Growth potential

REITs are emerging in markets around the world, but the biggest opportunities may be yet to come

by Loretta Clodfelter

Before the ink was even dry on the Indian government's draft REIT-proposal legislation, Bangalore, India–based Embassy Group was planning a major offering. In partnership with The Blackstone Group, the Indian developer will launch a Rs 50 billion ($800 million) REIT, possibly by the end of 2015. The 27 million-square-foot portfolio of income-producing commercial real estate joint-owned by Blackstone and Embassy illustrates one of the roles REITs can play in new and emerging REIT markets — as an exit path for real estate private equity funds.

The REIT structure has been expanding across the globe and, in the wake of the global financial crisis, a number of new REIT markets are opening up in the Americas, Asia and Europe. The introduction of REIT regimes in countries such as India, Ireland and Mexico, as well as the modernization of REIT structures in countries such as Spain, has widened the opportunity set for REIT investing around the globe. And investors continue to watch China, where the potential for REIT investment is huge.

Of course, it remains to be seen exactly what sort of REIT market will develop in many of these countries, as the introduction of legislation alone is not enough to create a vibrant REIT market.

It is important to remember "a REIT is a tax structure; it has nothing to do with operating strategy," says Marc Halle, managing director and senior portfolio manager with Prudential Real Estate Investors.

Still, in markets with active REITs as well as listed real estate operating companies, differences

Torre Mayor in Mexico City is the tallest building in Mexico — and part-owned by Fibra UNO, the country's biggest REIT.

between the two types of companies typically develop. While REOCs are not limited by the strictures that govern REITs, they often have more diverse business lines and take on significant development risk. And REOCs frequently trade at discounts to their net asset values. By contrast, REITs focus on the ownership of income-producing properties, and they typically have more stable portfolios with less development risk — and they frequently trade at premiums to their net asset values.

"Many of the publicly traded real estate markets in their early stages of evolution are dominated by developers," says Dan Pine, managing director with Forum Securities. "Typically, a risk and yield profile of a real estate development company is materially different than that of a REIT." He points out the establishment of a new REIT regime often leads to the creation of a new breed of local companies, offering higher and more stable income streams, increased transparency, and favorable tax structures.

"The REIT is a more mature vehicle that typically is present in markets where property portfolios exist and are ready to be securitized," agrees Chris Blanchard, global real estate securities portfolio manager with Presima. In addition, he says, "The REIT structure is also attractive to investors for the stable and generally higher yield that they offer."

In speaking with people in the industry, it becomes clear no one goes public for the sake of going public — some downsides certainly are associated with the increased reporting and scrutiny — and so a real estate operating company must weigh the benefits against those costs. REITs are a way to connect investment capital with real estate and, to see REIT market capitalization grow quickly, there has to be a strong need for that capital. Following the global financial crisis and the distress it engendered, that need for capital became paramount, and the REIT structure's desirability increased around the world.

REITs go south of the border

In Latin America, the REIT market *número uno* is Mexico. Mexican REITs, known as FIBRAs, or fideicomisos de infraestructura y bienes raíces, got their start in 2011. The first FIBRA remains the largest: Fibra UNO, with a market cap of $6.8 billion as of Jan. 30, 2015. Other FIBRAs include FibraHotel, Fibra Macquarie, FIBRA Prologis, Fibra Shop and Terrafina.

A FIBRA must have at least 70 percent of its assets invested in real estate, and it must distribute at least 95 percent of taxable income to shareholders. Less attractively, according to industry participants, FIBRAs also must be externally managed. One compromise made in regards to that requirement can be seen with Terrafina. The FIBRA, which is focused on the industrial sector, uses a management structure that has an independent management team, allowing it to be internally managed by a dedicated team as well as externally advised by PREI.

"If there's one thing we could change globally, we would prefer to see management integrated into the companies," says Wilson Magee, director of global real estate and infrastructure securities at Franklin Real Asset Advisors. "We really like the alignment of management being inside the company, rather than a collection of assets being third-party managed."

Despite that, Mexico's listed real estate market has experienced substantial growth in recent years, partially as a result of their higher yields

versus their U.S. or European counterparts, notes Presima's Blanchard.

In addition to Mexico, REIT legislation is on the books in Argentina, Brazil, Chile, Colombia and Peru. Mexico and Brazil represent the biggest and most liquid public real estate markets in Latin America, but "in Brazil the REIT part of the public market remains small in proportion to the overall size of listed companies," says Pine. Instead, Brazil's public real estate market is dominated by REOCs, especially housing developers.

Asia's 800-pound gorillas

The Asia Pacific region is no stranger to REITs. Australia and Japan have been major REIT markets for more than a decade, and REIT regimes are found throughout the region. But when talking about emerging REIT markets, the two biggest fish are India and China, and they have yet to make a very big splash.

Blackstone's plan to launch a REIT in partnership with Embassy Group is the highest profile deal in the market since the approval of a REIT structure by the Securities and Exchange Board of India. While no Indian REITs have been launched yet, the market could grow quite large.

"It is estimated that the size of the Indian REIT market can reach $20 [billion] to $25 billion," notes Pine, "with expectations of REITs being listed in India as early as 2015."

Under regulations promulgated in August 2014, Indian REITs must have at least 80 percent of their assets in income-generating commercial property, and development properties are limited to only 10 percent of the value of REIT assets. In addition, Indian REITs must distribute at least 90 percent of cash flows at least every six months.

Another restriction: Borrowing is limited to 49 percent of the loan-to-value of the REIT's assets. This means Indian REITs will have much lower leverage than Indian developers, which Magee notes have been "massively borrowing money," and the REIT structure is expected to offer a new source of capital and lower interest costs for Indian real estate companies.

While some clarity has come to the Indian market, the progress of REITs in China remains murky. China's listed property sector has a current market capitalization of $500 billion, according to EPRA, which notes the Chinese REIT market has the potential to grow tenfold in the next decade.

"Right now there's no regulatory regime for existing REITs in China, and there also are a number of legal and tax hurdles," says Peter Zabierek, CEO of Presima. "For instance the real estate registration system is not comprehensive in China. It's really not just a matter of a pen stroke or carbon copying the J-REIT structure or the U.S. REIT structure." Zabierek notes things need to happen within the Chinese real estate market to create the foundation for a healthy REIT market, and "those things are still happening right now."

Citic Securities Co. has launched a vehicle, Qihang Specific Asset Management Plan, which, although it neither walks like a REIT nor talks like a REIT, still is considered China's first REIT. The product was listed on the Shenzhen Stock Exchange in 2014 but on a special section restricted to a few institutional investors. The vehicle, which has a portfolio comprising two office properties in China, also appears not to have any of the tax benefits that REITs traditionally receive. Forum's Pine notes potentially more private REITs similar to the Citic vehicle are in the pipeline.

Establishment of a Chinese REIT market that would be open to retail investors is still in the works, as REIT guidelines have yet to be published by Chinese authorities. One reason may be wariness on the part of officials, who may not want to see more capital channeled into China's overheated property markets.

In the wake of the global financial crisis, a number of new REIT markets are opening up in the Americas, Asia and Europe.

"With the penchant of Chinese investors for real estate, the lack of investment alternatives domestically, and strong interest from the global investment community toward China, REITs are likely to be popular and grow rapidly once launched," says Pine.

In the meantime, China-focused REITs continue to be listed in Hong Kong and Singapore. For foreign investors, those markets have a big advantage: ease of use. According to Ritson Ferguson, CEO and co-CIO of CBRE Clarion Securities, investing in India and China (outside Hong Kong) requires special regulatory approval to be able to trade on the markets. "This creates barriers to non-domestic investors," notes Ferguson, "which ultimately limits one of the biggest benefits of having REITs, which is to create bigger, deeper markets for funding a country's real estate."

Distress opens new markets in Europe

When it comes to REITs, Europe is a bit of an emerging market, and much of the interest in the past couple years has been directed toward those markets that suffered the most distress

during the global financial crisis and subsequent sovereign debt crises.

"REITs in Spain and Ireland reflect a broader flow of capital back into real estate in these peripheral European countries that were hardest hit by the global financial crisis," says Ferguson.

The Spanish REIT regime, known as SOCIMIs, or sociedades cotizadas de inversión en el mercado inmobiliario, was first introduced in 2009 and modernized in 2012. That recent modernization has made SOCIMIs much more attractive to investors.

"The public market in Spain experienced a surge of new listings," says Pine, "and Italy is expected to follow suit."

South Dock House in Dublin was acquired by Hibernia REIT in 2014 as part of a loan portfolio takeover from Ulster Bank.

As property fundamentals have improved in Spain during the past 18 months, the new SOCIMIs have been a beneficiary, as the market now has a half-dozen significant Spanish REITs, including Axiare, Hispania Activos Inmobiliarios, Lar España Real Estate and Merlin Properties — the latter of which raised €1.25 billion ($1.4 billion) in its 2014 IPO. Hispania Activos began 2015 with a plan to create a resort hotel REIT in partnership with hotel operator Grupo Barceló.

Another emerging REIT market in Europe is Ireland. The REIT structure was introduced in 2013 as a way to provide additional capital to the distressed Irish property market. Hibernia REIT and Green REIT each launched in 2013, raising €365 million ($408 million) and €310 million ($347 million), respectively, in initial public offerings. The REITs were launched as blind pools — or "cash boxes" — because, similar to U.K. REITs, assets contributed to the vehicle's portfolio at launch are subject to capital gains taxes. While not required by law, the current crop of Irish REITs are externally managed. Irish Residential Properties REIT, for example, is externally managed by CAPREIT.

One obstacle for the Irish REIT market may be the overall size of Ireland's commercial real estate market.

"In Ireland in particular, the size of the market … may be a challenge for some of these REITs," cautions Presima's Blanchard, "because you get to a certain size, and then where do you grow?"

What's next for global REITs?

The expansion of the REIT regime globally generally is perceived as a positive development, especially as the structure brings with it transparency, liquidity, price discovery and tax simplicity.

However, PREI's Halle says, "I'm cautious when I look at emerging markets as new REIT frontiers." Instead, he is more enthusiastic about the possibility of increased penetration of listed REITs in existing core countries and markets. He notes 10–15 percent of commercial real estate in the United States is owned by publicly traded REITs, whereas in Germany the equivalent figure is only 1–2 percent. "I'd rather see Germany go from 1–2 [percent] to 5 percent of their market securitized, which is a much bigger opportunity than opening a new market in, say, Costa Rica," explains Halle.

Presima's Zabierek agrees that the trend toward a higher percentage of institutional-quality real estate in REITs' hands will continue. "Approximately 90 percent of the market is held by private investors. The publicly traded REIT industry is still only 10 percent of the institutional-quality real estate in the world," says Zabierek, who notes there are "very few other asset classes where you can say that." He points to the tech industry, which is dominated by public companies such as Apple and Google. "In the commercial real estate market, that's flipped upside-down; very little of it is publicly traded," adds Zabierek.

Still, the current small size of these emerging REIT markets — at least until the REIT markets in China and India get off the ground — can make volume and liquidity a challenge for investors. For the investor that truly wants to focus on an emerging-REIT strategy, the best plan may be a bespoke separate account, as global REIT funds would allocate only a small portion of their investment toward emerging REITs. ❖

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