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Introduction

In the ninth edition of our annual REIT report, we have reinvigorated our focus on global real estate investment trust (REIT) markets with a number of additions to our coverage.

This year’s report opens with an in-depth analysis of the REIT regimes around the world, in which we evaluate each regime’s maturity level according to 12 areas of focus that we believe are critical to the success of a REIT’s operations.

In the “Spotlight” section of the report, we take an in-depth look at the issues affecting seven REIT markets around the world, including:

- **Australia** – We review the state of the M&A market and its significance to REIT growth in the region.
- **Canada** – The importance of valuation metrics, corporate governance and internalization of management is discussed in the context of the institutionalization of the REIT sector.
- **India** – We explore the potential of the emerging REIT market to help spur both domestic and foreign investment into the country’s operating real estate and infrastructure sectors.
- **Japan** – We discuss the options available to REITs to grow in this mature and sometimes challenging market, including initial public offerings (IPOs) and mergers and acquisitions (M&A).
- **Singapore** – We look at the state of REIT management structures in view of growing the market’s attractiveness to foreign investors.
- **UK** – UK REITs would be well advised to keep a close eye on their construction projects, especially related to construction cost escalation and contractor risk.
- **US** – We discuss the opportunities and challenges created by the increasing flow of investment dollars from foreign investors into the US real estate market, along with the impact of activist investors on the sector.

We hope you find this report informative and useful as you continue to grow and develop your business.

Sincerely,

Howard Roth
Global Real Estate, Hospitality and Construction Leader
EY

Mark Kaspar
REIT Sector Leader
EY
Introduction and methodology

REITs have become an increasingly popular vehicle for real estate ownership. Global market capitalization now stands at approximately US$1.7t, up from US$734b in 2010.1 As Figure 1 shows, since 2010, the US REIT market has grown by almost 150%, while the market capitalization of non-US REITs has more than doubled in United States dollars (USD) terms. The two fastest-growing markets in the last five years have been Australia and Japan, both of which have now overtaken France and the UK to be the second- and third-largest global REIT markets, respectively.2 As our country spotlight sections explore in more detail, M&A activity, and to a lesser extent IPOs, are clearly evident in these markets, as the REIT concept continues to attract new capital.

Figure 1: REIT market cap by market, 2010 vs. 2016 (US$b)

The REIT concept is over half a century old. The US first introduced REIT legislation in 1960, and today, roughly two-thirds of the global REIT market cap resides in the US.3 Countries such as Australia, New Zealand and the Netherlands were early adopters and have grown significantly. The last 10 years have seen a notable increase in the number of countries introducing the REIT concept; 16 jurisdictions have introduced REIT or REIT-like legislation since 2006, although not all have fully functioning active participants.4 According to SNL Financial, that brings the total number of countries with REIT or REIT-like regimes to 36 today.

REITs globally take many forms, with significant differences in structure, strategy and operations. However, we believe that their activities can be broadly categorized into 12 areas, which are shown in Figure 2. The maturity of the REIT concept globally now means that for any of these 12 characteristics, it is relatively easy to find examples of leading practices. As the REIT concept continues to grow globally, this should provide invaluable insight for new entrants.

1. SNL Financial, SNL XL Database; accessed July 2016.
2. Ibid.
3. Ibid.
Global REIT markets

The relative maturity of REIT regimes will likely impact the operations and activities of specific REITs within any particular jurisdiction. Recognizing a country, or ultimately an organization’s relative standing on this maturity scale, may help identify factors or issues that need to be addressed. We have grouped the results of our analysis into four categories: nascent, emerging, established and mature. With many examples globally of leading practices in each of our 12 areas, organizations that reside in our nascent or emerging categories have the opportunity to move forward rapidly by avoiding the mistakes made by those in some of the more mature jurisdictions.

As Figure 4 highlights, the US alone accounts for almost 66% of global REIT market capitalization. Just under 30% is held in our established category.

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**Figure 2: The 12 areas of focus for REIT management teams**

<table>
<thead>
<tr>
<th>Capital flows/flow of funds to the sector</th>
<th>Corporate structure</th>
<th>Capital allocation</th>
<th>Transaction activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing</td>
<td>Property specifics</td>
<td>Regulatory environment</td>
<td>Risk management</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Financial reporting</td>
<td>Cross-border issues</td>
<td>Market trends</td>
</tr>
</tbody>
</table>

For any given entity, the relative importance of the 12 characteristics will vary. We believe that 9 of these 12 areas can be assessed at a country or REIT jurisdiction level to provide an indication of relative maturity. The three areas that we do not believe lend themselves to a macro assessment are corporate structure, capital allocation and market trends. These three areas vary at the country and entity levels with considerable scope and should be tailored to an organization’s structure or approach to its specific market.

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**Figure 3: REIT jurisdictions – maturity***

- **Nascent**
  - Bahrain
  - Brazil
  - Bulgaria
  - Costa Rica
  - Greece
  - Hungary
  - India
  - Israel
  - Kenya
  - Pakistan
  - Philippines
  - Taiwan
  - Thailand
  - United Arab Emirates (UAE)
  - Vietnam

- **Emerging**
  - Belgium
  - Finland
  - Ireland
  - Italy
  - Malaysia

- **Established**
  - Australia
  - Canada
  - France
  - Germany
  - Hong Kong
  - Japan
  - Mexico
  - South Africa
  - South Korea
  - Spain
  - Turkey

- **Mature**
  - Netherlands
  - New Zealand
  - Singapore
  - United Kingdom
  - United States

*A detailed description of the analysis used to evaluate the REIT regimes’ maturity can be found in the Appendix on page 36.

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**Figure 4: Market capitalization by category (US$m)**

- **Total US$1.7t**
  - 1,337 (Nascent)
  - 75,778 (Established)
  - 496,386 (Mature)
  - 1,102,935 (Nascent)

Source: SNL Financial
Nascent markets

Most of the countries categorized as nascent have yet to see a listed REIT, even though basic REIT legislation exists. India is a good example where tax legislation remains challenging, even though broader REIT rules are now in place. We explore this issue in more detail in the India section of this report.

This group represents the next wave of REIT markets as regulatory and legislative issues are ironed out. When that occurs, companies and REIT markets can move forward rapidly. Spain provides a good example of how quickly things can change; the Spanish SOCIMI REIT (Sociedades Anónimas Cotizadas de Inversión Inmobiliaria) concept was introduced in 2009, but the original rules included a 19% corporate tax rate that failed to negate the double tax issue experienced by international investors. As a result, no SOCIMIs listed on the Spanish stock exchange between 2009 and 2012. In late 2012, the SOCIMI tax rules were revised and the requirements brought more in line with REITs globally. In 2013 SOCIMIS started listing on the Spanish Mercado Alternativo Bursátil alternative market. Many of these organizations did not raise new capital; rather, owners took advantage of the SOCIMI structure as a more favorable tax wrapper in which to hold existing assets. In 2014, four SOCIMIs listed on the Continuo (main) market, raising US$3.6b of equity capital. This group has seen its market cap grow 72% to US$6.2b today. Transaction volumes of US$5.6b from these four entities have accounted for 17% of activity in Spain since 2014 and have done much to restore liquidity to the broader Spanish commercial real estate market.

Listings as a result of regulatory improvements are not enough to move some of the countries in this group into the emerging category. As Figure 5 shows, many of these countries are developing in areas such as country risk, ease of doing business and property-level transparency, which we use as proxies for the relative health at a country level of risk management, ease of operating across borders and property-level metrics.

Figure 5: Country risk – average ranking by level of maturity

Source: The World Bank

Global investors will likely remain cautious of backing entities whose value is underpinned by an immobile, illiquid asset without the comfort of greater transparency. However, a strong corporate wrapper may entice global investors, and listed status can help bring liquidity. REITs can play a role in improving transparency by implementing good corporate governance, financial reporting and risk management practices and communicating regularly with investors across all aspects of the business.

Emerging markets

This category includes many of the younger REIT markets such as South Africa, Mexico, Ireland and Spain. There are two issues currently challenging these markets, neither of which are likely to be a long-term impediment to progress:

1. Country-level metrics such as risk, real estate transparency, ease of doing business and general corporate governance are generally considered adequate rather than particularly strong.

2. Market cap – Most countries have REIT sectors with market caps under US$10b.

Mexico and South Africa rate well from a property perspective with REIT sectors in excess of US$15b and reasonably good real estate transparency scores. Broader equity and debt markets are, however, relatively small (by global standards) and neither country scores particularly well in areas such as transaction volumes, ease of doing business or country risk. South Africa is, nevertheless, an example of where a mature and global real estate investor community already exists. Aside from supporting the growth of their domestic companies, this has led to a number of UK REITs undertaking secondary listings on the Johannesburg Stock Exchange to broaden their access to capital.
Established and mature markets

The established and mature categories share many of the same traits. These countries have large, developed real estate markets that attract both domestic and international capital. They are enhanced by deep and liquid equity and debt markets, as well as a mature and reasonably open corporate environment.

One area of differentiation across this group is the propensity with which companies have adopted the REIT concept (see Figure 6). Hong Kong and Germany are prime examples of regions where non-REIT structures remain the preferred listed concept. Japan and Singapore, and to a lesser extent the UK, are jurisdictions where REITs are important but are just one of the listed structures available.

Figure 6: REIT market cap as a percentage of listed real estate market cap

In many cases, this is likely due to either the nature of a specific company or the characteristics of the REIT legislation itself. Most notable perhaps is the amount of development undertaken and the challenge this poses to distributable income, risk profile and the composition of returns (income vs. capital). REIT structures are unlikely to be suitable for companies more focused on development activity, and in some cases, like Japan, development within a REIT structure is prohibited.

In recent years, the decline in long-term interest rates has pushed investors toward robust income streams. This has favored REITs. In Japan, for example, the approximate 3.1% dividend yield offered by REITs is significantly higher than that available from the major developers (generally less than 1.5%). Consequently, the REIT share of listed real estate has grown from 32% in 2010 to 43% today.

M&A activity in our mature and established markets picked up through 2015 and 2016 year to date (YTD). Transaction volumes increased by almost 60% in the US during 2015, partly as a result of more conducive equity pricing. The first half of 2016 has seen a further US$13.5b of deals. Markets such as Australia, Japan, Germany and the UK have also seen notable transactions.

10. Ibid.
12. Ibid.
Two themes have been evident: first, private equity real estate funds have taken REITs private, and second, REITs have looked to M&A as a way to grow. Large private equity funds and global real estate investors are currently awash with capital — 10 private equity real estate fund managers collectively raised over US$50b in 2015.13

High-quality assets such as those owned by many REITs remain attractive in a world where drivers such as demographics and technology are rapidly changing the way people work and live. In the US, several going private and REIT-to-REIT merger transactions have occurred over the past two years.

Also, mature capital markets have helped facilitate consolidation in the REIT sector where M&A provides an alternative to organic growth. In Australia, the growth of direct real estate investors from overseas (Sydney has been the fourth most popular destination globally for cross-border capital in the last five years and Melbourne is ranked ninth)14 has created a very competitive domestic market. Market conditions remain favorable, and as the Australia spotlight section explores in more detail, we believe further transactions are both likely and to the benefit of the wider REIT market.

REITs in 18 countries have raised equity capital since the beginning of 2015. Mature or established markets like the US, Japan, Singapore and Australia have generally led the way, but fundraising has also been significant in emerging markets like Spain. Globally, REITs raised approximately US$53b in 2015 and a further US$36b through mid-August 2016.15

US institutional REIT ownership has historically been dominated by a relatively small number of major REIT investors. SNL Financial suggests that at the end of 2015, 20 institutions owned US$388.6b of US REIT common equity. The September 2016 change in the Global Industry Classification Standard (GICS®), in which real estate gained its own classification, should be a further catalyst to the sector. According to SNL Financial, the 20 largest actively managed mutual funds with REIT exposure had average holdings of 1.55% against the benchmark weighting of 3.17%. Weightings have increased but only 3 of the 20 funds were overweight REITs at their last reporting date.16 This GICS change validates the growing institutional acceptance of REITs as a stand-alone and legitimate asset class. In many markets this change will likely serve to bolster fund flows to the sector, but it may also challenge some REITs to revisit their operations, structure and capital allocation in light of an increasingly institutionalized investor base. As we explore further in our spotlight sections, this looks to already be the case in some markets such as Canada.

Spotlight REIT regimes
There are a number of key factors that are currently shaping the performance environment and near-term outlook for the Australia REIT (A-REIT) market. Trends in valuations are driving new equity issuances and increasing M&A activity.

**Are valuations too high?**

The A-REIT market has experienced a strong run of performance for the best part of five years. The benchmark S&P/ASX A-REIT 200 Index is currently trading at an all-time high with the pre-global financial crisis high watermark (achieved in February 2007) exceeded for the first time on the last day of June 2016.¹

The strong performance of the A-REIT market has, in part, been carried by a rally in broader equity markets. While the correlation of return between A-REITs and the broader market remains high at around 0.80, A-REITs have outperformed in down-markets, consistent with the defensive performance expectations for the sector.

We believe the future M&A in the A-REIT sector will be predicated on delivering both financial and nonfinancial benefits to investors.

We are observing a growing divergence in views on current A-REIT valuations with two schools of thought. The first sees current pricing supported by reasonable earnings fundamentals, strong transactional evidence and a historically wide bond spread. The second highlights concerns about yields being at or near historic lows and the danger of capitalization and discount rates widening from here. It will be interesting to observe how this plays out in terms of future price corrections in the A-REIT sector. To the extent that bond yields continue to be bid down, however, this will support the performance of the A-REIT market.

Sourcing returns through acquisitions and M&A

The Australian REIT sector saw approximately US$6.8b in M&A activity in 2015. Most of that (US$6.6b) comprised the Federation Centres merger with Novion Property Group. The remaining US$230m included 360 Capital Industrial Fund’s acquisition of Australian Industrial REIT. Deal activity in 2016 has been more muted, with just one US$42m deal taking place: NorthWest Healthcare Properties Real Estate Investment Trust’s acquisition of Generation Healthcare REIT.

Current elevated pricing also means that organic growth is harder to achieve as the cost of capital increasingly diverges from the underlying return on assets. This is supporting M&A as A-REITs look to grow through accretive acquisitions.

Over the past three months, a number of major A-REITs have been active in the acquisition of new direct properties (e.g., Mirvac Group's US$167m majority acquisition of Toombul Shopping Centre in Brisbane and Charter Hall’s acquisition of two industrial properties for US$44m).

Takeover plays have also occurred, as demonstrated by Centuria and Growthpoint’s efforts to acquire the management of the US$440m GPT Metro Office Fund. The concentration of the A-REIT market toward the established landlords (Westfield/Scentre, Goodman, etc.) means that smaller A-REITs are seeking opportunities to consolidate and achieve better economies of scale, enhance liquidity and, ultimately, be in a stronger position to participate in the market and enhance returns to shareholders.


Outlook

Looking ahead, M&A options afford a number of operational benefits, particularly for smaller A-REITs as they seek to compete with larger landlords in the market. For example, a well-planned synergistic merger can offer an opportunity for shareholders to benefit from cost and management efficiencies using the acquirer’s existing management infrastructure and further enhance balance sheet strength. We believe the future M&A in the A-REIT sector will be predicated on delivering both financial and nonfinancial benefits to investors, particularly in an environment of tightening yields and lower asset returns.
The Canadian real estate market is rapidly evolving into an institutionalized asset class. Institutions have their foot on the accelerator, real estate allocations are increasing in both the public and private markets, and there are no signs of this trend abating. A number of market changes have borne this out. On the private investor side, an EY survey of Canadian pension funds concluded that every fund surveyed either recently added an allocation, was expecting to increase their fund allocation or was considering adding to their fund real estate investments. Anemic bond yields were cited as the top justification. Recent news of British Columbia Investment Management Corporation (BCIMC) internalizing and growing its real estate investments further validates the importance of real estate in the private institutional investor markets.

Figure 1: Institutional shareholder ownership percentage by market cap category

<table>
<thead>
<tr>
<th>Market cap</th>
<th>Ownership Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;US$1b</td>
<td>22%</td>
</tr>
<tr>
<td>US$1b-US$2b</td>
<td>44%</td>
</tr>
<tr>
<td>&gt;US$2b</td>
<td>37%</td>
</tr>
</tbody>
</table>

Source: SNL Financial
In the public markets, real estate has been designated as a sector under the Global Industry Classification Standard structure. This was implemented on 31 August 2016. In the past, REITs have been included in the GCIS Financials sector, and given their relatively small weighting and relative illiquidity, they have historically been overlooked by institutional investors. According to SNL Financial, institutions own just 35% of the US$47b market cap of the Canadian REIT sector. However, the new GICS sector will provide a higher profile for REITs. With real estate having its own GICS sector, institutional fund managers will need to explain why they are underinvested in a sector that has significantly outperformed the broader Canadian market over the last 10 years.

This view has certainly been validated by the REIT performance YTD. As of 25 July 2016, the S&P/TSX Capped Real Estate Index had delivered a total return of 15.3%, beating the S&P/TSX Composite Index, which delivered 13.4%. The relative outperformance of the REIT sector is overshadowed in Canada due to the strong performance of the broader commodity-heavy Canadian market. This was driven by a soaring recovery in commodity prices in the past year. The phenomenon is more pronounced in the US, where the commodity-light S&P 500 Index has significantly underperformed the MSCI US REIT Index with total YTD returns of 7.4% vs. 15.7%.

Not surprisingly, the largest and most liquid Canadian REITs have posted significant outperformance in the sector YTD as investors move their portfolio market weight into REITs. Some may argue that the volatility following the UK’s Brexit referendum has had a stronger negative impact on the broader market than the REIT sector. The sector is, more often than not, viewed by investors as a “defensive” sector that benefits from a benign interest rate environment and pullback in Government of Canada (GOC) bond yields. However, it appears that the S&P 500 has fully recovered to levels even higher than those at the date of the Brexit announcement.

The shareholder register of Canadian REITs is likely to change significantly as the sector attracts new institutional capital. Consequently, it would seem that the questions on every Canadian REIT CEO’s mind in 2016–2017 should be how to compete for capital among a highly sophisticated investor base and how to appeal to a broader investor base.

What REITs should consider

Focus on key valuation metrics disclosure:

Two of the three key valuation metrics on which institutional REIT investors base their investment decisions are funds from operations (FFO) and adjusted funds from operations (AFFO). These are determined
from REIT public disclosures. Yet FFO and AFFO are not audited metrics. While FFO is prepared by management in accordance with the FFO white paper standards, there are still many subjective inputs that can vary from REIT to REIT, including the adjustment for capitalized interest. AFFO remains totally subjective, and there is no consistency in the assumptions underlying the key components in deriving AFFO, such as estimated recurring capex expenditures.

In order to compete with other GICS sectors where key valuation metrics such as earnings are consistent and audited among all market participants, a greater push by the Canadian REIT industry in regulating these key metric disclosures would be prudent.

Focus on corporate governance: Some REITs have been placing greater emphasis on corporate governance to make themselves more attractive to potential investors. The boards of trustees of several large REITs have moved to grant additional rights and remedies to unitholders to achieve parity with the investor protection guarantees that are automatically provided to corporate shareholders under the Canada Business Corporations Act. The Canadian Coalition for Good Governance (CCGG) is a shareholder rights group backed by many of Canada’s largest pension funds and money managers. In 2007, when corporations converting to income trusts were still a common occurrence, the CCGG began pushing for income trusts to offer the same rights and remedies for investors that corporations offer. It seems likely that the same could follow for REITs, given their new GICS profile. To date, five high-profile REITs have added investor protection mechanisms. Such investor protection mechanisms may include access to an “oppression” remedy (which ensures all securities holders are treated fairly) and “dissent and appraisal” rights (which essentially allow investors to bow out and demand fair value for their stakes if there is a fundamental change in what the company does). These mechanisms may also include enhanced procedures for, and conduct at, unitholder meetings. However, the investor rights granted cannot be identical to those available to shareholders of corporations because they have to be given through contract rather than through statutes such as those in the Canada Business Corporations Act.

Internalize management: Whether or not it is warranted, external management presents the potential for a conflict of interest between unitholders and management, and for this reason, externally managed REITs have been a relatively small component of the US REIT market (a more mature REIT market than Canada) for over a decade. The Canadian REIT market, where external management structures once thrived, has seen the species slowly dwindle away as institutional investors start to penalize valuations and, in some cases, boycott externalized REITs altogether.

Look to US REIT leading practices as a compass: The US institutional investor market to Canada is an important benchmark. Approximately 50% of foreign fund flows into Canadian real estate over the last decade have been from US investors who are, by far, the most active foreign investor in Canadian REITs.3

In order to compete with other GICS sectors where key valuation metrics such as earnings are consistent and audited among all market participants, a greater push by the Canadian REIT industry in regulating these key metric disclosures would be prudent.

The Indian securities market regulator, Securities and Exchange Board of India (SEBI), authorized the framework for Real Estate Investment Trusts (REITs) and Investment Infrastructure Trusts (InvITs) in India in September 2014, thereby paving the way for introduction of an internationally accepted investment structure in India.

In India, REITs have been created as vehicles for housing completed revenue-generating assets such as commercial office property, while InvITs have been created as vehicles for revenue-generating infrastructure assets such as roads, highways, warehouses, etc.

The framework introduced for REITs and InvITs in India is similar to the guidelines prescribed by the regulating agencies in international jurisdictions such as the US, UK, Singapore and many other countries. One key difference between the REIT framework in India vis-à-vis the US is that in the US, listed REITs are primarily managed internally, whereas in India, they are externally managed.
While these regulations were introduced in September 2014, the tax provisions were not attractive enough for the market to launch any REITs or InvITs, as the stipulations did not promote tax efficiency. Accordingly, based on feedback from industry participants and key stakeholders, authorities changed the regulations and tax provisions to provide greater clarity around tax requirements.

At present, India’s real estate market is in dire need of capital, as banks have reached a bottleneck where lending to the real estate industry is not a priority. Data on real estate transactions for the past few years shows that private equity funds, pension funds and sovereign wealth funds have been active in providing much-needed liquidity to the real estate. Developers have benefited from investors acquiring office properties in order to create the liquidity they need to expand their presence in the market. As Figure 1 shows, 2015 marked a watershed moment where the volume of office transactions exceeded that of development sites.

Most of the transactions have been between funds and developers, and, in most cases, the deals employed equity as well as structured debt. The current real estate market size of US$140b is projected to be US$180b by 2020. Per industry estimates, approximately US$43b to US$54b of those real estate assets are eligible for REIT status. The market capitalization of listed Indian real estate developers is approximately US$14b, and they raised approximately US$3.3b between 2011 and July 2016. For the market to meet its projected growth, significant funding will be required in the future. REITs will be able to provide a much-needed capital injection into the real estate sector, which developers can use to monetize assets and raise funds.

Under the Indian REIT regime, some of the key regulations include minimum asset size of US$74.37m; minimum offer size for initial offer of US$37.19m; mandatory listing on a recognized stock exchange; 80% of its asset value in completed and rent-generating properties either directly or via special-purpose vehicles; distribution of at least 90% of its net distributable cash flows to investors; and a maximum of three sponsors in a REIT with a minimum holding of 15% of outstanding units at all times. India, in spite of being the second-largest country in terms of population, is lagging behind in terms of infrastructure facilities, as there are still cities without basic infrastructure. India ranks 81 out of the total 140 countries in terms of infrastructure in the World Economic Forum’s Global Competitiveness Report 2015-16. India needs INR26t (US$405b) for its infrastructure development by 2020, with about 80% of the funds needed for power, roads and urban infrastructure segments. Additionally, the government of India has earmarked INR500b (US$7.8b) and INR480b (US$7.5b) to develop 100 smart cities across the country and for the transformation of 500 cities under the Atal Mission for Rejuvenation and Urban Transformation (AMRUT) mission, respectively. As per the Foreign Direct Investment Policy, there is no specific prohibition on investment by an overseas REIT into an Indian REIT. However, one of the clauses of SEBI regulations specifies that an Indian REIT shall not invest in another Indian REIT. The question of permissibility of an overseas REIT investing in an Indian REIT would require a confirmation from SEBI.

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There is a real need for investing capital in both real estate and infrastructure in India. Almost all the large players are over-leveraged and in need of funds. Banks and private lenders are not keen to fund these businesses, and, as a result, infrastructure companies and real estate companies are stuck in a deadlock and are not able to deliver projects. Equity is currently the primary need in the sector, and REITs/InvITs will be an essential new source of equity for developers.

**Key challenges in the Indian market**

Despite high demand for property, the Indian markets have yet to see the launch of the first REIT or InvIT. This is attributable to the following commercial and regulatory factors:

- Companies engaged in infrastructure and real estate development or ownership are generally dependent on debt, which constitutes 70%-80% of their financing requirements. However, REIT and InvIT regulations provide that borrowings by a REIT or an InvIT shall not exceed the overall limit of 49% of total assets. This condition may not be practically possible to satisfy given the current market conditions and lack of equity capital.

- Given that there is no REIT/InvIT that has listed yet, there is no guidance or benchmark around the valuation metrics and expectations. Companies are cautious and do not want to be the first one to go out into the market to discover valuation and pricing.

- An important issue that needs to be addressed immediately is enabling a tax-efficient transition/transfer of existing, completed infrastructure/rental assets to InvITs/REITs without having to compromise on the tax costs apart from stamp duty issues, which still seem to be deal-breakers. The income tax breaks currently extend only to transfer of shares of the company in which the assets are held as all asset transfers or sales would be a taxable event.

- Guidelines with respect to REITs and InvITs provide that assets should not be purchased at a value less than 90% and more than 110% of their appraised value by professional appraisers. This can reduce bargaining power and flexibility when there are distressed assets available in markets.

- Guidelines for REITs also provide that the area leased to a related party cannot exceed 20% of the underlying area of assets. This significantly reduces the possibility of a REIT executing an intragroup sale and leaseback kind of transaction, which is a very common occurrence among related parties in India.

Despite the above, developers have started undertaking initial go/no-go studies. Further, the government is advancing the agenda of REITs and InvITs and is keen to see these vehicles emerging successfully in India. Success of these vehicles will offer perpetual capital and exit opportunities for developers and financial investors, allowing them to unlock capital employed in completed assets. It will also offer international investors a transparent regime to invest in a revenue-generating asset with exit flexibility. We expect international capital to find its way into India and deployed in REITs/InvITs once these impediments are resolved.

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7. “Clause 21(8) of the REIT regulations and InvIT regulations,” Securities and Exchange Board of India, 26 September 2014.

8. “Clause 19(7) of the final regulations related to REIT,” Securities and Exchange Board of India, 26 September 2014.
The Japan REIT (J-REIT) market is developing rapidly along a similar path to the US REIT market due to growth as a result of active equity offerings, J-REITs’ active role in the real estate transaction market and diversification of property sectors.

The development of the J-REIT market

The J-REIT market is currently the second-largest REIT market in the world behind the US market, with a total market capitalization of JPY11.6t (US$112b)\(^1\) as of June 2016. J-REIT market capitalization has nearly quadrupled since late 2011, after having suffered a decrease during the global financial crisis and the East Japan earthquake in 2011.

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\(^1\) SNL Financial, SNL XL Database, accessed July 2016.
There are three key factors contributing to the expansion of the J-REIT market.

**Market growth due to equity offerings**

Since the 2012 recovery, there have been active equity offerings. Total equity amounts raised from 1 January 2012 through 31 December 2015 exceeded JPY3t. Approximately one third was raised from IPOs and two thirds from follow-ons (see Figure 2). The Tokyo Stock Exchange (TSE) REIT Index has risen to 1,850 in 2016 from 1,000 in 2012.² J-REITs are predominantly owned by banks and corporations (retail investors account for less than 10%). Although overseas investors account only for approximately 20% of all investors in the J-REIT market, the market has been influenced by overseas investors, since overseas investors have participated in approximately 50% of the transactions.³ They have benefited from various monetary policies implemented after Prime Minister Abe took office in late 2012 as part of “Abenomics.” Quantitative easing, which involved the purchase of J-REIT shares by the Bank of Japan (BOJ), has supported the market when it has come under pressure. Adoption of negative interest rates by the BOJ, when combined with attractive dividend yields, has also encouraged investors to favor the sector. The delay of a consumption tax hike (from 8% to 10%) until October 2019 has been a further catalyst.

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**J-REITs are prominent in the real estate transaction market**

J-REITs are now beginning to play an important role in the real estate market in Japan. According to Jones Lang LaSalle, during the first half of 2016, commercial real estate investment volumes by listed J-REITs account for 44% of total commercial investment volumes, with private funds contributing the second-largest amount of capital. Furthermore, J-REITs purchased more high-quality and landmark properties as well as more regional and local properties in recent years.

**Diversification of property types**

We have seen new sector-specific J-REITs in recent years. Among 57 J-REITs listed at August 31, 2016, about 30 REITs were listed before the global financial crisis and half of these REITs are diversified REITs. Furthermore, office, residential and retail sectors including diversified accounted for 90% of the total number of REITs. After the global financial crisis, there were more new property sector REITs, including an additional four logistics, three health care and three hotels with spa facilities. In addition, two regionally focused REITs and a neighborhood shopping center REIT were listed.
Traditional REITs will also continue to grow in number. At 31 August 2016, there are 57 listed J-REITs. There are several registered REITs waiting for IPOs and a few others currently under preparation.

There are a number of important issues and considerations that need to be addressed to structure a J-REIT with diversified property types, including specialized assets. The practical questions relate to "business model," "risk management" and the "lease structure" relevant to a particular property type. Sponsors considering a REIT structure need to consider eight key questions:

1. REIT-able assets: Are they REIT-able assets from both a strategic and technical perspective?
2. Business model: Can sponsors create a viable business model with a compelling growth strategy?
3. Risks: Have you identified any unique risks? How can you manage these risks?
4. Lease structure: Have you considered an appropriate lease structure?
5. Sale and leaseback: How should a sale and leaseback transaction with an operator be structured?
6. Rent provisions: Have you considered various rent provisions, such as fixed/variable rents, incentive mechanisms, the lease term, renewal options and rent reviews, to achieve an appropriate earnings structure?
7. Responsibilities for capex: Who is responsible for repairs/maintenance and capital expenditures? Lessor or lessee?
8. Operational issues: What are the business, accounting and tax consequences with a particular REIT structure?

REIT era with an initial wave of IPOs. In the US, that was then followed by a period of consolidation. We could see the same in Japan, given the 30 J-REITs with market cap between US$1b-US$5b. Consolidation could be an important avenue for growth if market conditions (e.g., lack of available product) and features such as external management and limitations on activities and structures continue to restrain organic growth.

Should the regulatory restrictions ease, or more non-core/specialized assets such as net retail, hospital, data center and self-storage form as REITs, it appears that the J-REIT market has room for growth.

**J-REIT challenges**

**Regulatory issues**

J-REITs are generally externally managed by an asset manager like many other Asian REIT regimes. The J-REIT model is a very passive REIT regime compared with the US REIT regime. For instance, neither property development nor active operations are allowed by J-REITs. No taxable REIT subsidiary (TRS) exists, no umbrella partnership REIT (UPREIT) structure is available and there is a 50% ownership limitation in another corporation. Additionally, no preferred share or convertible bonds can be used to finance the REIT’s activities.

**Growth limited by supply pipeline**

J-REITs are faced with a limited supply of available properties. Active participants, including private funds, private REITs and J-REITs are competing for a scarcity of quality properties. There is also a wide gap on expected yield between sellers and buyers. With no tax mechanism such as an UPREIT structure to facilitate the transfer of the property to J-REITs, supply by the corporate real estate community through sale-leaseback structures is also limited.

**The J-REIT market: outlook and opportunities**

We see two themes emerging in the J-REIT market:

**Further growth in both “traditional” and “nontraditional” REIT markets.** More diversified property REITs with operational and specialized assets present opportunities for nontraditional REIT players. A lot of corporations currently own operational assets on their balance sheets. For instance, many retail properties, including supermarkets, convenience stores, stand-alone gas stations and restaurants are owned by retail operating companies.

Challenging growth environment for existing REITs. It is somewhat surprising that the J-REIT market has expanded so significantly with relatively few property types, difficulties in sourcing property and restrictive operating conditions. In some ways, the evolution of the J-REIT market is mirroring that of the US in the modern...
Since the launch of the first Singapore REIT in 2002, the REIT sector has become one of the biggest success stories of the Singapore Stock Exchange (SGX). Singapore REITs have since grown into a US$53b market, the sixth-largest market globally by market capitalization according to data compiled by Bloomberg. After Japan and Australia, Singapore now has the third-largest REIT market in Asia. It is twice the size of the Hong Kong REIT market, which ranks fourth.

How did the Singapore REIT market grow into a US$53b real estate market in the relatively short span of 14 years on an island that measures just 31 miles (50 kilometers) from east to west? Apart from an attractive REIT regulatory framework that affords investors sound governance practices and a highly favorable tax regime, it requires REITs in Singapore to look beyond its 120-mile (193 kilometers) shoreline.

Figure 1: Asian REIT market cap (US$b)

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Cap (US$b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>110</td>
</tr>
<tr>
<td>Australia</td>
<td>105</td>
</tr>
<tr>
<td>Singapore</td>
<td>53</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>27</td>
</tr>
</tbody>
</table>

Source: SNL Financial

Unlike other REIT markets that remain largely domestic in their focus, Singapore REITs hold properties from all over the world. In fact, more than two-thirds of Singapore REITs hold foreign properties, and 10 of the 32 REITs have portfolios that comprise entirely foreign properties. These numbers will continue to grow with the mounting challenge to find “REIT-able” quality assets within the land-scarce country.

Another striking characteristic is that REITs in Singapore are typically established and supported by a strong sponsor. Given the development-driven nature of the REIT market, the support provided by the sponsors (especially developers) can be significant. In fact, strong sponsor backing and the importance of sponsors in the supply of assets have been important drivers of the growth of the Singapore REIT sector.

Undoubtedly, the continued success of the Singapore REIT sector will depend on its ability to respond to increased competition from existing and emerging REIT regimes in China, India, Indonesia, Thailand and the Philippines. At the same time, hot-button issues will arise – oftentimes a natural phenomenon as the market matures. The need for the sector to duly consider and, where necessary, address such issues should not be downplayed. Two such issues that have witnessed continuous debate in recent years are the fee structure of REIT managers and whether Singapore REITs should be internally or externally managed.

**Fee structure of REIT managers**

In Singapore’s context, the REIT manager is usually the party that sponsors the REIT listing. The attraction for the sponsor is the management fee paid to it as REIT manager.

The REIT manager typically earns a fee that is made up of a base fee calculated based on a fixed percentage of the value of the properties in the REIT, as well as a performance fee pegged to the REIT’s performance, such as gross revenue and net property income. This underscores a concern among investors that REIT managers may be motivated to acquire more properties to grow the REIT’s portfolio size and income and to earn higher fees. This is exacerbated by the current, extremely low interest rate environment that makes cheap financing available for such purchases. Attempts by REITs and REIT managers to address this investor concern may see more and more distribution-per-unit (DPU) accretion-based fees surfacing in the market and becoming the norm in time to come.

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2. Updated as of 28 July 2016. Figure excludes Saizen Real Estate Investment Trust, which had disposed of its entire property portfolio on 4 March 2016.
The REIT manager also earns a fee when the REIT makes an acquisition and sells a property. The fee is typically charged at 1% and 0.5%-1.0% of the purchase price and sales price, respectively. This raises another worry that a REIT manager may constantly buy or sell from the property portfolio under its care to earn more acquisition and divestment fees. In the case where a REIT acquires a property from its sponsor, the scope of work performed by the REIT manager is likely to be more limited, and this again raises the question as to why it needs to be paid a fee based on the size of the transaction.

Despite regulators’ most recent bid to require disclosures on the various types of fees that a REIT manager charges to ensure they are “reasonable, informative and meaningful so that unitholders are provided with details of how the various types of fees co-exist and serve their respective purposes,” this appears to have done little to allay investors’ concerns about the size of fees charged by REIT managers for property transactions.

**Externally vs. internally managed REITs**

In a report issued by the Asia Pacific Real Estate Association in June 2014, a survey of some 195 senior institutional investors and fund managers investing in real estate and REITs revealed that 94.1% of the respondents preferred internal over external REIT management. The result is a stark contrast to the reality, where the external management model is prevalent among REIT frameworks in the Asia-Pacific region, including Singapore. In Singapore, it is noteworthy to highlight that currently all REITs are externally managed, typically by the REIT sponsors.

Conflicts of interest and cost leakage are often cited as negatives of the external model. While external managers owe a fiduciary duty to act in the best interests of investors, separating ownership and control raises the risk that managers or related parties will use the assets for their own gains at the expense of investors.

In what may be the first action on this issue in Singapore, with the potential to reignite interest and discussion over this hot topic, a mainboard-listed property business trust, Croesus Retail Trust, obtained investors’ approval in June 2016 to internalize its trustee-manager and bring its overall management and day-to-day operations in-house. The business trust believes this would help facilitate a stronger alignment of interests and increase distributions to investors from resultant cost savings. While Croesus Retail Trust is not a REIT, this latest move in the market could potentially be the beginning of a time where we may see REITs, especially the non-sponsor-led REITs, considering a similar move to internalize their REIT managers.

The last major review of the Singapore REIT regime by the regulator was concluded in July 2015. As a result of the review, changes were made toward fostering stronger governance practices and greater alignment of interests while providing REITs with more operational flexibility to enhance their portfolios to deliver stronger performances. Such improvements are crucial to instilling greater investor confidence and sustaining trust and growth and are expected to be an ongoing effort as the Singapore REIT market continues to mature.

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3. “Response to Feedback Received – Consultation on Enhancements to the Regulatory Regime Governing REITs and REIT Managers,” Monetary Authority of Singapore.

The legislation bringing REITs to the UK came into effect in January 2007, and now, nearly 10 years later, more than 80% of listed property companies (by value) that could convert to REITs have done so.¹

The early years for UK REITs were not easy. The onset of the financial crisis shortly after they were introduced led many to emergency rights issues with some not surviving in their previous form. The subsequent recovery in UK markets has seen REITs perform well, but an increasingly prominent role played by overseas investors in the UK real estate market — accounting for more than 50% of acquisition volumes since 2014² — has provided further challenges. This has contributed to pricing of assets in some areas exceeding pre-financial crisis levels.

REITs have responded in a variety of ways; the sector has continued to account for 6%-9% of UK acquisition volumes,³ which

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³ Ibid.
The UK construction industry faces a number of existing and emerging challenges.

has included exploiting new opportunities created by the growth of demand in previously fringe submarkets. Others have looked to leverage their property skills by developing (or redeveloping) assets. 2015 saw the eight largest REITs expand their property portfolios by 3.6% through acquisitions, with a further 7.1% expansion to asset value added from their committed development pipeline.6 The committed pipeline as a percentage of the investment portfolio remains broadly similar in 2016.6 REITs clearly intend to continue this activity; the prospective pipeline of the same eight REITs now stands at over US$13b (£10b)6 (approximately 18% of their total investment portfolio).

Development is challenging, even in the best of times. The sheer number of unknown variables that exist in the development process that can take place over a number of years means mitigating risk is a priority. REITs have removed risk from projects both financially, by using well-known approaches such as forward sales or joint ventures, locking in construction costs, holding assets in special purpose vehicles (SPVs), and lowering company-level leverage, and operationally, by obtaining security through pre-lets.

As market indicators suggest, we may be reaching the top of the property cycle, and increased uncertainty has been the product of the recent Brexit vote. As a result, UK REITs will need to proceed with caution in committing to future developments. Pushing ahead with a new development project is a complex decision that needs to take in many variables. Counterparty risk is a factor. The UK construction industry faces a number of existing and emerging challenges. Structure and company-specific challenges remain a barrier to a more operationally and financially robust sector. At the heart of the problem has been working capital management7 and access to liquidity,8 which have fueled a net increase in debt across the construction industry.

Construction cost escalation and contractor risk are areas to consider.

1. Construction cost escalation

The fragmented nature of the construction industry in the UK allows investors to lock in favorable terms up front, but bulging order books, staffing challenges and, to a lesser extent, the cost of raw materials result in cost and time overruns being a very real threat. The recent decision by the UK population to leave the European Union (EU) adds a further layer of uncertainty around the outlook for both labor and material costs in the UK:

- Labor – Official figures suggest about 12% of construction labor in the UK comes from abroad, and mainly from the EU.9 The true number could be higher. Any impact on the free movement of people could not only add to labor costs, but also to the skills shortage that already exists.

- Materials – The construction sector imports about 60% of its materials from the EU.10 The decline in sterling will impact import costs in the near term, while future trade agreements arising from Britain’s EU exit may have a longer-term effect.

In the short term, REITs will likely be able to continue to lock in costs and mitigate this impact. But in the longer term, we believe the UK construction market will consolidate11 and, in doing so, address these issues. Fewer companies with better operating structures and more pricing power will reduce the need to underbid and subsequently overrun. Counterparties, including REITs, will benefit through greater certainty around costs.

2. Contractor risk

Contractor and subcontractor risk remains a concern. The industry structure creates a highly competitive bidding process, and the focus on turnover at the expense of profit, and crucially cash flow, has contributed to a spate of (sub)contractor insolvencies in recent years.

7. A historically strong working capital position has been due to the tendency for customers to make large down payments; however, this has shown a steady decline between 2010 and 2014. Cash to cash days across the UK’s 12 largest construction companies has deteriorated 12 days, from 24 days in 2010 to 12 days in 2014, which equates to £980m of cash.

8. In 2015, total disclosed facilities reached 10.5 times the level of combined earnings before interest, taxes, depreciation and amortization (EBITDA) for the top 10 contractors, up from 6.9 times in 2009.


Contractor insolvencies are typically more disruptive than cost escalation. An insolvent (sub)contractor either means renegotiating project work, which is time-consuming and expensive, or agreeing a cost share between the investor and contractor in order to fund the (sub)contractor through to completion. Where (sub)contractors provide specialist services, it may not be possible to simply bring in a replacement. This will likely delay the entire project. In the worst cases, the contractor, and ultimately the investor, may find itself beholden to a receiver who is able to exert significant influence over the completion of the subcontract. The risk of financial loss as a result of a process outside the control of a REIT is very real. To manage the risks in connection with construction counterparties, REITs should conduct a rigorous tender process. Agreeing on fixed costs will reduce risk; however, attention should be given to the covenants the contractor can offer and the quality of service. REITs should consider developing and monitoring a robust and complete set of company-level parameters (including likely subcontractors) and assessing the risk/return of awarding contracts to lower-quality, higher-risk operators in return for lower construction fees. The financial benefit would likely be mitigated by the enhanced risk such a contract carries. On privately funded projects in the US, surety bonds can be used to create a smooth transition from construction financing to permanent financing and provide support to the contractor, as well as ensure project completion. Table 1 shows the principal warning signs that REITs should monitor.

Development or redevelopment of assets will likely remain a focus for UK REITs with a significant prospective pipeline to progress in the years ahead. The construction industry will therefore remain an important partner. We believe the industry is set to see significant change over the coming years, which will ultimately result in a more financially robust and operationally efficient industry that will, in turn, reduce the risk associated with construction.

However, as UK REITS approach their 10th anniversary, the UK vote to leave the European Union has led to a likely prolonged period of uncertainty, which will impact occupier demand and speed of decision-making and commitment to new space. For those developing new space, this brings an additional complexity and risk factor to overcome. This makes it even more important that the cost side of the development is managed as effectively as possible and REITs consider the broadest range of risk/return prospects for a contract in order to maximize the potential and success of development schemes.

Table 1: **Principal consequences of insufficient diligence in engaging construction services**

<table>
<thead>
<tr>
<th>Stakeholders</th>
<th>Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Absence of clear strategy (e.g., overstretching into non-core areas)</td>
<td>• Overexposure to key customers (e.g., government) without mitigating strategies</td>
</tr>
<tr>
<td>• Market concerns on credibility of corporate strategy and/or management</td>
<td>• Inflation relating to key inputs</td>
</tr>
<tr>
<td>• Absence of proactive communication undermining market confidence, particularly when a business is facing challenges</td>
<td>• Overly aggressive pricing strategy locking in loss-making contracts</td>
</tr>
<tr>
<td>• Threat or emergence of shareholder activism</td>
<td>• New market entrants, particularly with local or specialist knowledge</td>
</tr>
<tr>
<td>• Sudden or unexplained departure of CEO or CFO</td>
<td>• Absence of a complementary M&amp;A strategy (divestment and acquisitions)</td>
</tr>
<tr>
<td>• Suboptimal portfolio management</td>
<td>• Exposure to external cyclical factors (e.g., political changes, funding cycles and investment)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Operations</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Ineffective risk management during contract life cycle</td>
<td>• WCAP/cash flow pressure caused by inadequate cash flow or forecasting processes</td>
</tr>
<tr>
<td>• Lack of integration of acquisitions and new contracts</td>
<td>• Risk of, or actual, covenant breach or missed interest payment</td>
</tr>
<tr>
<td>• Planning forecasting insufficient to accurately forecast cash, capex and working capital (WCAP) requirements</td>
<td>• Refinancing required within 24 months</td>
</tr>
<tr>
<td>• Loss-making or underperforming contracts</td>
<td>• Profit warning and earning underperformance vs. peers</td>
</tr>
<tr>
<td>• Disputes and deductions due to operational underperformance</td>
<td>• Lack of forward visibility of cash or cash targets</td>
</tr>
<tr>
<td>• Loss of key contracts and customers</td>
<td></td>
</tr>
</tbody>
</table>

Source: EY
Activist shareholders changing the landscape for REITs

Between the start of 2014 and 8 July 2016, 38 activist shareholder campaigns have been launched against 35 listed US REITs (see Figure 1). This represents almost one-fifth of activist campaigns against all companies as registered by ThomsonOne and S&P Capital IQ during this time frame. The relative ease with which investors can form an opinion of company value in the real estate space may make REITs more susceptible to activist shareholders. Our research suggests this issue is nuanced; however, we have seen activists build a case for change across areas such as strategic direction, use of assets, liquidation or partial sales, debt reduction and share buybacks, and increasingly, corporate governance.

Figure 1: Number of activist campaigns and number of REITs targeted by activists

Source: ThomsonOne, S&P Capital IQ, and SNL Financial

There is no typical activist shareholder. Some are prominent real estate-focused funds or hedge funds that invest across multiple industries. Others include labor unions as well as smaller players. Our analysis suggests activist investors’ shareholdings vary from less than 1% up to as much as 8%. Generally, they are relatively small stakeholders, but they often get their leverage by establishing relationships with institutional investors that hold a larger stake in the company. Institutional investors generally make an assessment on a company-by-company, not activist-by-activist case. For major shareholders, determining the long-term value of an activist’s case is essential. In instances where shareholders do not believe the company is being well run, they will entertain activists’ ideas and follow their lead. For companies facing activist campaigns, it is essential to understand the position of their major shareholders.

“\nWhen an activist says, ‘We’ve talked to shareholder XYZ,’ that may be true but there is a difference between listening and agreement.” — Audit Committee Leadership Network investor representative

Sectors

Activist shareholders have targeted what they view to be underperforming companies in the REIT space. Since early 2014, lodging REITs have been the target of 13 campaigns, or approximately one-third of those initiated. There have been a further six campaigns against retail REITs.

Despite the fact that certain other property sectors performed worse during this time frame, the large volume of lodging and retail companies that have been targeted by investors coincides with two sectors that are experiencing unique operational challenges and active labor unions. Activists look to agitate for change not only at specific targets, but also in segments of the real estate market where companies are most affected by fast-moving changes in technology, consumer behavior, employee issues and business disruption more generally.

Impact

The activist record in improving longer-term share price performance in the REIT space is mixed. REITs typically received a boost in performance following the launch of activists’ campaigns; almost 60% of companies that continued trading in their existing format subsequently outperformed their peer group over a one-month time frame. But most companies could not maintain the positive momentum. After six months, 42% were outperforming their peers, and after one year, only 21% of these organizations had outperformed their peer group. Four companies that have been the target of activist campaigns since 2014 have subsequently been acquired.

“Every board should educate themselves on these issues and trends, consider the range of alternatives available and appropriate for their particular company and be prepared to act quickly when issues are raised by shareholders.” — Partner at Latham & Watkins LLP

Leading indicators and implications for companies

Share price performance, both absolute and relative to peers, is a useful guide to the likely emergence of an activist shareholder. On an absolute basis, about two-thirds of the companies targeted produced negative returns in the year prior to the launch of an activist campaign. However, relative performance is more insightful and allows us to identify three main precursors to activism: (1) sustained underperformance, (2) relatively immature (listed) entities and (3) companies that, while performing well against their peer group, are targeted due to a view that the company may have substandard corporate governance.

We explore each of these categories by looking at the results of activist campaigns and the implications for other companies in order to avoid being a target in the future.

1. Sustained underperformance

Almost half of the activist campaigns launched since 2014 have been against companies that have underperformed their peer group on both a one- and three-year basis. Unsurprisingly, almost all campaigns in this category are seeking a change in strategic direction or for the company to seek alternative options such as a sale. Very often, these demands are supplemented by a request for board representation as a way to better facilitate this process. Shareholder rights also emerge as an issue within this group about a third of the time, suggesting corporate governance is a further concern.
Our analysis reveals that of the 18 campaigns launched against this group of companies, 6 remain pending and 3 remain unresolved. Of the nine that have been resolved, two resulted in corporate transactions where the target REIT was acquired. Two REITs approved activists’ proposals that included changes to general corporate governance. Four REITs approved the activists’ proposed changes in corporate structure, while one activist withdrew its demand.

2. Relatively immature (listed) entities

Based on our analysis, eight campaigns (approximately 20%) have been against relatively young companies — those listed for less than three years. Seven of the eight companies underperformed their peer group in the year prior to the campaign. Again, activists are generally targeting alternative options for these entities either through a change in strategy or a more draconian measure such as a sale of all or part of the business.

According to our analysis of the eight campaigns in this category, four remain pending and one remains unresolved. One company was acquired, while one activist withdrew its board nominee and subsequently sold all its shares in the company. To date, only one of the target companies adopted the proposed change to the composition of the board structure.

The propensity for activist shareholders to target relatively young companies is a reminder to sponsors of the importance of ensuring newly listed companies are truly capable of operating successfully when considering a new listing.10

3. Corporate governance

Almost one-third of campaigns have been against companies that have outperformed their peer group on either a one- or three-year basis or across both time periods.11 Where companies have outperformed across both time periods, activists are typically looking more closely at board composition, shareholder rights and general corporate governance.

Based on our analysis, three companies changed the composition of their board structure by nominating activist proposed directors. One company nominated a non-activist proposed director. Three campaigns are unresolved. Two REITs adopted shareholder rights/bylaws proposals. One target company was acquired, one company defeated an activist campaign for board control and one campaign is still pending.

Corporate governance in various forms is increasingly being raised as an issue for REITs. Green Street Advisors highlights how companies with good corporate governance should, and do, trade at valuation premiums relative to companies with poor governance.12 Much has been done over the last decade to improve corporate governance, including dismantling of takeover defenses and near universal adoption of the destaggered board structure. However, Green Street Advisors’ annual corporate governance assessment still shows the average REIT falls well short of best in class (see Figure 2).13

Green Street Advisors highlights three key areas of corporate governance for REITs:

1. A sound and well-structured board:
This includes 1) the composition of the board (enough accountable independent directors), 2) the ability for investors to hold the board accountable annually (an entire board should be up for election every year and there should

9. Note: We classify unresolved activist campaigns as events that remain live more than one year after the initial approach. Live events of less than one year are considered pending.
10. The IPO process is challenging, and as we concluded in our 2014 Global REIT report in the IPO readiness section, it is one step to become a public company; it is another step to then operate successfully as one. Organizations need to be prepared for the latter.
13. Ibid.
be no way to change this annual voting measure without prior shareholder consent), 3) proxy access and 4) a track record of shareholder-friendly actions.

2. Minimal anti-takeover weapons: Shareholder-friendly REITs tend not to have shareholder rights plans to maintain minimal ownership limits and to opt out of state anti-takeover provisions.

3. No conflicts of interest: There are no conflicts of interest, especially in regard to business dealings with management.

“A sound set of corporate governance principles sets the stage for healthy interactions between shareholders and management.” — Cedrik Lachance, Managing Director and Director of US REIT Research at Green Street Advisors

We believe REITs are mirroring broader trends in considering the adoption of proxy access. A provision that only began gaining traction recently, has now been adopted by more than a third of Standard & Poor's 500 companies within a two-year span, driven largely by the submission of shareholder proposals calling for the reform.

Around 60% of almost 200 companies that received proxy access shareholder proposals for 2016 annual meetings adopted proxy access bylaws before the proposal even went to a vote.

Pressure on companies to adopt proxy access is likely to increase. Actions to consider:

- Proactively raise the topic with key shareholders to better understand their views on proxy access, including views around preferred terms (e.g., shareholders’ ability to work as a group and the number of board seats that may be filled)
- Confirm that communications around board composition make clear how the skill sets of individual directors are aligned with the company’s strategy and risk oversight efforts, and discuss the board’s assessment, refreshment and nomination processes

EY review of the 2016 proxy season suggests that companies continue to enhance investor communication but that board composition remains a key focus — with director tenure and board leadership coming under increased investor scrutiny. Based on our analysis, 15 of 35 REITs targeted by activists received requests for either additional board members to be elected or the composition of the board to change. This mirrors a wider trend where nominating committees are facing heightened scrutiny from investors and other governance specialists who are intensifying their focus on board composition and director qualifications.

Activists are one catalyst for this alongside the push for greater diversity in the boardroom, increased investor and company interest in board assessments and the emergence of proxy access as a new leading practice. Table 1 highlights three important considerations for nominating committees with respect to the composition of the board.

15. Ibid.
The challenge of developing a nuanced understanding of governance issues may also require channels of communication that go beyond formal disclosures, such as more direct engagement between shareholders and the company, including the board. In a recent survey of large institutional investors, 45% said that in the past five years, they had met with the board privately, without the presence of management.

Ann Yerger from the EY Center for Board Matters noted, “It is important for directors to know that institutional investors are not monolithic. They have different approaches to how they handle governance issues. You should know who your largest owners are and how they handle these responsibilities. It can be quite different. Don’t think just about size of your owner — sometimes the smallest ones can cause you the biggest problems.”

Management’s response

Based on our analysis, activist shareholders have been prominent in the REIT sector over the last two-and-a-half years with 35 companies impacted. Activists’ demands for engagement mirror the wider trend being seen in corporate America of institutional investors reshaping the corporate governance landscape and challenging how boards think about fundamental issues such as strategy, risk, capital allocation and board composition. Large asset managers are increasingly outspoken on governance issues and urging companies to think long term. Companies are responding to investor demands for increased board accountability and transparency. They are enhancing communications with investors to share the board’s message on governance and strategy and highlight director qualifications and board responsiveness to investor concerns. Companies would be well advised to retain a proactive approach to engaging with investors and look at ways to engage across the business to include not only the C-suite but also appropriate senior management and board members.

“The prospect of activism certainly isn’t the only reason to engage with your long-term shareholders. That said, if a company hasn’t engaged or communicated over time and, as a consequence, shareholders don’t have a consistent sense of the company’s strategy or direction, it’s far easier for an activist to come in and fill that vacuum.” — Major institutional shareholder


<table>
<thead>
<tr>
<th>Table 1: Considerations for nominating committees</th>
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<tr>
<td><strong>Leading practice</strong></td>
</tr>
<tr>
<td>Evaluate and enhance disclosures about director qualifications, board composition and board assessment processes</td>
</tr>
<tr>
<td>Integrate diversity, expertise and tenure considerations into board composition and succession planning</td>
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<tr>
<td>Growing attention to board composition and quality may influence how investors vote in future director elections</td>
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2015 saw a step change in cross-border capital flows to the US as overseas investors acquired US$95b of real estate, more than double the volume of 2014, and 17% of all US deal volumes.1 Historically, overseas capital has accounted for approximately 10% or less of the market.2 The first half of 2016 has seen transaction levels slow somewhat, partly as a result of a drop in multibillion dollar portfolio deals. However, overseas investors have acquired a further US$32b of property (15% of overall transaction volumes) through 2 August 2016.3

The growth of overseas investment has been well documented and as the heat map in Figure 2 shows, investors from mainland China, Singapore, Germany and Norway are now all important capital sources alongside Canada. The jump in overseas activity gives rise to two important questions: Can we expect recent trends to continue? How can US REITs capitalize on these trends?

Figure 1: Cross-border capital flows to the US; 2011-2016 (US$b)

Source: Real Capital Analytics

2. Ibid.
3. Ibid.
Real estate is a cyclical asset class, and capital flows have historically proven to be volatile. This is particularly the case with cross-border capital flows, as 2007–2009 proved. Investors’ retrenched; overseas capital invested in the US real estate market collapsed from almost US$50b in 2007 to less than US$5b in 2009.4 Year-on-year cross-border capital flows will ebb and flow, but there are a number of positive drivers over the medium to long term:

1. **The growing middle class will fuel flows of capital to institutional managers.**
   Developing economies have a huge opportunity to grow their institutional investor sectors, as very often their financial systems are largely bank based. Growth will depend on key policy decisions such as the establishment of a national pension system with a funded component, a common feature in most Organisation for Economic Co-operation and Development (OECD) countries.

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Large pension funds and public pension reserve funds, for example, are already commonplace in many developing economies.\textsuperscript{5} The flow of capital will likely grow as wealth increases and foreign pensions become a prominent source of US real estate investment. For example, 2015 saw the number of households in mainland China earning more than US$35k exceed those in the United States for the first time. The number of households in China earning over US$35k is forecast to more than double between 2015 and 2025 to nearly 260 million.\textsuperscript{6} As household wealth increases, wealth products such as insurance and pensions will benefit.

2. Increasing allocations to alternatives including real estate. The OECD annual survey of large pension funds (LPFs) and public pension reserve funds (PPRFs) noted a clear increase in alternatives among both LPFs and PPRFs between 2010 and 2014. LPF allocations to alternatives now stand at 15.3% (2010: 14.3%) with PPRFs at 13.5% (2010: 11.2%).\textsuperscript{7} Shifting market values and relative return expectations undoubtedly impact this trend, but the OECD noted that funds with the ability to set long-term policy targets and maintain a long-term view on liquidity have seen portfolios drift toward alternatives.

3. Increasing comfort of investing overseas. Funds have mostly invested across borders by diversifying equity and fixed income portfolios, but some also invest in foreign alternatives such as real estate, private equity and infrastructure.\textsuperscript{8} Chinese insurance companies, for example, have become a high-profile cross-border real estate investor, but in 2015 only 6 of the top 20 Chinese insurance companies actually invested overseas. Activity could increase as a further six have expressed interest subject to approvals.\textsuperscript{9} According to the OECD, the average large pension fund invested 34.1% of total assets in foreign markets. Foreign diversification is mostly the result of regulation and investment policy, although large funds based in countries with small domestic markets may be more inclined to invest abroad to diversify and increase the opportunity set.\textsuperscript{10}

4. Foreign pension funds. Foreign pension funds are benefitting from a recent US tax law change in the Foreign Investment in Real Property Tax Act (FIRPTA) rules that generally enables them to invest in US real estate and JVs without a US tax cost upon their exit from these investments. Forty-four percent of OECD pension fund assets are held outside the US, and the sector grew by 107% (US: 64%) between 2003 and 2013 to US$13t.\textsuperscript{11} Navigating what looks to be an increasingly competitive real estate market will challenge the capital allocation skills of REIT management teams. One tool that REITs in the US and Canada, in particular, have used is joint ventures.

REITs with high-quality portfolios, extensive operating platforms and potentially strong development track records should be particularly well positioned as partners to overseas capital. One of the themes we have seen from cross-border capital emerging from China, for example, is the willingness to align with groups who provide additional or local expertise.

Investment activity from China and Singapore has grown considerably in recent years. In 2011 and 2012, investors from these countries contributed barely US$1b to the US market, compared to more than US$24b in 2015.\textsuperscript{12} The depth of capital sources in China is particularly significant; Real Capital Analytics identified over 80 buyers from China in 2015, of which 22 invested more than US$300m

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7. Ibid.
The long-term drivers of cross-border capital flows look to be well entrenched, and while year-to-year volumes will fluctuate, we expect this trend to have a long-lasting impact on the US real estate market.

Overseas capital has been surprisingly consistent in its approach as gateway markets have received approximately half of overseas capital in every year since 2011. While the high profile of the assets in gateway markets would lead one to believe those markets were the sole target of offshore investors, overseas investors have been a viable source of capital for US REITs operating in almost all US markets. Potential approaches to deploy capital include, but are not limited to:

- Partial interest sales to recycle capital
- Asset or fund type partnerships to tie overseas capital to REIT expertise
- Limited liability to the LLC members
- Flow-through tax treatment (i.e., no LLC-level income taxation)
- Maximum transaction structuring flexibility
- The ability to manage member-level specific tax concerns, including unrelated business taxable income with member-level “blocker” entities (e.g., corporations or REITs)

Partnering with overseas investors can be challenging, particularly due to the cultural issues that may arise. In all cases, a full strategic assessment, including tax implications and structuring options, should be made ahead of undertaking a transaction. Issues to consider likely include assessing whether a joint venture makes strategic sense before considering who might be the right partner. Utilizing relationships and conversations remains an essential component of finding the right partner with whom to form a joint venture.

From there, tax and structuring options are of great importance. Joint ventures can take various legal entity forms; we have seen some corporate joint ventures make REIT tax elections to provide tax benefits to the joint venture partners. However, as a working assumption, many joint ventures today take the form of a limited liability company (LLC) that is generally treated for tax purposes as a partnership. The reasons for this include (but are not limited to):

- Limited liability to the LLC members
- Flow-through tax treatment (i.e., no LLC-level income taxation)
- Maximum transaction structuring flexibility
- The ability to manage member-level specific tax concerns, including unrelated business taxable income with member-level “blocker” entities (e.g., corporations or REITs)

The long-term drivers of cross-border capital flows look to be well entrenched, and while year-to-year volumes will fluctuate, we expect this trend to have a long-lasting impact on the US real estate market. Recent trends suggest this will not be limited to gateway markets. An ever-widening pool of investors will challenge REITs’ capital allocation strategies. The flexibility provided by a well-structured joint venture (JV) remains an important capital allocation tool. The number of potential JV partners has likely never been higher. Aligning with a like-minded and trustworthy partner around a suitable structure and a clear strategy remain essential requirements for continued success.

Appendix: methodology details

REITs globally take many forms, with significant differences in structure, strategy and operations. REIT markets also contain many nuances that make direct comparison challenging. We believe, however, that REIT activities can be broadly categorized into 12 areas. In trying to assess the relative maturity of different global REIT markets (not specific REITs), we have developed a framework around which to assess and track the development of country level REIT regimes. This framework applies to 9 of the 12 areas, with a recognition that capital structure, capital allocation and market trends are company or market specific, and therefore best excluded from our global analysis.

In most cases, we have used a single data point from a reputable source as a measure for each of the nine areas. Often, however, this data point is itself a combination of many subsets. The data points used are as follows:

- **Capital flows/flow of funds to the sector** — market cap of REIT sector, REIT market cap vs. listed sector market cap, and REIT market cap vs. listed real estate market cap
- **Financial reporting** — World Economic Forum (WEF) strength of auditing and reporting standards
- **Corporate governance** — WEF efficacy of corporate boards
- **Risk management** — BMI Research’s country risk index
- **Regulatory environment** — number of years the REIT regime has existed and number of companies with REIT status
- **Cross-border issues** — World Bank doing Business Index
- **Transaction activity** — average annual national transaction volumes (last three years)
- **Financing** — size of equity market and size of debt market
- **Property specifics** — Jones Lang LaSalle Transparency Index

Every market is then allocated a score of between zero and five based upon a quantitative and qualitative analysis of the data, with the sum of all scores used to bucket markets into each of the “nascent,” “emerging,” “established” and “mature” categories. This framework is designed as a simple way to group heterogeneous markets with REIT legislation that, while broadly similar, contain many specific nuances. It is intended to provide a framework around which to assess the growing maturity of the REIT concept today and in the future. It is in no way an assessment of company level maturity, and company level metrics have been specifically excluded from the analysis.
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