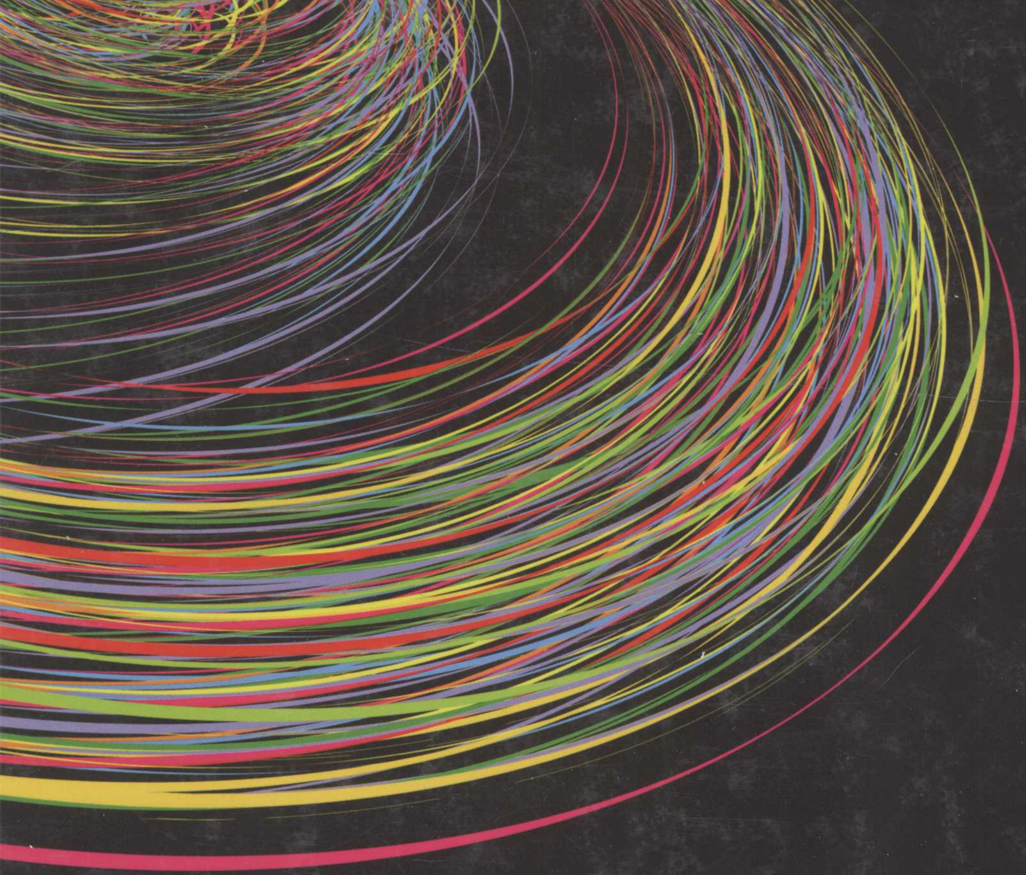

# Global Real Estate Investment Trusts

## PEOPLE, PROCESS AND MANAGEMENT

David Parker

WILEY-BLACKWELL

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*People, Process and Management*

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# Global Real Estate Investment Trusts

*To my wife and our twin teenagers.*
*May the future with Susan, Elliot and Victoria*
*recompense for that foregone.*

# 1 Envisioning

This book seeks to explain the real estate investment decision making process by which a *real estate investment trust*, or REIT, converts \$1 of unitholder capital into \$1 of investment real estate. Focusing equally on the people and the process, the contributions of the key participants in the real estate investment decision making process are described and analysed with a particular emphasis on both the overlap between their roles and their interaction.

The process of real estate investment decision making is a fusion of the 'how' and the 'why'. In this book, the *how* is based on the results of new, original academic research, including structured interviews with the managers of a wide range of different types of REITs, as well as the research and publications of others as referenced, together with the author's 25 years experience in REIT management. The *why* is drawn from the real estate theory, capital market theory and finance theory that underpins real estate investment management.

While the real estate investment decision making process draws on a range of tools, such as the Capital Asset Pricing Model, the role of intuition and judgment remains vital. Spreadsheets, sensitivity analysis and scenarios all have an important role to play in real estate investment decision making but need to be balanced with the intuition and judgment that come from years of practical experience.

Real estate investment decision making is presented in this book as comprising three Phases with six Stages and 30 Steps, being an ongoing, cyclical process. The first Phase, the Preparing Phase, comprises the Envisioning Stage and the Planning Stage wherein the REIT articulates where it is going and how it is going to get there, providing unitholders with

*Global Real Estate Investment Trusts: People, Process and Management*,
First Edition. David Parker.

a clear understanding of the risk-return profile to expect from the managers investment of their funds. The second Phase, the Transacting Phase, comprises the Dealing Stage and the Executing Stage, wherein the REIT implements the outcomes of the Preparing Phase through the creation of a tangible real estate portfolio. The third and final Phase, the Observing Phase, comprises the Watching Stage and the Optimising Stage, wherein the REIT ensures that its performance will achieve its goals and so attain its vision, thereby completing the cyclical process of REIT real estate investment decision making.

The six chapters of this book address each of the Stages of the REIT real estate investment decision making process sequentially, introducing and explaining the contribution of the relevant members of the REIT management team to that Stage. For each Stage, the relevant supporting theory, or the *why* for the *how*, is explained in detail and illustrated by application to Super REIT, a $15 billion diversified REIT.

REITs are a continuously evolving real estate investment product. Similar to listed equities investment funds, many REITs started through association with an entrepreneur who was the sole decision maker focusing on specific assets and evolved over time into a team approach focusing on a portfolio of assets. However, whereas the dominance of sophisticated international institutional investors in listed equities investment funds has pressured portfolio managers to adopt more transparent, explicable and repeatable investment decision making processes which are independent of individual decision makers, this has been less evident in REITs where the investment decision making process often appears to be opaque, curious and *ad hoc*.

This book seeks to increase the transparency and explicability of the real estate investment decision making process by REITs, thus contributing to the potential for repeatability, by shifting from a greater emphasis on people to a greater emphasis on process, so contributing to the continued evolution of REITs as a real estate investment product.

Extensive research over the last 25 years has shown that real estate investment is not necessarily different to other forms of investment. While many aspects of real estate investment can be explained by the application of theories and principles developed for other forms of investment, some aspects of real estate investment remain specific to the real estate sector. Similarly, many of the skills required to manage a REIT can be drawn from disciplines other than real estate while some skills remain firmly rooted in the real estate discipline. As the highly successful US real estate investor, Sam Zell, observed:

> *REITs are no longer different from any other industry that is dependent on access to capital markets,*

and

> *The successful REITs are the ones that can be characterised as operating companies versus a collection of properties.* (Garrigan and Parsons, 1997)

This is a view echoed by Geltner et al. (2007):

> *Shares of the major REITs are publicly traded in the stock exchange. Viewed by Wall Street as operational firms, that is, actively managed corporations, they are valued as such (i.e. not as passive portfolios of properties). Thus, REITs are valued in essentially the same way other publicly traded firms are valued …* (Geltner et al., 2007)

This book seeks to view the REIT holistically as a major business enterprise which combines roles and skills common to all major business enterprises with roles and skills specific to the real estate sector. Similar to mining enterprises having CEOs as well as geologists or airline enterprises have CFOs as well as pilots, a REIT may be considered as just another type of business enterprise where the CEO and CFO work in a business team with dealers and developers. This reflects the increasing trend around the world for the CEO and various members of a REIT senior management team to increasingly be experts in a discipline other than real estate and for those with expertise in the real estate discipline to decreasingly occupy positions inside the C-suite.

With a REIT sector now forming part of the stock market of the US, Australia, numerous Asian countries and an increasing number of European countries, this book seeks to provide principles of real estate investment decision making that are capable of application in all countries (subject to local laws, regulations and rules) rather than focusing on decision making within the context of a specific country's laws, regulations and rules.

For clarity, this book adopts the hierarchy whereby a REIT may comprise a group of funds and each fund may comprise a group of portfolios and each portfolio may comprise a group of properties. Also, the term '*appraisal*' is used instead of '*valuation*' though it is acknowledged that *valuation* is commonly used in Commonwealth countries.

Further, this book focuses the application of the REIT real estate investment decision making process on the acquisition of a property, though it is acknowledged that the process is equally applicable to the disposal of a property or other major transaction such as a large lease renewal or the letting of a substantial area of vacant accommodation.

Finally, where individual authors have contributed ideas specifically referred to in a chapter such authors are acknowledged individually in the text, with those authors contributing ideas generally referred to in a chapter being acknowledged in the references at the end of that chapter to which the reader is referred for greater detail.

This chapter seeks to outline REITs in principle with an overview of the REIT real estate investment decision making process and the key participants. Accordingly, by the end of this chapter, the reader should understand:

- the relevance of **commercial** and **legal principles** underlying a REIT and its characteristics;
- the importance of the **structure** and **composition** of a REIT management team for effective control of a large and often international business; and
- the significance of the **Phases, Stages** and **Steps** comprising the REIT real estate investment decision making process.

## 1.1 People and process

As the title *Global Real Estate Investment Trusts: People, Process and Management* indicates, this book focuses on both the people and the process involved in real estate investment decision making with the consideration of people intentionally coming first. This reflects the current emphasis on people relative to process in REIT real estate investment decision making which, as referred to above, is expected to reverse as REITs continue their evolution to a greater emphasis on process.

### *1.1.1 People*

Over the last 40 years, the global REIT sector has developed from a small adjunct to the stock markets of several countries to a significant sector of the global equities market. REITs themselves have grown from small businesses collecting rents from a handful of buildings to massive multinational conglomerates undertaking a wide range of activities related to real estate.

The evolution from being small, localised entities into being large, international entities has been accompanied by an evolution in both people and real estate investment decision making processes. Accordingly, REITs today are major business enterprises, with management structures that mirror other major business enterprises, but happen to have a principal business undertaking a wide range of activities related to real estate.

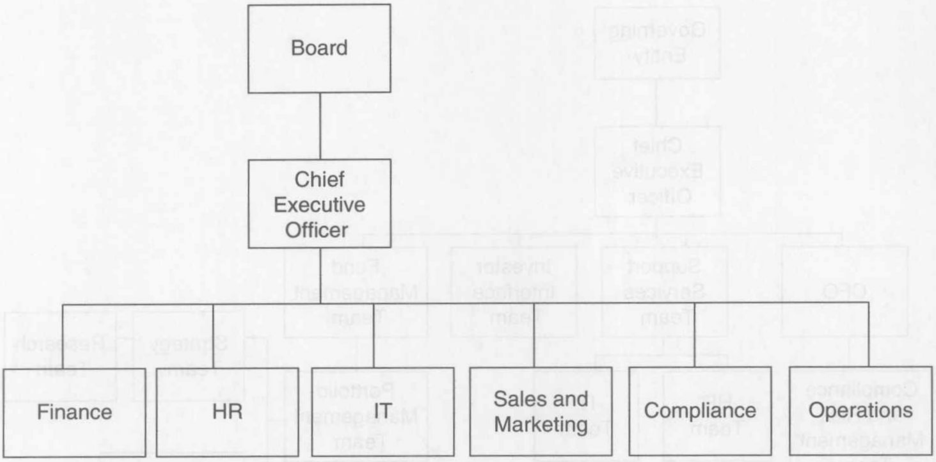


**Figure 1.1** Typical management structure of an international enterprise.

As small, localised entities, REITs were often lead by an individual and managed by a small team who, between them, fulfilled all the roles necessary for the REIT to function. As is common in small business, the respective roles may not have been defined and may have overlapped.

As large, international entities, REITs have evolved to adopt that management structure common to many international enterprises as illustrated in Figure 1.1. Though such line management functions as Finance, HR and IT are common to both REITs and major enterprises in other sectors such as banking, retail and so forth, REITs may be considered to have evolved the sales and marketing and operational line management functions to reflect the nature of the REIT business.

The sales and marketing line management function has evolved to comprise an investor interface function including marketing, sales and investor relations. For a business that specialises in real estate, the operational line management functions have evolved most specifically in REITs and so exhibit the greatest difference, as may be expected, to line management functions in other enterprises.

The operations line management functions for a large REIT reflect the various line management layers involved in the fund level, portfolio level, asset level, property level and facility level management of a REIT as illustrated in Figure 1.2. Those people comprising each of the management functions illustrated in Figure 1.2 contribute to the real estate investment decision making process within a REIT and are considered in the chapter outlining that part of the real estate investment decision making process with which they are most closely associated. Accordingly, the Portfolio Management, Strategy and Research Teams are

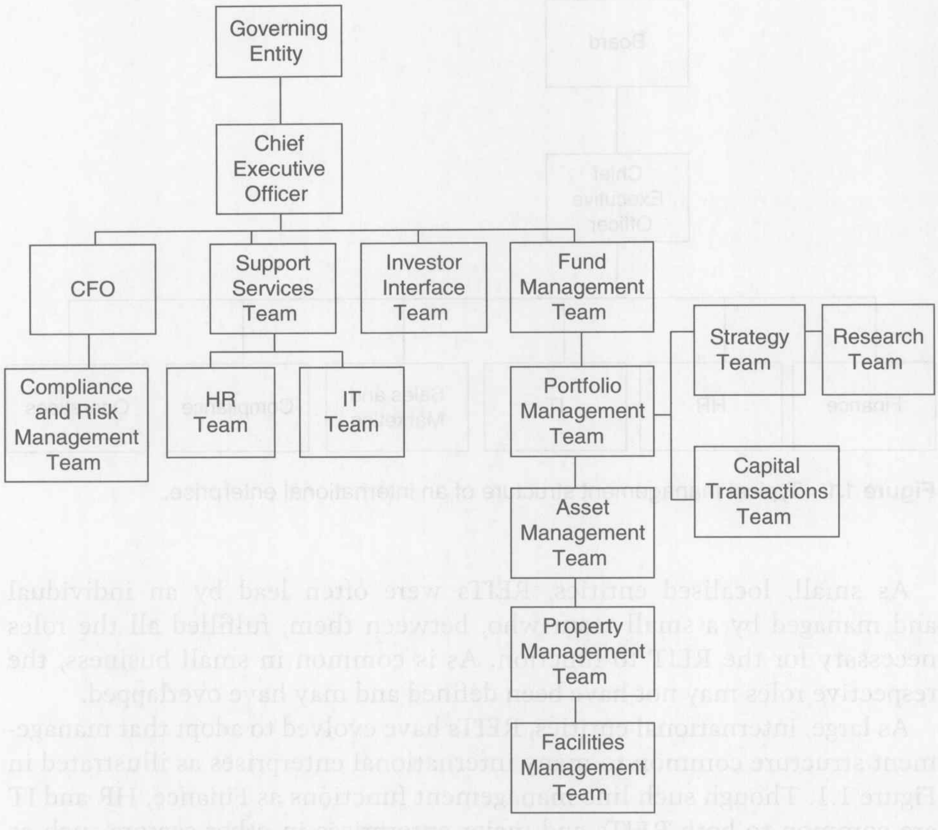


**Figure 1.2** Typical management structure of an international REIT.

considered in Chapter 2 (Planning Stage), the Capital Transaction Team is considered in Chapter 3 (Dealing Stage), the Investor Interface Team is considered in Chapter 4 (Executing Stage), the Compliance and Risk Management Team is considered in Chapter 5 (Watching Stage), the Asset Management, Property Management and Facilities Management Teams are considered in Chapter 6 (Optimising Stage) with the Governing Entity, CEO, CFO, Support Teams and Fund Management Team considered in this chapter (Envisioning Stage).

While generic names have been adopted for the various management roles, it is accepted that names may vary in different countries and for different REIT models. It is also accepted that only the largest international REITs may separate all of the various roles considered, with smaller REITs and domestic REITs combining roles to suit operational requirements.

### *1.1.2 Process*

The real estate investment decision making process outlined in this book is based on new, original academic research, including structured interviews with the managers of a wide range of different types of REITs and the research and publications of others as referenced, as well as drawing on the author's 25 years experience in REIT management.

While this book focuses on the steps involved in real estate investment decision making in the context of a large sectorally and geographically diversified REIT, the principles of the steps may be equally applied to small REITs and to sectorally or geographically focused REITs.

However, rather than the size or nature of the REIT, a potentially greater challenge to the effective implementation of the steps in the real estate investment decision making process comprises the willingness of REIT management teams to evolve their approach to decision making which may be succinctly summarised as:

> *To some degree, the quest to upgrade* the *quality of real estate decisions is perhaps a classic exposition of the aphorism: "You can lead a horse to water, but you can't make him drink".'* (Roulac in Pagliari, 1995)

Real estate investment decision making is the synthesis of theory, history, content, context, process and methodology (Roulac, 2001). This book breaks the REIT real estate investment decision making process down into three phases comprising six stages with 30 sequential steps as summarised in Table 1.1.

The Preparing Phase comprises the:

- **Envisioning Stage** – in which the REIT clearly articulates its destination together with a high order route map by which to get to the destination and some measurable outcomes to determine whether or not the REIT has arrived at the destination (considered in detail in this chapter); and the
- **Planning Stage** – in which the REIT converts its destination into the identification of a target list of specific real estate assets for potential acquisition that meet the stock selection criteria and may be mis-priced (considered in detail in Chapter 2).

Accordingly, on completion of the Preparing Phase, the REIT has articulated where it is going and how it is going to get there, providing unitholders with a clear understanding of the risk-return profile to expect from the managers investment of their funds and is positioned to undertake the Transacting Phase.

**Table 1.1** Phases, Stages and Steps in the REIT real estate investment decision making process.

| Phase | Stage | Steps | Steps | Steps | Steps | Steps |
|---|---|---|---|---|---|---|
| Preparing | Envisioning | Vision | Style | Goals | Strategic Plan | Objectives |
| | Planning | Property P'folio Strategy | Strat. Asset Allocation | Tactical Asset Allocation | Stock Selection | Asset Identification |
| Transacting | Dealing | Preliminary Negotiation | Preliminary Analysis | Structuring | Adv. Fin Analysis | P'flio Impact Assessment |
| | Executing | Governance Decision | Transaction Closure | Documentation | Due Diligence | Independent Appraisal |
| Observing | Watching | Settlement | Post Audit | Performance Monitoring | Performance Measurement | Portfolio Analysis |
| | Optimising | Asset Managem't | Prop. & Fac. Management | Transformation | Portfolio Rebalancing | Disposal |

The Transacting Phase comprises the:

- **Dealing Stage** – in which the REIT converts the target list of specific assets for potential acquisition into an in-principle transaction for the acquisition of a nominated asset (considered in detail in Chapter 3); and the
- **Executing Stage** – in which the REIT verifies all information relied upon and assumptions made in the pricing process and reflects this in the documentation necessary to protect the interests of unitholders at settlement (considered in detail in Chapter 4).

Accordingly, on completion of the Transacting Phase, the REIT has implemented the outcomes of the Preparing Phase through the creation of a tangible real estate portfolio and is positioned to undertake the Observing Phase.

The Observing Phase comprises the:

- **Watching Stage** – in which the REIT monitors the portfolio to determine whether or not the objectives, goals and hence the vision for the REIT will be achieved (considered in detail in Chapter 5); and the
- **Optimising Stage** – in which the REIT takes such action as may be necessary to ensure the objectives, goals and hence the vision for the REIT will be achieved (considered in detail in Chapter 6).

Accordingly, on completion of the Observing Phase, the REIT has ensured that its performance will achieve its goals and so attain its vision, thereby completing the cyclical process of REIT real estate investment decision making.

While the complete cyclical process of REIT real estate investment decision making is only likely to be undertaken sequentially by a newly formed REIT at inception or by an existing REIT facing transformational change or restructure, respective stages or individual steps may be undertaken by existing, operational REITs on an ongoing basis or as required. For example, while an existing operational REIT may be expected to undertake the Watching Stage on an ongoing basis, it may only be expected to undertake the Dealing Stage when required for the acquisition or disposal of a property or other major transaction within the portfolio.

Reflecting the fiduciary nature of REIT management, individual steps within a given stage should be completed sequentially in order to avoid a significant omission. For example, an existing, operational REIT undertaking the Dealing Stage when required should complete the five steps of the Dealing Stage sequentially and not omit a step, such as the Portfolio Impact Step, as this will result in important data then being missing from the real estate investment decision making process and a potentially suboptimal decision then resulting which may not be in unitholders' best interests.

To illustrate the REIT real estate investment decision making process, a fictitious existing and operational REIT, named Super REIT for convenience, is used by way of example for each Phase, Stage and Step. Super REIT is a $15 billion diversified REIT which implements the real estate investment decision making process to invest in Superman Tower in the fictitious city of Metropolis.

The approach to REIT real estate investment decision making described in this book is premised on a normative approach of sequential Steps undertaken by rational participants in a methodical manner with access to all the information, data and tools that may be required to make logical, optimal decisions in an unproblematic environment. Significantly, while the approach is described as normative, being how an investor should behave, it is based on and supported by new, original academic research (including structured interviews with the managers of a wide range of different types of REITs, as well as the research and publications of others as referenced) providing a descriptive approach, being how an investor actually behaves.

Interesting research is currently underway around the world, drawing from the disciplines of cognitive psychology and behavioural finance, that fundamentally challenges the premis of such a normative approach, arguing that real estate investment decision making is neither sequential, rational, methodical, informed, logical nor optimal and often undertaken in a problematic environment, being:

> *'undertaken by imperfect players in imperfect markets using imperfect information'* (Roberts and Henneberry, 2007).

Ongoing research suggests that the real estate investment decision making process may be influenced by the individual decision maker, their decision making environment (which may be complex, dynamic and chaotic) and the extent of information available, with a propensity for the decision maker to *'collapse down'* the decision making process and take short cuts, potentially leaving the decision making process open to the influence of multiple biases, perceptions, beliefs, preferences, judgment and sentiment (MacCowan and Orr, 2008; French and French, 1997; French, 2001; Gallimore et al., 2000; Gallimore et al., 2000a; Gallimore and Gray, 2002; Roberts and Henneberry, 2007).

Such research is consistent with the long accepted view that real estate investment decision making is more than an explicit process, including *'... the implicit decision-making apparatus of judgment, hunch, instinct, intuition, faith, and gut feel.'* (Pyhrr et al., 1989), so underlining the vital connection between people and process.

### *1.1.3 People and process*

This book seeks to explain the real estate investment decision making process by which a real estate investment trust, or REIT, converts $1 of unitholder capital into $1 of investment real estate.

While focusing equally on the people and the process, as the book title indicates, the REIT real estate investment decision making process is dependent upon the combination of and interaction between people and process, being incapable of effective operation in the absence of either and sub-optimal in the event that either is compromised.

## 1.2 REITs: an introduction

The original role of a REIT, which remains the core role of many REITs today, was to unitise and securitise otherwise illiquid investment real estate. As individual buildings increased in value and became denominated in billions of dollars rather than just in millions, the ability of and wisdom for investors to own such a building in its entirety came into focus.

By acquiring a billion dollar building and offering a billion one dollar units tradeable on a stock exchange, the REIT provides an intermediation role allowing a building for which there may otherwise be a limited market of possible purchasers to be owned indirectly by investors who would otherwise be unable to own such real estate.

The same intermediation principle is applicable to buildings in different real estate sectors, different states and different countries. In each case, the REIT offers the opportunity for bricks and mortar investment real estate to be broken down into small paper units tradeable on a stock exchange.

Further, the same intermediation principle is applicable to either individual buildings or to a very large number of buildings. As the number of buildings owned by a REIT grows or as the REIT expands into different sectors, states or countries, the REIT may group the buildings, sectors, states or countries through the creation of funds and portfolios based on such characteristics or upon other characteristics such as income, capital growth and so forth.

The evolution of REITS varies between countries with, for example, US REITs based in specific enabling legislation, Australian REITs based in trust law and other countries adopting varying combinations of both. While the details of governing documents may vary between countries, a common feature of REITs worldwide is that they enjoy some form of beneficial tax treatment in their local jurisdiction requiring very close adherence to local laws, regulations and rules in order to qualify for and maintain the tax benefit.

In the US, REITs were shaped through successive legislation including the Real Estate Investment Trust Act (1960), the Tax Reform Act (1986) and the REIT Modernisation Act (1999). US REITs have to fulfil a variety of criteria including a specified proportion of assets invested in real estate, mortgage loans, shares in other REITs, cash or government securities and deriving a specified proportion of gross income from rents, mortgage interest or gains from the sale of real estate (Block, 2002; Chan et al., 2003). From a taxation viewpoint, US REITs pay no corporate taxes provided that they distribute at least 90% of taxable income to unitholders who then pay tax at their individual tax rate (Block, 2002; Chan et al., 2003).

Comparatively, in Australia, REITs were initially shaped by the equitable principles of trust law generally and latterly by corporations and taxation legislation specifically. Australian REITs have comparatively few criteria to fulfil, with the nature of investment determined by those investments authorised under a financial services licence (Booth, 2006). From a taxation viewpoint, Australian REITs pay no corporate taxes provided that they distribute all relevant income to unitholders who then pay tax at their individual tax rate (Booth, 2006).

With REITs now existing not only in the US and Australia but also growing across Asia and emerging in Europe, the range of differing laws, regulations and rules for the REIT sector in the respective countries is vast and beyond the scope of this book to address. Readers seeking further detail of REIT laws, regulations and rules in those countries with an active REIT sector are referred to the comprehensive overview provided by Rachel Booth in *Real Estate Investment Trusts: A Global Analysis* (2006).

In addition to the common feature of some form of beneficial tax treatment, REITs across the world are also gradually converging on more transparent governance while gradually diverging on the nature of REIT models developed.

### *1.2.1 Transparency in governance*

While there is a trend to greater transparency in the governance of entities listed on stock exchanges around the world, the details of acceptable levels of transparency vary significantly between countries.

For the purposes of this book, a high level of transparency in governance is assumed though it is acknowledged that this may be in excess of the level required in certain jurisdictions. In this sense, the level of openness and explicitness in the principles of real estate investment decision making outlined in this book may be considered aspirational targets rather than a required threshold in some countries.