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The Globalization of REITs: New Challenges and Opportunities

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REITs have clearly gone global. For several decades after their inception in 1960, REITs were largely confined to the United States and Australia. The last few years have, however, seen a dramatic expansion across the globe. This expansion has been manifested in two ways: (i) the increasing level of investment by REITs outside the United States and Australia; and (ii) the proliferation of REIT legislation in numerous European and Asian countries.

The growing appetite of US and Australian REITs for overseas investment is perhaps a function of the state of their home markets more than anything else. The size of the Australian market is such that REITs based there have historically looked abroad for investment opportunities. For US-based REITs, overseas expansion is a more recent phenomenon and largely attributable to the scarcity of new opportunity in the States. Returns have been suppressed by an increase in the amount of capital which has been chasing fewer opportunities. In turn US REITs have increasingly looked outside their borders for new investments. Certainly geopolitical issues are also at play – the establishment of the European Union and the increasing (but far from complete) level of comfort with investments in China are two reasons for the outward expansion. However this trend could be dampened significantly by the recent unfavorable currency exchange rates between the United States and Europe.

EXPANDING HORIZONS

In a dozen or more countries REIT legislation has been enacted or is pending. The UK and Germany are actively considering the adoption of REIT legislation. They have been struggling with attempting on one hand, to facilitate the creation of a new investment vehicle and the attendant additional tax revenue and, on the other, to minimize the tax leakage from the conversion process. These two goals might turn out to be incompatible. It is safe to say that Asian REITs have developed more quickly than their European counterparts. The Japanese J-REIT has now been around for over four years and has achieved a market capitalization of approximately US$13.6 billion. The Singapore and Hong Kong markets are less developed but likely to expand rapidly. The South Korean model has yet to develop a significant following, as the legislative framework has been perceived as unusually restrictive.

The newfound fascination with REITs has several sources. Clearly, the strong performance of the US REIT market in recent years has been a factor. Current income coupled with the opportunity for significant capital appreciation has shown a positive light on REITs in an otherwise lackluster equity market. Because of the long-term nature of real estate leases in the US, REITs are also perceived as potentially counter-cyclical. It remains to be seen if and to what extent these factors will translate abroad.

There still remain some important questions as to the development of REITs. Is there much reason to expect that German REITs will outperform the traditional German property funds? And what inflation protection will Asian REITs offer if leases remain significantly shorter in term than in the US? In Europe, will the new REIT legislation sufficiently differentiate the new vehicle from other publicly traded property companies? In the US, except for a brief and largely unsuccessful experiment with master limited partnerships, REITs stepped into a vacuum in the public markets. Will this be the case in jurisdictions such as the UK and Hong Kong where public property companies have a longer and more successful history?

REITS: THE BENEFITS

Clearly there is a persuasive case to be made for a publicly¬ traded collective investment vehicle for real estate in any market. For developers and property owners a publicly traded vehicle offers tremendous access to additional, and relatively cheap, capital (albeit with significant administrative problems). For smaller, retail investors, REITs offer access to real estate investment as never before. While the individual investor could not previously hope to invest directly in large commercial holdings, REITs offer a mutual fund-like vehicle to play with in this market. For larger investors, such as public and private pension funds, REITs provide an attractive alternative to direct investment, offering the opportunity for greater liquidity and diversification with significantly less direct transaction cost. For tax authorities, REITs are thought to facilitate a more active real estate market with the attendant additional tax revenue from increased trading. Creating a domestic vehicle may also reduce tax leakage from investments by foreign-based REITs.

A review of REIT legislation outside the United States and Australia leads to two related conclusions: (i) that REITs share a common name but differ significantly in structure from jurisdiction to jurisdiction; and (ii) the newest REITs resemble the earliest incarnations of the US REIT. They are externally managed and subject to significant legal and market constraints.

WHEN A REIT IS NOT REIT

Not all jurisdictions employ the term REITs. The UK, for instance, has denominated its investment vehicle as a property investment fund or PIF. Yet, all of the newly created vehicles have been lumped under the heading of REITs. Even in the US, this designation may be misleading. While the earliest REITs were typically Massachusetts business trusts, today only a fraction of the active REITs are created using a trust structure. Many are C corporations (taxable corporations) electing to be treated as REITs under the Internal Revenue Code.

Outside of the US, the confusion is likely to be even greater. The appropriate legislative framework in Australia would likely not be suitable for Hong Kong, as these REITs are primarily intended to facilitate trading in developed Hong Kong real estate than to encourage additional development or investment abroad. But investors should proceed cautiously and understand that there are significant disparities in the structure and intended use of the collective investment vehicle.

As the various Asian markets become more comfortable with the REIT structure, it is likely that, as has happened in the United States, many of the legal and market constraints will be

eliminated. Until then, it is important that investors—especially those familiar with the more advanced US and Australian models—recognize that not all REITs have been created equal, and that the legislation in each jurisdiction should be reviewed carefully.

EXAMINING REIT VARIABLES

We suggest that potential investors will want to compare REITs across several variables:

- *Tax Treatment.* In some jurisdictions, such as Hong Kong, the tax treatment of REITs differs little from that of other publicly-listed property companies. REITs are taxed like any other corporate investment vehicle. There is no dividends-paid deduction, which, in the US, avoids a corporate level tax on distributed income. While many of the newer REITs have been formed in jurisdictions with little or no tax burden, investors should be aware that few, if any, of the new REITs have been structured to offer any tax relief at the corporate level.
- *Operating Structure.* In the United States, even though the legislation enabling REITs was first adopted in 1960, REITs did not become a key and stable player in the public markets until they began using the operating partnership structure. This enabled REITs to acquire properties in exchange for operating units—a non-cash currency which facilitated the growth of REIT portfolios while offering tax deferral to sellers. The exchange of property for a partnership interest is not taxable until the unit (or the share into which it can be exchanged) is sold.
- *Management.* Initially, US REITs and their Australian counterparts were required to be externally managed. Over the years, the requirement that REITs be managed by third parties has all but disappeared in the United States and has been somewhat loosened in Australia. None of the new crop of Asian REITs is permitted to conduct self-management.
- *Leverage and Development.* Most legislation for Asian REITs restricts development activity and limits leverage to well under 50% of asset value. Of course, it remains to be seen how REITs will function with these limitations. Coupled together, these restrictions could certainly become inhibitors of growth. If a REIT is required to distribute most of its income and yet is limited in what it can borrow, it is not clear how REITs will be able to grow their property portfolios other than by equity placements, which is an expensive way of raising capital.
- *Financing.* Even with the significant restrictions on leverage, the ability of the new REITs to finance on a secured or unsecured basis is likely to be important to their success. Traditionally, secured financing requires that lenders be comfortable with the laws of foreclosure and remedies in the applicable jurisdiction. Lenders will also be concerned about the quality of collateral. For instance, financing on a ground leasehold interest is often conditioned on the lender receiving additional protections from the ground leaser. Investors will want to confirm that the laws and quality of collateral will be sufficient for the efficient use of leverage.

Unsecured finance arrangements have been used increasingly by US REITs to enable the REITs to move quickly to secure the acquisition of investment opportunities. The lenders' willingness to provide unsecured credit lines will require that the REITs can provide the necessary transparency to their financial condition. It may be some time before internal lenders become sufficiently comfortable with the uniformity of accounting standards and financial reporting across the applicable Asian jurisdictions to offer unsecured arrangements.

CONCLUSION

We noted at the outset the two primary aspects of the increasing globalisation of REITs (i) the growing appetite of United States REITs for investments abroad, and (ii) the proliferation of REIT legislation throughout Asia and Europe. It remains unclear whether these factors will continue to push the trend toward globalisation. The interest on the part of US REITs in overseas investment could be cyclical and better returns at home and unfavorable exchange rates could cause the focus to return to the US. On the other hand, one can argue that the appetite of United States (and other) REITs has become so large that it can no longer be satisfied by one market.

Continued attention to overseas markets might therefore be argued, but it may also drive a trend toward regionalisation. Just as the largest US players cannot know all of the local domestic markets and must look for knowledgeable and quality partners, REITs operating abroad will likely have the same need to rely on others for market knowledge and penetration. Perhaps US REITs should welcome the opportunity to team up (or even take over) foreign REITs with the appropriate market presence.

For this to occur, however, it will likely be necessary that foreign REITs achieve greater levels of transparency and management focus. It is questionable whether large US investors or REITs themselves will become comfortable with significant investments in or with foreign REITs until they are assured that the financial statements and other public information provided by the newer REITs are reliable and complete.

As noted above, the external management characteristic of most of the new REITs may also be an impediment to growth and to interaction with the established US REITs. While external management was originally required of US REITs, it cannot be a mere accident that the shift toward internal management coincided with the unprecedented growth and performance of US REITs at the end of the last century. It may be that the external management structure is something not sufficiently dynamic to provoke innovation and to drive performance.

Overall, however, the global growth of REITs looks set to continue. As it does, the experiences of more established REIT markets, such as the US and Australia, should be a helpful touchstone for the do's and don'ts of establishing a legal framework for REITs