COMUNICAÇÃO

DO **XV CONGRESSO INTERNACIONAL**
DE CONTABILIDADE E AUDITORIA

A CONTABILIDADE E O INTERESSE PÚBLICO

ISCA COIMBRA | 11 E 12 JUNHO DE 2015

OTOC
Ordem dos Técnicos Oficiais de Contas

ISCAC

Heading:

Decision-making factors in the constitution of a REIT.

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Abstract

Real Estate Investment Trusts (hereinafter, REIT) are investment companies which enable to capitalize real estate assets by offering company shares into stock markets.

The recent positive outlook and the signs of change in the economic cycle have entailed a sharp increase of REITs constitutions. Nevertheless, real estate managers must consider its advantages compared to other alternatives of financing real estate activity. This implies the analysis of those variables affecting REITs performance such as, market price and market capitalization (compared to its net asset value), REIT expected liquidity, constitution costs, systematic risk, finance costs or tax benefits, and also other aspects like, company control, transparency requirements or regulatory limits.

REITs have become a competitive way to finance real estate activity, especially considering credit constraints this industry is still experiencing. In this context, the present paper analyses what should be taken into account in the decision of establishing a REIT.

Heading:
Factors influencing the decision to set up a REIT.

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Abstract

Real Estate Investment Trusts (hereinafter, REIT) are investment companies which capitalize real estate assets by offering company shares on the stock markets.

The recent economic upturn has led to a sharp increase in the constitution of REITs. Nevertheless, real estate managers should weigh up the advantages of these securities compared to other alternatives of financing real estate activity. Variables affecting REIT performance that managers should analyse include market price and market capitalization (compared to net asset value), expected liquidity, start-up costs, systematic risk, finance costs and tax benefits, and also other aspects such as company control, transparency requirements and regulatory limits.

REITs have become a competitive way to finance real estate activity, especially in the light of the credit constraints that still affect the industry. This paper analyses the factors that managers should take into account when considering whether to set up a REIT.

1. Introduction

In recent years, the real estate industry has faced its worst crisis since the 1930s. Real Estate Investment Trusts (hereinafter, REIT), investment companies which capitalize real estate assets by trading company shares in the securities markets (Kroszner & Shiller, 2011), were badly affected.

However, the incoming macroeconomic data are showing signs of change for financial and real estate markets. As part of this positive economic trend, the reforms introduced by the Spanish government have made the Spanish REIT regime, known as *Sociedad Anónima Cotizada de Inversión en el Mercado Inmobiliario* (hereinafter SOCIMI) more attractive. This has led to a significant intensification of REIT start-ups, not only at local level but also among large international investors.

Real estate managers should weigh up the advantages of setting up a REIT over alternative methods for financing real estate activity. They must analyse a variety of factors affecting REIT performance, such as market price and market capitalization (compared to its Net Asset Value (hereinafter, NAV)), expected liquidity, constitution costs, systematic risk, finance costs and tax benefits, as well as other aspects such as company control, transparency requirements and regulatory limits.

REITs have become a competitive way to finance real estate activity, especially in the light of the credit constraints the industry is still experiencing. This paper examines the factors that managers should take into account when deciding whether to establish a REIT.

2. Methodology, data and hypothesis

The methodological approach applied in the study is as follows. First, we review the global scientific literature on REITs, in particular with reference to aspects related to REIT start-ups. Second, though the state of the art has been analysed at international level, we conduct a market study focusing on Spanish REITs in order to identify the advantages and disadvantages of setting up a SOCIMI. Third, we compile data from the *National Stock Market Commission* (hereinafter, CNMV) and the *Alternative Investment Market* (hereinafter, MAB), as well as on-line information from Spanish REIT websites and interviews.

3. Factors that managers should analyse when considering the constitution of a REIT

In this section we analyse the main decision factors that managers should take into account when considering setting up a REIT.

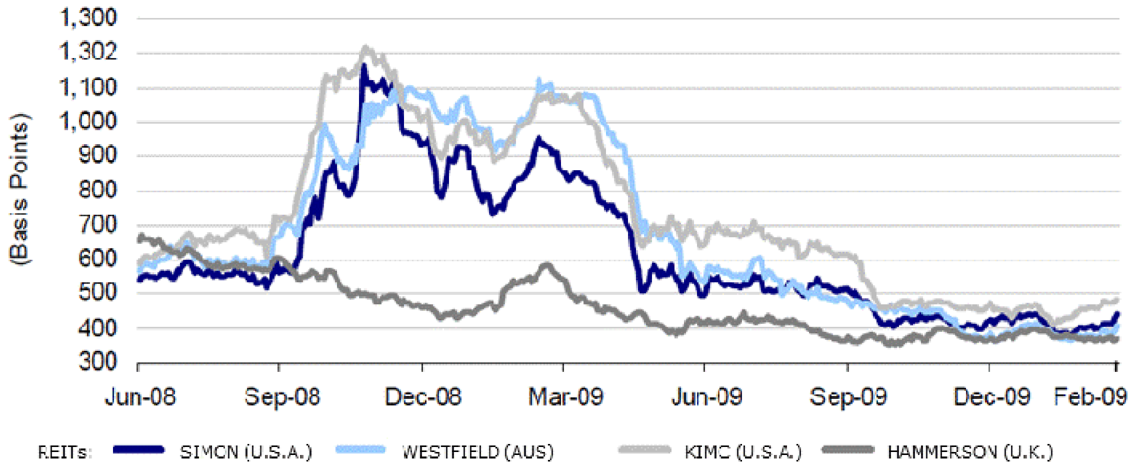
3.1 Financing costs

Several studies have demonstrated that REITs enjoy better access to credit than non-traded real estate companies (Hardin and Hill, 2011; RREEF Research, 2010; Deloitte, 2011). According to Hardin and Hill, the credit availability for REITs is associated with the historical data on dividend distributions.

Thus, when assessing the credit risk of a REIT, lenders may consider its capacity of generating dividends as an equivalent of cash flows. If they see that REIT managers are reluctant to shorten dividends and that a greater distribution is required by law, lenders could consider dividends as a cash flow guarantee, which in the worst-case scenario can be used as repayment for the debt.

Data in Figure 01 indicate the credit spread decline of REITs, a trend that started in Australia, and continued in the UK and the US (RREEF, 2010).

Figure 01. Spreads of Credit Default Swaps of REIT Evolution



Source: RREEF, 2010.

3.2 Cash obtained through the sale of shares

Obtaining liquidity through the constitution of a REIT has been shown to be a competitive strategy for real estate finance compared with other alternatives such as mortgages (Roig and Soriano, 2015).

Nevertheless, managers should analyse, on a case-to-case basis, whether the establishment of a REIT (which involves the sale of shares in the financial markets) is at least equivalent to other scenarios such as property disposals or mortgages.

3.3 Liquidity

In other investment instruments in the real estate industry, such as direct investment in properties, liquidity may be significantly lower than other types of assets. However, REIT liquidity is closer to that of other listed companies in the financial markets (Marcato & Ward, 2007).

However, the moderate liquidity of the underlying assets has a negative impact on REIT liquidity; this leads to lower share switching than in other listed companies in the industry. Table 01 displays a clear difference between REITs and non-REIT real estate companies (Ghosh, Miles & Sirmans, 1996).

This liquidity advantage of REITs over non-REIT companies is clearly reflected in REITs share prices, with a quantified impact between 12 and 22% (Beneviste, Capozza and Sequin, 2001). REITs are obliged to publish more information regarding their financial situation; this increases transparency and, in turn, their liquidity.

Table 01. A Liquidity Comparison between REIT and Non-REIT companies

Year	**Market Value** (Millions of $)		**Daily Trading Volume** (% market shares)	
	REIT	Non-REIT	REIT	Non-REIT

		companies		companies
1987	154	162	0.14	0.43
1988	178	186	0.09	0.25
1989	195	203	0.11	0.5
1990	160	170	0.09	0.41
1991	176	188	0.09	0.67
1992	248	265	0.14	0.41
1993	371	389	0.23	0.63
1994	402	372	0.18	0.45
1995	456	434	0.15	0.52
Mean	260	263	0.14	0.47

Source: Ghosh, Miles, Sirmans (1996), Real Estate Finance

Moreover, according to Demsetz (1968), Stoll (1978) and Ho and Stoll (1981), the factors underlying liquidity are the financing costs, the expected return, and risk. Consequently, present liquidity is estimated to be moderate in the present context with its high financing costs – even though the Euribor is at a record low, the expected return is moderate, and the risk premium and the perceived risk in the real estate market are both high.

3.5 Discounts to Net Asset Values

REIT share prices in the financial markets are affected by volatility and systematic risks which lead to disparities between the quotation and the NAV. These differences can be attributed, in particular, to rational factors such as the size of the REIT, country effect, liquidity and transparency, or to irrational factors such as investment sentiment and real estate expectations.

3.6 Flotation costs

The costs of being listed on the financial markets should not be ignored. First there is the cost of going public, and then the cost of trading on the financial markets. Although it is possible to quote in markets with lower costs such as the MAB, REITs should set aside a non-negligible budget for this area and scale economies should be studied.

Conducting external audits and valuations and employing share issue consultants or fiscal advisors are some of the costs of establishing a REIT.

3.7 Company control

The sale of shares to third parties is a transparency requirement and to some extent represents a loss of company control. Managers should value the potential negative impact that the sale of the share framework may have on shareholders.

3.8 Transparency

REITs are listed in the financial markets. Although managers can choose to be in a less regulated public market such as the MAB, information requirements will always be higher than in non-listed companies.

The obligation to make greater amounts of information public may initially be costly. The sale of shares to third parties represents a transparency requirement and to some extent a loss of company control. In the long term it is likely to be especially effective as it reduces the perception of company risk and thus directly increases the value of the REIT (Bushman & Smith, 2003).

3.9 Legal constraints

REITs must comply with legal requirements in order to take advantage of tax benefits. These legal requirements, such as a high percentage of dividend distribution, a minimum net capital and the allocation of at least 80% of the property investments for leasing reduce managers' room for manoeuvre, but recent changes in the Spanish regulations have done a great deal to encourage the constitution of new REITs.

3.10 Systematic risk

Investors should bear in mind that REIT shares are listed in the financial markets, and so are subject to far more volatility than their underlying assets (three times more, according to Kallberg, Liu & Srinivasan (1998). In other words, REITs are affected by systematic risk. Daily information has an immediate impact on shares but a lower impact on property valuations, resulting in the appraisal smoothing effect (Quan & Quigley, 1991).

3.11 REIT risk-return trade-off

REIT managers should assess the fact that markets demand a higher level of profitability than other assets because the volatility variable does not include the total risk of the asset (Table 02); that is, in the risk analysis regarding investment decisions of REITs, the study of volatility is necessary but not sufficient.

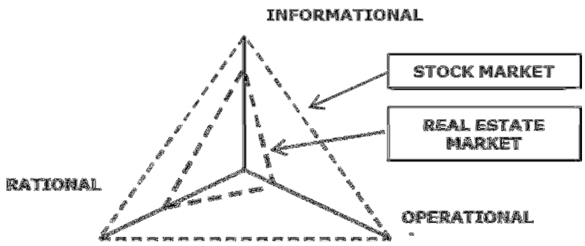
Table 02. A Comparison of the Risk-Return Trade-Off

Period	REITS		Large-Cap Companies		Small-Cap Companies		Bonds	
	Return	Risk	Return	Risk	Return	Risk	Return	Risk
1972 – 2007	13	17.4	11.2	17	14.3	22.5	8.7	11.5
1988 – 2007	12.3	17.4	11.8	16.6	13.5	19.9	9.3	10.1
1998 – 2007	10.5	20.4	5.9	17.3	10.6	22.2	7.3	8.8
2003 – 2007	18.2	22.3	12.8	9.8	17.2	25.1	5.7	4.1

Source: NAREIT, 2010.

This is due to the informational, rational and operational market inefficiencies in real estate (Figure 02) which mean that the distribution of the returns does not follow a lognormal law. This in turn implies a lower diversification effect in an investment portfolio (McCoy, 2006 and Shleifer, 2000).

Figure 02. An Efficiency Comparison between Stock and Real Estate Markets



Source: Sabal (2008).

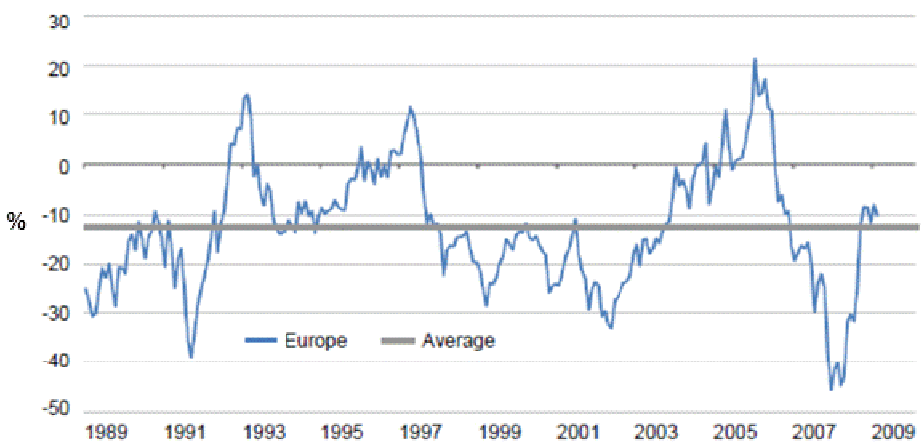
3.12 Departures from NAV in REIT pricing

REIT share prices often differ from their NAV. There are many reasons for the differences in the Price to NAV ratio: rational factors such as REIT size, country effect, liquidity, diversification or historic returns, and irrational factors such as investor expectations or investor sentiment (Fernández et al, 2012)

If managers expect a marked decrease in the Price to NAV ratio, they would have no incentive to establish a REIT because there will be more efficient ways to finance their real estate activity – for instance, mortgages.

Figure 03 outlines the evolution of the Price to NAV ratio for European real estate companies and shows that the relation between these two variables varies over time.

Figure 03. European Index of the Price to NAV Ratio (FTSE EPRA/NAREIT)



Source: RREEF, 2010.

3.9 Summary:

Table summarizes the decision-making factors involved in the constitution of a REIT.

Table 03. Decision-making factors in the constitution of a REIT.

	Factor	Description
Positive Factors	Cash generation	The generation of liquidity via property assets without the need to sell them.
	Not accounted for as debt	The sale of shares does not affect debt ratios; this means that financing costs remain stable and, in turn, liquidity is obtained.
	Company management	Depending on the company's free-float, managers will retain company control.
	Liquidity	Real estate listed companies have more liquidity than property assets; this is positively reflected in their price.
	Financing costs	Historically, REITs have obtained better competitive financing costs than non-traded real estate companies.
	Public image	The constitution of a REIT improves the public perception of the company among stake-holders.
	Company risk	REITs are perceived as being more transparent than non-traded real estate companies. This reduces the perceived company risk and mitigates the decrease in the price to Net Asset Value.
	Tax benefits	By fulfilling the legal requirements, the SOCIMI and its shareholders receive tax benefits not available to other real estate companies.
	Price-discount to NAV	If shares are sold at a price higher than the Net Asset Value, shareholders obtain more profitability than in a scenario in which assets are sold.

	Factor	Description
Negative Factors	Flotation costs of firms	Being listed in the financial markets entails significant costs for companies – not only initially, but throughout the time the company is listed.
	Company control	The sale of shares involves a certain loss of control over the company. More information must be provided, and the strategy must be shared with new shareholders.

	Management costs	Investors' expectations regarding property prices are reflected in both the appraisals and stock prices. Nevertheless, future price expectations influence appraisers less than investors.
	Transparency	Trading on the financial markets obliges firms to report more information – a possible entry barrier.
	Legal constraints	The legal requirements imposed on REITs reduce management flexibility.
	Price-discount to NAV	If shares are sold at a price lower than the Net Asset Value, shareholders obtain more profitability than in a scenario in which assets are sold.
	Systematic risk	In trading on the financial markets, REITs will be affected by idiosyncratic risk but by systematic risk as well.

Source: Compiled by authors.

4. Conclusions

Before establishing a REIT, managers must analyse a large number of factors, both positive and negative.

Certain additional external factors represent opportunities or threats that have a significant influence on the decision-making process. For example, the economic context and the real estate cycle are currently recovering, but during the financial crisis they represented a major obstacle.

It seems that the factor valued most highly by managers is the advantageous tax treatment. Other positive and negative aspects do not tend to be considered in the decision-making process. However, positive aspects such as liquidity, cash generation, not being accounted for as debt, financing costs, public image, company risk and company management, and negative aspects such as company control, flotation costs, management costs, transparency, legal constraints, price-discount to NAV and systemic risk are also key success factors that should be taken into account.

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