



Global REIT markets



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Introduction

Since our last report, global real estate and investment trust (REIT) markets have continued to expand and now surpass a total market capitalization of approximately US\$1.7t. The number of countries now offering REITs as an investment vehicle has almost doubled in the last 10 years to 37, with 7 new country entrants in the past 4 years and 2 more on the cusp of new REIT legislation. It's clear that as these regimes have evolved, the use of the REIT vehicle has become better understood and more widely accepted around the world as an investor-friendly, tax-efficient vehicle for real estate investment.

Global capital raise and initial public offering (IPO) activity, which is a good indicator of the health of the sector, has trended up and remains remarkably resilient, despite periods of public market pricing dislocation that has somewhat subdued capital-raising activity for certain sectors. Cross-border transaction activity remains elevated as foreign investors continue to provide joint venture capital alongside established REITs; meanwhile, some foreign sponsors are now forming REITs to invest in local country jurisdictions, which before now has been surprisingly limited in scope.

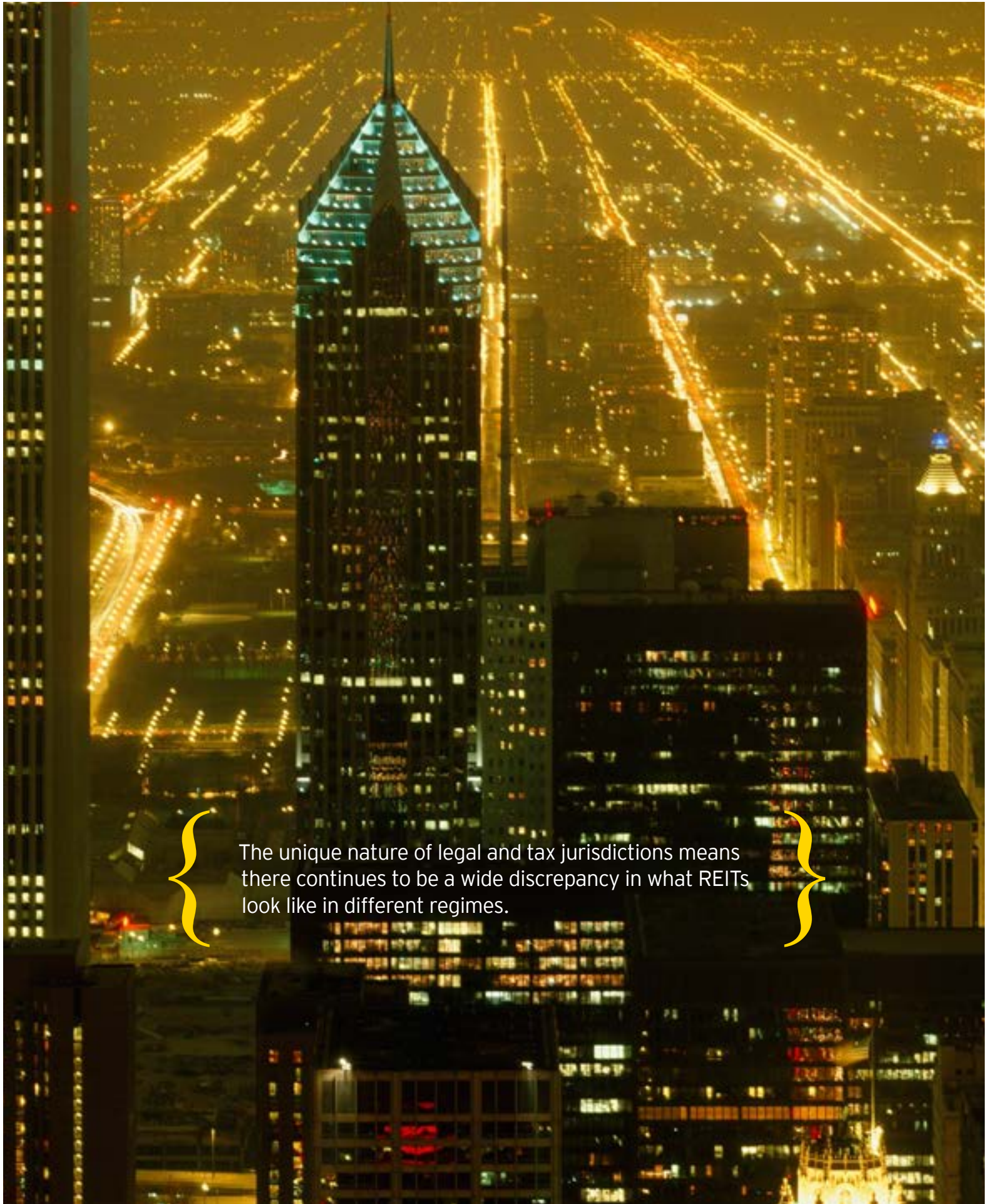
Tax legislation continues to evolve across all REIT markets and particularly in less-developed jurisdictions, where a broad REIT framework exists but in some countries has not proven to be favorable enough to see companies convert or execute an IPO. REIT industry groups from around the world have responded by actively exploring ways to refine existing legislation to make it more attractive and provide the type of tax incentives to further promote the use of the REIT structure. In the US, the REIT industry has a foundation of 50-plus years of tax law that works efficiently, but this may be disrupted by new, broader tax legislation that has been proposed.

It's evident that REITs are operating in a very dynamic environment that is evolving rapidly as disruptive technology, changing demographics, developing legislation and governance, and globalization continue to accelerate the pace of change. In this article, we address many of these changes, and have updated our in-depth analysis of these evolving REIT regimes.

We are excited to share these insights with you and hope you find them to be valuable to your business.

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The unique nature of legal and tax jurisdictions means there continues to be a wide discrepancy in what REITs look like in different regimes.

Globally, the real estate and investment trust (REIT) concept is gathering pace. There are now 37 REIT markets with a total market cap of approximately US\$1.7t. Seven new REIT regimes have been established since 2013 (Ireland, South Africa, India, Kenya, Bahrain, Vietnam and Saudi Arabia), and Poland and China are both edging closer to introducing REIT legislation.

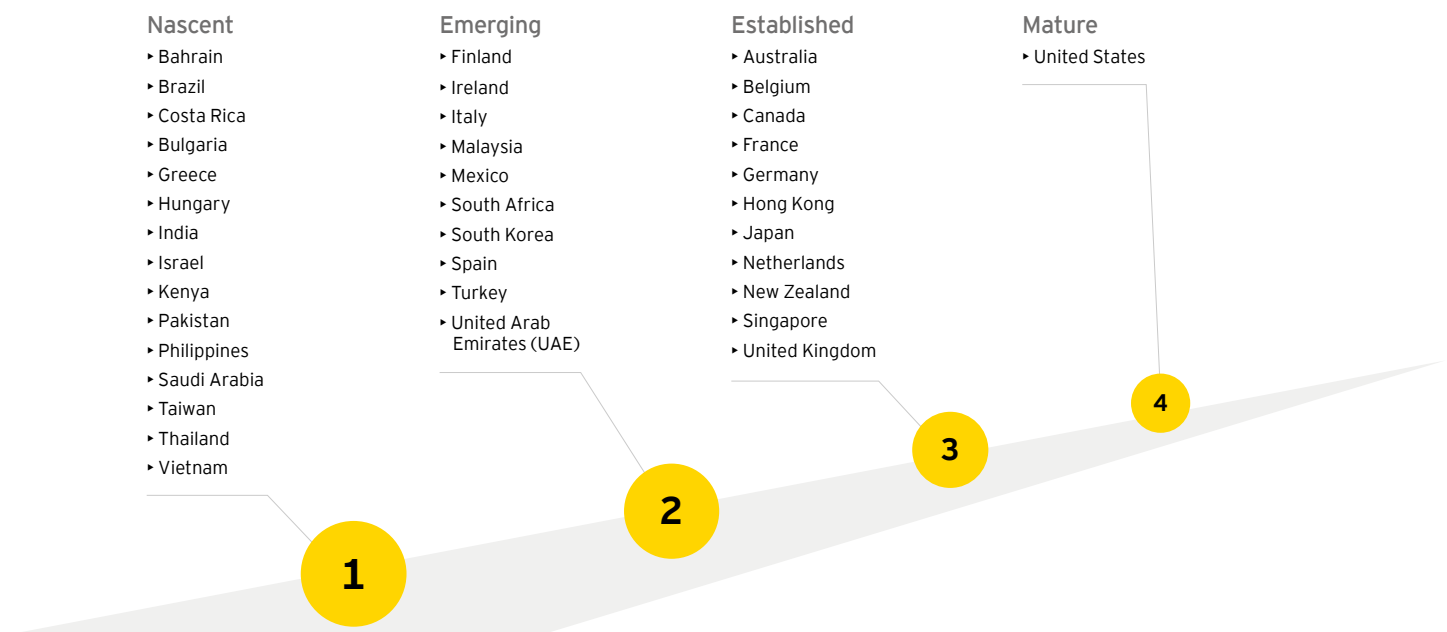
In all jurisdictions, REITs are creatures of the tax code, with aspects unique to each country. Many commonalities do exist; however, many of the younger jurisdictions are still in their early stages of organization, which means further developments are necessary to make use of the legislation. As part of this evolution, we have seen significant interest from delegates associated with new regimes looking to expand their knowledge of the REIT concept by better understanding both market developments and various financing and structuring alternatives utilized by more mature REIT markets, in effect, offering a shortcut to a fully functional market.

EY's REIT jurisdiction maturity assessment is an attempt to group REIT markets around their evolution and identify themes common to many. We introduced the concept last year¹ and present an updated version in Figure 1. Australia and the UK are edging closer to being considered mature markets, but the principal area of debate is between the emerging and established categories.

We have moved Belgium to the established group, having classified it as emerging last year, while Finland and South Africa are on the cusp of elevation. Finland has had REIT legislation for eight years and scores well on many metrics but remains constrained by a lack of active REITs. South Africa, on the other hand, is a relatively young regime, but maturing fast, and now has 23 active REITs as well as a number of secondary listings from overseas REITs. South Africa also rates well on important metrics like capital market maturity, corporate governance and real estate transparency. Elsewhere, jurisdictions like Ireland, Spain and Mexico will likely be considered established in the near future.

The size of the global REIT market continues to grow since we released last year's report. Market capitalization of REIT regimes around the globe rose by approximately 4% to US\$1.7t from the first half of 2016 to the first half of 2017 on a US dollar basis, but virtually all of this expansion is attributable to the approximately US\$58b of equity capital raised by the industry in this period.² With 4% growth during this period, the US REIT market continues to dwarf all other global markets and is roughly twice the size of all others combined.³ In local currency terms, Spain, Singapore and Hong Kong have led the way, with the most significant growth through 2017 to date.

Figure 1: Stages of REIT regime maturity



¹ Global perspectives: 2016 REIT report, EYGM Limited, September 2016.

² SNL Financial XL database, SNL website, <https://marketintelligence.spglobal.com>, accessed 15 August 2017.

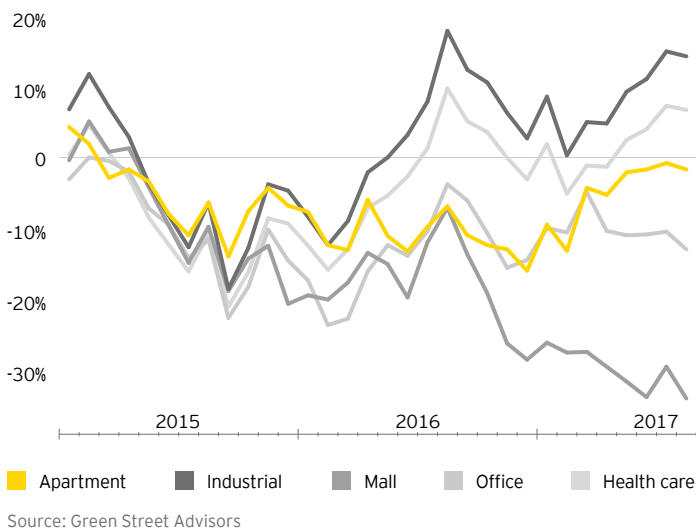
³ Ibid.

Access to capital remains a critical business priority

Consistent and reliable pricing of common equity has become more challenging for parts of the industry in recent years due to market pricing dislocation. In the US mall sector, discounts to net asset value (NAV) have widened further through 2017, and implied spreads between higher- and lower-quality properties have also increased (see Figure 2). The office sector continues to trade around a 5%-10% discount to NAV, but, conversely, the industrial and health care markets retain sizeable premiums. Health care operators in particular have taken advantage of favorable market conditions to raise US\$3.5b through the first half of 2017 (2016: US\$4.9b).⁴ Access to capital remains a critical business priority for all REITs, and the ability to raise funds in an accretive manner remains a driver of equity market activity.

Through the first half of 2017, US\$32b has been raised globally,⁵ which is broadly in line with recent years (see Figure 3). With widening discounts to NAV, retail REITs have been relatively absent from the market, while apartment operators have taken advantage of the closing NAV discount to raise more capital in the first half of 2017 than all of 2016. REITs globally have continued to favor follow-on equity offerings, which account for 61% of capital raised in 2017.⁶ Private placements of common stock have contributed a further 11% of all capital. Private placements are likely appealing for REITs trading at notable discounts if private pricing can surpass public market alternatives.

Figure 2: US REITs: premium/discount to NAV over time

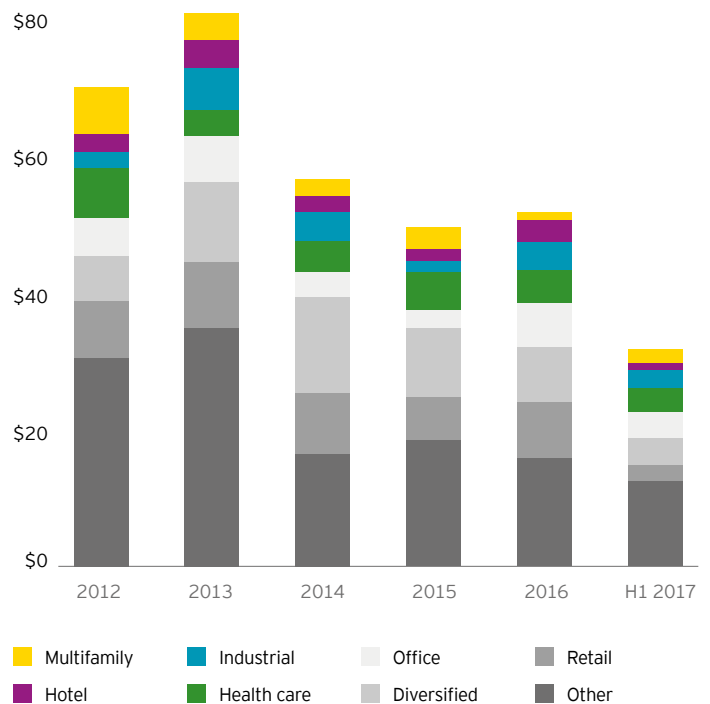


⁴ SNL Financial XL database, SNL website, <https://marketintelligence.spglobal.com>, accessed 15 August 2017.

⁵ Ibid.

⁶ Ibid.

Figure 3: Global REIT equity offerings, excluding IPOs (US\$b)*



* Includes specialty REITs, mortgage REITs and REITs that are no longer operating

Source: SNL Financial

The first half of 2017 has seen positive signs for REITs, with a steady flow of IPOs globally (see Figure 4). Nine markets have seen new listings, with a total of US\$4.2b raised through the first half of 2017.⁷ IPO activity remains below the 2013-14 period, when recovering market conditions, the introduction of new REIT jurisdictions and a wave of portfolio IPOs in Japan in particular drove activity. With the exception of a high-profile US IPO that raised US\$1.5b, global IPO activity has primarily focused on smaller entities, with 38 organizations raising US\$9 billion in the last 12 months.⁸

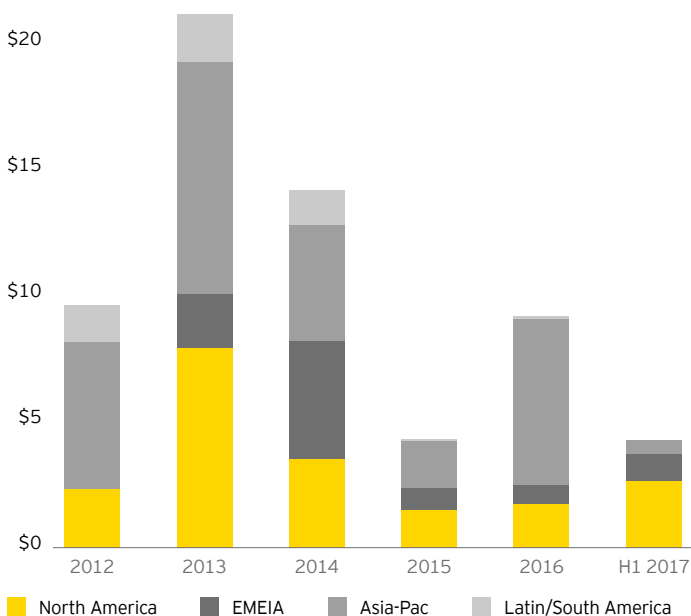
Selective public-to-private transactions continue to occur

2017 has seen significant NAV discounts emerge in pockets of the market, and, with major private equity (PE) funds and large institutions awash with capital, a handful of public-to-private transactions have occurred. Multibillion-dollar transactions in the US have seen office and residential REITs taken private by a mix

⁷ EY.

⁸ Ibid.

Figure 4: Global REIT IPO volume: 2012-1H 2017 (US\$b)



Source: Dealogic, EY

of capital sources, including both PE and major pension funds. While the relatively mature nature of this real estate cycle means investors continue to display a degree of caution, we believe that selective public-to-private transactions will occur where obvious synergies exist. This is in contrast to previous cycles, when market-wide opportunities existed as a result of the availability of cheap capital.

Tax legislation remains a fundamental requirement to create an effective REIT market ...

Tax legislation continues to evolve across all REIT markets and particularly in nascent jurisdictions where a broad REIT framework exists but is not practicably favorable enough to see companies convert or go public. REIT industry groups from around the world have been actively exploring ways to refine their existing legislation to make them more attractive and provide the type of tax incentives to further promote the use of the REIT structure. In India, for example, the regulations for investment trusts (real estate and infrastructure) were introduced in 2014. Since then,

the regulations have gone through significant amendments to bring more clarity to sponsors and investors. The potential investor base has also been widened by permitting insurance, pension and mutual funds to invest in the product and by introducing tax breaks to make these vehicles more attractive. This is an important development; as we mentioned in last year’s Global REIT report, there is an estimated US\$405b need for infrastructure improvements in India by 2020.⁹ The first infrastructure investment trust (InvIT) listing has taken place in 2017, and so far the Indian stock market has witnessed two listed InvITs. In the REIT market, a listing sponsored by a US-based private equity fund manager is imminent and will likely set the tone for this product in India, as several other large commercial office developers are looking to list assets through REIT structures in an effort to generate liquidity.

In the US, the REIT industry has a foundation of 50-plus years of tax law that works efficiently, but this may be disrupted by new, broader tax legislation. Relative to other industries, real estate has historically made good use of tax-advantaged vehicles, including REITs and partnerships, to reduce or eliminate so-called double taxation. In many instances, real estate investors (individuals, private equity and companies) have been willing to accept a heightened degree of tax complexity to benefit from these vehicles and to defer taxation upon disposition (e.g., through like-kind exchanges and other strategies). While the debate concerning the exact nature of the changes to US tax reform is ongoing, a significant reduction in corporate tax rates and certain income from partnerships that is currently proposed could affect decision-making related to the type of investment vehicle chosen by real estate owners. For existing US REITs, once there is more clarity as to potential changes in US tax law, management teams will need to evaluate the resulting impact on taxable income, and cash flows and dividend yields, as well as on the opportunity for tax deferral planning. These issues are central to the valuation of real estate ownership and operations and capital allocation decisions.

... and legal and tax issues continue to influence the structure of REITs across different markets ...

The unique nature of legal and tax jurisdictions means there continues to be a wide discrepancy in what REITs look like in different regimes. As a result, issues that, for some, may appear

⁹ “India Requires Rs.26 Trillion for Its Infra Financing in 5 Yrs: PHDCCI & CRISIL,” *India Investment News*, 8 January 2015, via Factiva, © 2015 Contify.com (2015 average exchange rate used – 64.14-SNL).

resolved for others remain very relevant. One such area is the decision to operate with an internal or external management structure. Globally, 38%¹⁰ of REITs by number are externally managed, partly because in markets like Japan they are required to be, whereas others, like Singapore, choose to be. Even in markets such as the US, where for many this issue has long been resolved, we are seeing better structures that overcome historic fee and alignment issues; these have reinvigorated the non-traded REIT market. This concept may be increasingly of interest to other non-US REIT markets. A companion article on internal vs. external management structures (EYG no. 06329-174GBL) looks in more detail at the challenges inherent to an external management approach and the issues that need to be addressed in order to best mitigate these challenges.

... while all types of investors push for greater adoption of best practices

Universal acceptance of best practices in terms of structure, corporate governance, financing and capital allocation is rarely achievable, but recent years have seen a more vocal group of activist investors pushing for change when they identify issues in these areas that they consider to be sub-optimal. Our analysis of two and a half years of REIT shareholder activism in the US suggests that shareholder rights, corporate governance, management structure, alternative strategies and strategic direction form the basis of most activists' concerns, as not all campaigns have been initiated against companies that have underperformed against their peer group. The rise of activist investors in the US has also coincided with a greater focus globally on corporate governance. REIT investors are increasingly challenging organizations around corporate governance, with board composition, transparency, accountability, diversity, experience and alignment seen as essential elements of good governance.

A companion article on investor activism (EYG no. 06285-174GBL), highlights business areas and issues being targeted and considers how companies can view themselves through the lens of a shareholder group in order to identify areas for improvement. While public activism, as seen in the US, has yet to become commonplace globally, the themes and issues raised by activists

provide a valuable reminder of the focus of REIT stakeholders. Many of the US activism themes are, therefore, directly applicable across all REIT markets.

Technology is accelerating the pace of change and contributing to a more dynamic and fast-moving real estate market

Technology will continue to create both challenges and enormous opportunities, and it is not just about disruption. Technology will help the real estate industry design more sustainable buildings, making better use of water and energy resources. Reduced operating costs and better safety features should result. It will also help real estate owners better understand the standing of specific assets within a certain submarket, enhancing their ability to make informed buy, hold or sell decisions. Technology will also be highly disruptive, however, in fundamentally redesigning the way tenants in all industries use real estate. This is challenging management teams to stay abreast of trends that evolve rapidly. For those unable to keep pace, the risk of asset obsolescence is very real, with negative implications for portfolio value and the business generally.

The accelerated pace of change seen in our markets makes obsolescence more relevant than ever before. Investors, lenders and rating agencies are considering these factors as part of their process in determining how to underwrite companies and their real estate assets. This may have future implications for a key REIT financing mechanism, affecting both an organization's ability to access debt financing as well as the pricing of that debt.

A companion article (EYG no. 06284-174GBL) shares insights around the convergence of technology and real estate in this dynamic environment.

¹⁰ SNL Financial, SNL XL Database; accessed August 2017.

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