

**Internal vs. external  
management  
structures**



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The recent trend toward management and fee structures that better mirror global best practice in the real estate funds' world will likely make externally managed REITs a more competitive alternative than they have been in the past.

For many real estate executives, and particularly those in the US, the debate around the relative merits of internal vs. external management structures<sup>1</sup> for REITs has long been resolved in favor of the internal model. A lack of alignment due to perceived conflicts of interest and questionable fee structures has been held up as exhibit A against external models. Internally managed vehicles are widely regarded as best practice, and, in the US, the world's largest and most mature REIT market, only 13% of REITs by number are externally managed.<sup>2</sup> Those 26 REITs account for just 3% of the industry's market cap.

As the REIT concept gains traction globally and emerging regimes and companies look to export best practice from the US, this would appear to be a simple win; for a REIT to be successful in the long term, it needs an internal management structure – case closed.

This may well still be the case, but a number of recent developments have clouded the picture. Globally, many emerging REIT markets have eschewed almost 30 years of modern REIT experience in the US and are largely composed of externally managed vehicles. As Figure 1 shows, in many parts of Asia and, to a lesser extent, Europe, external models are prevalent.

Two emerging trends will have important consequences for many REIT markets:

1. As the REIT concept has gained traction globally, there are more markets where the external concept is either a requirement or considered the default structure – Japan, India (required), Singapore, Hong Kong (default).

2. Externally managed vehicle structures are evolving to reduce the gap when compared to their internal brethren by addressing fee, conflicts of interest and, where appropriate (e.g., US non-traded REIT sector), liquidity issues by more closely mirroring successful fund models.

For new REIT entrants, and particularly those with institutional-standard sponsors, there may be reason to revisit the conversation around how to structure a REIT platform. Revised terms around alignment, and fees in particular, potentially make externally managed vehicles more competitive than has historically been the case. This is especially the case for smaller REITs.

### Pros and cons of externally managed REIT vehicles

Externally managed REIT vehicles have historically faced challenges around fee structures and conflicts of interest and, in pockets of the market such as US non-traded REITs, liquidity has been an issue. Well-structured externally managed vehicles do exist and usually operate around an approach of “we do well if you do well.” High-quality management teams, back-loaded fee structures and strong corporate governance are features of good externally managed vehicles. Table 1 highlights the major pros and cons of externally managed vehicles.

### Performance of internally vs. externally managed REITs

We studied the performance and capital-raising activity of REITs by comparing those with internal vs. external management structures. Our analysis that follows suggests there may be some merit to

Figure 1: Internally managed vs. externally managed REITs by market\*

Market	Netherlands	France	US	Belgium	South Africa	Italy	Canada	UK	Australia	Ireland	Spain	Mexico	Hong Kong	Singapore	Japan	
Number internally managed	4	17	169	8	19	3	30	24	19	1	1	0	0	0	0	
Number externally managed	0	2	26	2	5	1	15	13	14	2	3	8	8	37	45	
	Internal management								External management							
Percent of market cap externally managed	0	3	3	10	7	11	10	9	10	61	87	100	100	100	100	

Source: SNL Financial

\* We've based our analysis on SNL Financial's universe of global REITs, which does not include non-traded or privately owned REIT vehicles.

<sup>1</sup> Internal structures being a fully integrated operating company with management in-house, as opposed to an external structure where the REIT is a vehicle directed by a third-party manager.

<sup>2</sup> SNL Financial, SNL XL Database, accessed August 2017.

**Table 1: Pros and cons of externally managed REIT vehicles**

Pros	Cons
<p>An external manager can offer resources, talent (personnel) and influence that an internally managed REIT may not be able to rival due to the scale of the external advisor.</p> <p>An external manager brings these benefits on day 1 and can draft additional skills and/or resources from across the parent platform as and when they are needed. For an industry built around individual transactions and assets, access to best-in-class talent is critical.</p> <p>For new and/or smaller REIT vehicles, this can be a differentiating feature that enables a new REIT to establish itself more rapidly.</p>	<p>Externally managed REITs have often been high-load products, particularly in comparison with their internally managed peers, where annual overhead is typically less than 50 basis points (bps) of total assets. Management fees on externally managed vehicles are typically in excess of 100bps of net asset value, and fee structures may include sales commissions and dealer manager fees, as well as acquisition and investment fees.</p> <p>Fee incentives often challenge manager/shareholder alignment either through incentivizing transactions or by encouraging managers to raise capital and grow the size of the business in order to receive higher management fees at the expense of performance and/or shareholder dilution.</p>
<p>Capitalizing on market opportunity – with an existing platform in place, managers can launch REIT products in response to evolving market trends.</p>	<p>Performance hurdles may encourage managers to use excessive leverage and take undue risk.</p>

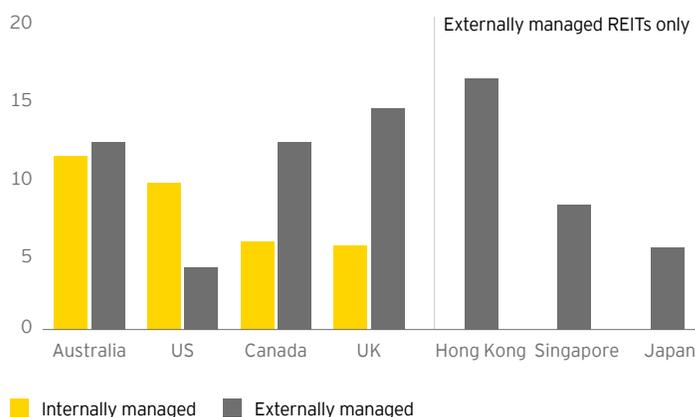
the arguments made against externally managed REITs, but it is far from conclusive and less valid for smaller entities. From a performance perspective, in the US, internally managed REITs have outperformed their externally managed peers by around 240bps per annum over the last five years. The differential is, however, reversed (externals outperformed by 145bps) for smaller entities (market cap under US\$2b) where many of the advantages listed in Table 1 are particularly relevant. Outside the US, externally managed vehicles have performed well of late and even outperformed internally managed peers in established REIT markets such as Canada and the UK.

The perception that externally managed REITs are particularly prone to raising equity capital also appears to have merit; externally managed vehicles in the US have raised 30% of their current market cap through subsequent equity raises (primarily follow-on offerings) in the last five years while internally managed vehicles have raised 13% of their current market cap.

### Performance and capital raising

Externally managed REITs have performed well over the last three years, with particularly strong returns in Canada, the UK and Hong Kong (see Figure 2). In the US – the most mature REIT market in the world – the performance differential heavily favors internally managed vehicles.

**Figure 2: Three-year average annual total returns (%)**



Source: SNL Financial, analysis by EY

### Five-year total returns

The US is the only market with a significant number of both internally and externally managed REIT vehicles with five-year track records. Internally managed REITs have outperformed externally managed vehicles by 240bps per annum on a total return basis. Externally managed vehicles with market caps

under US\$2b today have, however, marginally outperformed their internal peers. For smaller and potentially less established REITs, investors appear to benefit from an external platform (see Figure 3).

### Capital raising – equity

Externally managed REITs listed in the US have raised relatively more capital in the last five years than their internally managed peers. With about 30% of their current market cap raised through equity offerings in the last five years, raising equity in an accretive manner and allocating capital prudently – both core functions of any REIT – become exceptionally important. Whether across the entire REIT universe or for entities under US\$2b market cap, externally managed vehicles have been a lot more active.

For all externally managed REITs (not all of which have been listed for five years), the primary method of raising equity has been follow-on common equity offerings and, to a lesser extent, preferred equity (see Figure 4).

### Externally managed REITs in 2017 – better structures, better alignment and stronger governance

Institutional fund management platforms have strengthened internal controls, systems, processes and investor communication in response to both the financial crisis and subsequent regulatory overhaul. They are now looking to diversify capital sources and, where possible, create new products that complement existing fund offerings, i.e., back-loaded performance-based fee structures and strong governance controls. New, externally managed listed entities – in both the US and worldwide – with structures that better mitigate many of the historic alignment, fee and governance issues are becoming increasingly prevalent as a result. Listed REIT products are now providing retail and institutional investors of all sizes with access to best-in-class fund platforms.

In the US, the most significant change is occurring in the non-traded REIT market. Liquidity, fee structures and conflicts of interest have long plagued the sector. The introduction of the new fiduciary rule from the U.S. Department of Labor<sup>3</sup> and new product launches from institutional fund managers with structures more aligned to closed-ended funds (back-loaded fee structures aligned to performance) are redefining the market. Incumbent operators who fail to modernize their product are already being squeezed, with 41% of capital raised this year accruing to a single new product backed by a leading global private equity real estate

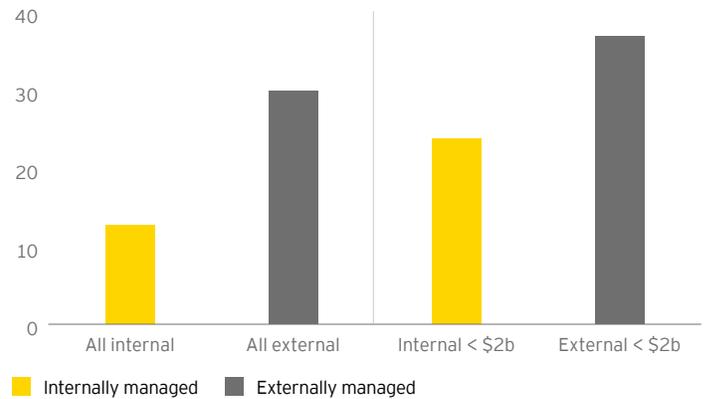
<sup>3</sup> The U.S. Department of Labor now requires financial advisors who handle retirement accounts to act as “fiduciaries” and, therefore, put the best interests of their clients first.

**Figure 3: US five-year average annual total returns (%)**



Source: SNL Financial, analysis by EY

**Figure 4: US equity capital raised as a percent of current market cap (%)**



Source: SNL Financial, analysis by EY

platform. Revised terms around fees, where trailing structures improve manager/investor alignment, as well as better provisions for liquidity, have been critical to the success of this vehicle. More investor-friendly terms annexed to a leading fund management platform have proven to be a highly attractive proposition.

Access to a best-in-class real estate platform is undoubtedly appealing, but it is the revised structures offered by these groups that make the proposition compelling. New products are organized in a way commensurate with a fund manager’s institutional funds

**Table 2: US non-traded REITs – evolution of concept**

	Previous	Today	Example terms – core+ vehicle
Fee structures	<p>High-load product:</p> <ul style="list-style-type: none"> <li>▶ Sales commission</li> <li>▶ Dealer manager fee</li> <li>▶ Acquisition, disposition, investment and management fees</li> </ul>	<p>Trailing structure:</p> <ul style="list-style-type: none"> <li>▶ Annual management fee</li> <li>▶ Performance fee</li> <li>▶ No acquisition, disposal, financing or development fees</li> </ul>	<ul style="list-style-type: none"> <li>▶ Management fee: 1.25% of NAV per annum</li> <li>▶ Performance fee: 12.5% of annual total return, 5% hurdle and a high-water mark</li> <li>▶ No acquisition, disposition, financing or development fees</li> </ul>
Liquidity	<ul style="list-style-type: none"> <li>▶ Limited share-redemption program</li> </ul>	<ul style="list-style-type: none"> <li>▶ NAV published monthly</li> <li>▶ Monthly or quarterly redemptions</li> </ul>	<ul style="list-style-type: none"> <li>▶ Monthly repurchases at prior-month NAV</li> <li>▶ 5% discount on shares not held for one year</li> <li>▶ 2% of NAV limit per month and 5% quarterly</li> <li>▶ No obligation to repurchase any shares</li> </ul>
Conflicts of interest	<ul style="list-style-type: none"> <li>▶ Fee incentives challenged manager/ shareholder alignment</li> <li>▶ Managers were also broker-dealers</li> </ul>	<ul style="list-style-type: none"> <li>▶ Fiduciary rule</li> <li>▶ Improved alignment around fees</li> </ul>	<ul style="list-style-type: none"> <li>▶ Fee incentives removed</li> </ul>

(even if the risk profile is often more core+ than opportunistic) and supported by extensive, efficient and globally connected platforms. The non-listed status of their REIT vehicles with monthly or quarterly portfolio valuations and repurchases<sup>4</sup> may also appeal to investors who are comfortable with the more limited liquidity proposition and smoother valuation process offered by real estate, and do not require instant liquidity, as offered by the listed market.

Getting the structure of an externally managed REIT right remains challenging, when, even in the simplest form, the relationship between management fees and promote can create an environment that influences, or is perceived to influence, subsequent management decisions.

One of the main challenges for externally managed REITs is messaging and specifically allaying concerns – however unfounded – that corporate actions are being taken without shareholders' interests in mind. Management teams should approach affiliated transactions with an expectation that the manager will receive scrutiny from the company's array of stakeholders.

<sup>4</sup> Subject to manager approval

Critical therefore to the success of an externally managed vehicle is addressing even the most detailed structuring issues during the formation of the management relationship. Avoiding the need to undertake affiliated events is essential, as anything perceived to benefit the manager will be viewed with skepticism. The amount of detail in the initial contract describing the key terms is critical and will set the tone for the REIT's success. Table 3 outlines the key areas for management teams to consider.

Agreeing on a number of these terms with a high degree of specificity will not only provide transparency to investors but also assist management and the board in confirming that the fees and expenses charged to the REIT are fair and truly represent a necessary cost of doing business. On the other hand, it is also essential that the REIT and its manager have a relationship that is economically viable to the manager so that they will have the incentive to act in a manner that is in the best interest of shareholders. A good example of this is how a contentious issue, such as high-water marks,<sup>5</sup> will work. From an investor perspective, a high-water mark is a valuable mechanism to

<sup>5</sup> A high-water mark is the highest peak in value that a fund has reached. If the manager loses money over a period, he must get the fund back above the high-water mark before being entitled to further performance-based compensation.

**Table 3: Externally managed REIT structures – best practice**

Issue	Detail
Cash investment	Aligns management with shareholders
Fee structures	No reward for routine property skills, i.e., no acquisition, disposition, financing or development fees
Fee alignment	Focus on alignment as much as quantum – trailing share-based payouts which vest over a longer time period (five+ years) to align management to long-term shareholder returns
Performance-related compensation	Linked to shareholder returns and not (entirely) to net asset value (NAV); paid (largely) in shares
Hurdles	Reflective of strategy, i.e., circa 5% for a core+ vehicle
Performance fees	Performance fees must align to strategy and the associated risk profile, i.e., the performance fee should not reward core or opportunistic returns for a core+ strategy
Board structure	In keeping with local best practice around composition, election, structure, diversity, expertise and subcommittees; consider specific board restrictions for an initial time period – see below
Manager exclusivity	No conflicts between the externally managed REIT and other manager vehicles in terms of investment strategy; an external shareholder-appointed supervisory board should be considered if conflicts are inherent in the structure
Internalization criteria	Clearly articulated so shareholders can value future liabilities
Reimbursements	Specify allowable costs rather than setting arbitrary values; provide mechanism for oversight of costs incurred to confirm proper expense management
Subsequent capital raises	Manager investment to help incentivize future performance; establish and communicate the terms up front
Governance	Independent directors elected in line with local best practice; scope for independent directors to review the performance annually and make recommendations regarding fee structure, cost reimbursements and retention of the manager

confirm a manager's performance fee is not paid a second time for recovering prior performance. From a manager's perspective, however, high-water marks can be terminal if they are perceived to be unattainable. If not properly structured to provide the right incentives, a manager may divert resources away from the REIT, which would create a drag on its future performance.

Board structure, composition, experience, expertise, diversity, election and independence have all been in the spotlight for corporates globally and REITs in particular. In the US, activist investors have targeted REITs and externally managed vehicles have been particularly impacted: 31% of externally managed vehicles (internally managed: 13%) have experienced an activist campaign since 2014, with board control and/or representation a key area of focus. Ultimately, a board should be structured in line with local best practice, but both the manager and investors need to consider the practical implications of this and the need to protect the investment they have made. From a manager perspective, launching a new REIT is a big commitment and they understandably need to take measures to protect both that investment and the manager itself. Investors, however, need to be sure that the REIT will deliver the strategy outlined at inception. Holding a board accountable through re-election is, therefore, a powerful tool. A compromise may be launching with a classified structure or plurality voting but committing to declassifying – which, as a process, can take a number of years – as part of the initial corporate governance strategy. This could give manager-appointed directors a set term (three to five years) to deliver the initial strategy before being subject to re-election and potential replacement.

Seemingly straightforward issues can also prove contentious. Reimbursements to the parent manager are one such area. Managing costs in an external structure is no less important than in an internal structure and almost always in all parties' best interests. Often, investors insist on a cap, which is sensible in principle but can lead to complications; a legal or accounting project, for example, that can be completed by the manager's in-house teams may have to be outsourced at a higher cost because the internal cost exceeds a predetermined limit. This often comes at a higher cost than using internal resources. A better approach is once again specifying up front which costs are reimbursable and which should be externally sourced. Table 3 summarizes these best practices for externally managed REIT structures.

## Conclusions

Externally managed REITs are increasingly mitigating fee, alignment and, where applicable, liquidity concerns. Greater acceptance of externally managed vehicles by investors will likely result, and our analysis of performance among smaller REITs suggests investors have become increasingly open to the concept. Greater acceptance of external structures is an important step in promoting further growth of the REIT concept globally as more managers sponsor products. Externally managed REITs have a long way to go to rival their internally managed peer group in market cap terms, but the recent trend toward management and fee structures that better mirror global best practice in the real estate funds' world will likely make it a more competitive alternative than it has been in the past.



Getting the structure of an externally managed REIT right remains challenging, when even in the simplest form the relationship between management fees and promote can create an environment that influences, or is perceived to influence, subsequent management decisions.



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