDERİCİ	72.9	42.4	−41.8
PERA	122.4	27.9	−77.3
REYSAŞ	245.7	79.6	−67.6
SAF	402.9	450.2	11.7
SİNPAŞ	1,087.7	425.2	−60.9
TORUNLAR	2,372.1	783.9	−67.0
TSKB	193.9	57.8	−70.2
VAKIF	107.6	212.7	97.6
YEŞİL	619.5	89.2	−85.6
YAPI KREDİ KORAY	62.7	28.8	−54.1

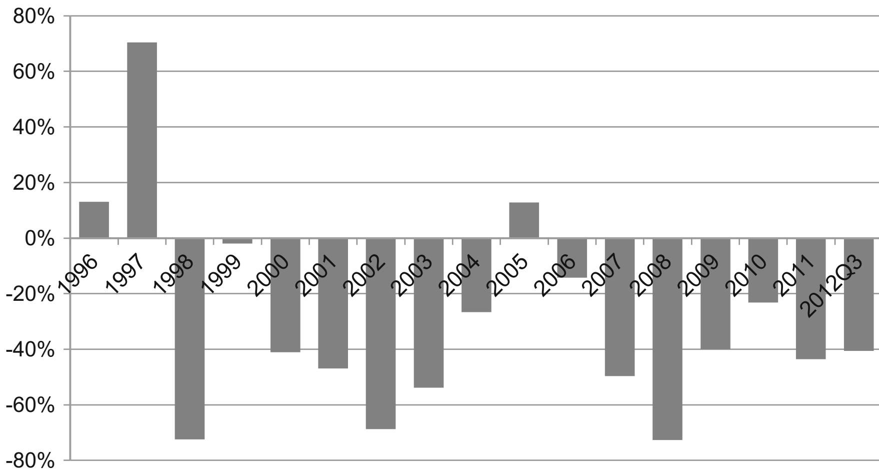

Fig. 16.8 The premium/discount trend of Turkish REICs (sector average)

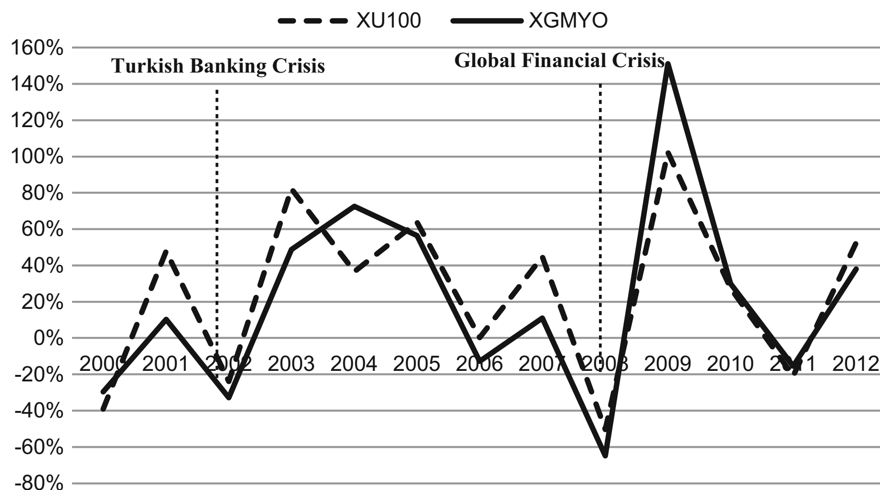

Fig. 16.9 The annual return performance of Turkish REICs versus Istanbul Stock Exchange (ISE 2013)

by REICs with a large commercial portfolio and implied higher return, followed by a fluctuation in return with the entrance of the specialized REICs. Another strong fall appeared with the negative effect of the global financial crisis in 2008, but was followed by the highest return ever which exceeded stock market returns.

According to the FTSE EPRA/NAREIT Emerging Market Index, eight listed Turkish REICs were included with combined market capitalization of USD 4 billion, as of February 2012 (Zahidi 2012). The EPRA Turkey index posted a 62 % annual growth with a healthy contribution to the EPRA Emerging Markets Index which has been one of the top performing indices with an annual return of 28 % in 2012.

16.5 Future Challenges

In the developed markets, REITs are predominantly owners and operators of high-end commercial properties with a little exposure to property development. On the other hand, the Turkish market is in its growth phase and the mix of classic REIT characteristics with added flexibility on development is perhaps the most suitable combination at the current stage (Zahidi 2012).

In fact, the construction sector is one of the engines of the Turkish economy, stimulated by an urbanization rate, population growth, young population ratio and housing demands which have expanded in direct proportion to real estate investment. The new mortgage law, introduced to the market in 2007, and the growing mortgage market will have a positive effect on the future of REICs

The recent regulation on the acquisition of property by foreigners, which allows the purchase of property without reciprocity, made the Turkish market more attractive on an international level. Foreign investors have entered the market not only by purchasing real estate, but also by directly developing projects, establishing partnerships with construction and development companies, and by making portfolio investments in the stock exchange market. Turkish REICs will play a more important role in the near future by attracting equity investment not only by domestic, but also by international investors.

The REIC regime has not only stimulated the listed market but also specialized companies focusing on specific sectors such as logistics, retail and hotels, which is one of the characteristics of a mature market. Developers need to differentiate their products with much more specialized assets. Furthermore, provided that REICs will be more active at investing in income-generating asset classes and will be able to create bigger portfolios, Turkish REICs will be more attractive for investors in the near future.

Investor interest is evident from the growth and IPOs offer good opportunity to reach new investors. The market dynamics have pushed a number of IPOs in the recent years; in addition at least four new REICs are in line for an IPO in the coming 2 years.

Turkish REICs act like developers, due to the lack of investment grade property portfolios in Turkey. Besides, construction companies prefer to be REIC to take tax-advantages. This trend is expected continue in the medium term.

Turkey has a well developed construction sector and experienced contractors, so they should not be limited to REICs, also “Infrastructure REITs” offer good opportunity for them.

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