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Busting the 5 myths associated with REITs

Prashant Das, Assistant Professor of real estate finance at Lausanne Hotel School, University of Applied Sciences, Western Switzerland busts the five myths associated with Indian real estate investment trusts (IREIT)

Prashant Das, Ph.D. | 8 February 2016

Real estate investment trust (REIT) was first introduced in the US in 1960, creating opportunities for retail investors to invest in big-ticket commercial real estate assets which is otherwise typically inconceivable. Netherlands (1969) and Australia (1971) soon followed suit. Over twenty countries have adopted the REIT structure since then, including developing nations like Malaysia, Mexico, South Africa and UAE.

Recently, SEBI introduced the REIT structure for India. Indian REIT ('IREIT' hereafter) borrows its fundamental structure from international markets but has its own unique features. Despite a relatively rich history of global REITs, IREITs will be young undertakings lacking their indigenous knowledge system. While it will take us a little while to put IREITs in real-world perspective and learn from experience, here are some myths (and the myth busters) to help build our fundamental understanding of IREITs

Myth 1: Investing in REIT is same as investing in direct real estate

Reality: While a few countries require a REIT to go public, units of IREITs must be publicly traded securities like common equity. Yet, they will derive their value from the underlying real estate assets that the trust holds and manages which are rather illiquid. Internationally conducted

empirical research offers mixed evidence regarding how the performance across the two (REIT stocks and underlying real estate assets) are correlated. Recently, REIT returns (large-caps in particular) have shown stronger correlation with real estate markets in the long run.

However, the association changes over market cycles. Knowledgeable REIT managers enjoy specialized knowledge of the asset segment and build strong economies of scale, thus offering more value of management expertise which is often superior to direct real estate holding. Yet, the benefits are not directly (or immediately) translated to the REIT units (as would be the case with direct real estate holdings) since the exchange-traded units are subject to stock market sentiments as well.

Myth 2: Investing in REIT is same as investing in small-cap stocks

Reality: REIT investment is fundamentally different from common stocks. Regulation mandates a REIT to distribute most of its taxable income (90% for an IREIT) to unitholders. In return, the distributed capital will be tax-exempt. To avoid the entity-level tax, REITs tend to distribute more than 100% of taxable income to investors. This mitigates double-taxation and avoids expensive tax-avoidance strategies that most corporations usually have to adopt. Traditionally, REITs were considered to be ‘dividend-machines’. However, since a REIT unitholder benchmarks its units with other corporations, a REIT is constantly under pressure to grow. As the retained earnings are limited, they often reach out to public to raise funds, thus raising the cost of capital. Yet, research suggests a positive net effect on the market capitalization caused by these REIT specificities.

Myth 3: All mutual fund managers may also manage REITs

Reality: Although mutual fund managers may find it relatively easier to adapt to the unique nature of REIT management, a REIT is a substantially different animal. IREIT regulation does not distinguishes between two distinct management activities that other countries are specific about: (1) property management and (2) advisory.

The property management activity refers to property-level operations and requires property-class specific skills. The advisory activity is related to investment management (acquisition/disposition of assets). In contrast to mutual funds, an REIT manager can influence the unit performance solely by optimizing the property management functions without significantly reallocating the assets. In fact, regulations restrict frequent asset dispositions which is often a requirement for portfolio reallocation strategies for cash-strapped firms such as REITs. The global REIT market shows a tendency to employ in-house advisors and are open to outsourcing property management to third parties. The IREIT mandate requires advisors to be external parties as well. Research suggests that although external advisory is perceived to be diluting control, it benefits when the property portfolio is geographically diversified. Local investment managers are more efficient in negotiating with local stakeholders such as lenders and regulators.

Myth 4: All real estate company managers may also manage REITs

Reality: IREIT is substantially different from the conventional real estate companies (RECs) in India. Most RECs are primarily focused on residential sector. IREITs cannot develop residential assets and are restricted to commercial assets. Besides, RECs mostly specialize in assets that are developed to be sold whereas an IREIT must hold 80% real estate assets which are ‘rent

generating'. Besides, 75% of the revenues must come from real estate operations. Short term capital gains are indirectly penalized. Beyond these considerations, an REIT manager must also be watchful of the interplay between NAV and unit prices. Executing suitable strategies (e.g. raising capital through secondary equity offerings when units are relatively over-priced and through selling properties when NAV is overvalued) is a skill that requires deep understanding of the 'Main Street' (properties market) as much as of the 'Dalal Street' (stock market).

Myth 5: All commercial real estate asset holdings can adopt REIT status

Reality: Technically, all income generating assets qualify as suitable real estate assets for IREIT. However, the regulation is not yet clear about some asset classes. Take hotels, amusement parks, cinemas owners, for example. While a large part of income from running such facilities could be attributed to real estate; not all of it is real estate income. A hotel guest, for example, buys a package of services beyond leasing a real estate asset for a night. Operators of such assets may find it challenging to divide such revenues into real estate versus non-real estate category. As the regulation stands now, the only feasible solution seems to be outsourcing the non-real estate activities to a third party who will lease the real estate asset for business from the owners.

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