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SECURITISED REAL ESTATE MARKET VIA REAL ESTATE INVESTMENT TRUSTS

Introduction & Understanding

A **real estate investment trust** (**REIT**) is an entity that owns, and in most cases, operates income-producing real estate. REITs own many types of commercial real estate, ranging from office and apartment buildings to warehouses, hospitals, shopping centers, hotels and even timberlands. Some REITs also engage in financing real estate.

REIT is a special investment company that invests money obtained from investors directly in real estate, either through properties or via mortgages. Investors receive the income from rent obtained from underlying properties as well as capital gains when properties are sold.

REITs ensure transparency as investors know what is being bought, including the property's current value. They also have a realistic income expectation from their investment. REITs offer accessibility to invest in real estate for those who find it difficult to purchase real estate as an investment option.

REITs were designed to provide a real estate investment structure similar to the structure mutual funds provide for investment in stock.

Types of REITs:- Equity REITs and Mortgage REITs

(1) **Equity REITs** are real estate companies that acquire commercial properties – such as office buildings, shopping centers and apartment buildings – and lease the space in the structures to tenants, who pay **rent**. After paying the expenses associated with operating their properties, Equity REITs pay out annually the bulk of the income they collect to their shareholders as dividends. Equity REITs also include capital appreciation from the sale of properties in the dividends they pay.

In the case of Timber REITs, their dividends include gains from the sale of timber. in all cases, this significant dividend distribution is designed to approximate the investment return investors would receive if they owned properties directly.

(2) **Mortgage REITs** (Financing Real Estate) invest in real estate mortgages or mortgage-backed securities, earning income from the **interest** on these investments, as well as from the sales of mortgages. Mortgage REITs, like other businesses, earn their profit from the difference between the income they receive and their costs, including their funding costs to purchase mortgage investments. They have the same requirement as Equity REITs to distribute the bulk of their income to their shareholders annually.

Benefits of REITs:-

- The greatest benefit will be that of fast and easy liquidation of investments in the real estate market unlike the traditional way of disposing of real estate.
- REITs typically own multi-property portfolios with diversified tenant pools. This reduces the risk of relying on a single property and tenant which one faces when directly owning a real estate property.
- The REIT investor enjoys the advantage of the power of the pool of capital to acquire interests in much larger opportunities than would be available to their personal capital alone.
- The process of buying or selling a REIT is transparent and flexible, just like trading stocks listed on the exchange. Investors can access information on the REIT prices and trade REITs throughout the trading day.
- REITs will helps in curbing black money menace. As real estate is the major sector engulfing black money thus, listed REITs will prune black real estate transactions.
- Provide hedging against properties:

  - If you are holding property, and want to sell it in future, you may short REITs index

  - If you wanting to buy property, you may long REITs index.
- Offers attractive and regular income distribution to wide range of investors and in return, entities gain access to debt and equity market often at very favourable costs.

Risks involved in REITs:-

- As REITs distribute a large amount of their income to unit holders, they may not have the ability to build up cash reserves to repay loans as they fall due. Thus they will typically seek financing by entering into new borrowing agreements, or other capitalisation measures such as rights or bond issues. One potential risk is higher refinancing cost when loans are due for renewal.
- Another risk is that a REIT which is unable to secure refinancing may be required

to sell off some properties if they are mortgaged under the loan. These risks could affect the unit price and income distribution of a REIT.

- REITs are, however, more volatile than property prices (due to public trading).
- REITs have relatively higher correlation with equities than real estate prices.
- Asset price bubbles is always a cause for concern in REIT as seen in 2008 Sub-Prime Crises.
- As there are dividend distribution requirements, REITs cannot grow the way corporate grow. Hence, REITs have to continuously look for capital and debt issuance.

Governance Structure:- Sponsor, Trustee and Manager are the main parties to the REIT.

- Sponsor is just like the promoter of the company who conceptualize the idea and set up the REIT and transfers his interest in real estate to REIT or SPV as the case may be and then, offering of shares to public via IPO or so. Sponsors are however mandatorily required to hold collectively at least 25% of the total units of the REIT on post issue basis along with lock in period of 3 years.

  For Instance: In most cases, **a sponsor or a major shareholder** is also present. For example, if a property developer launches a REIT, he may choose to keep X% (say 30% to 50%) stake in the REITs itself. Like any other investor, the developer in this instance will receive income distributed as dividends, where applicable.

- Manager is basically representing the board of directors of a company for carrying out day to day activities of the trust however, approval need to be taken on timely basis from trustees and also quarterly monitoring on the basis of reports. The underlying real estate properties are managed by a property managers and the REIT itself is managed by a REIT manager in exchange for a fee.
- The underlying assets are held by a trustee on behalf of the investors. Trustees are basically working on behalf of the unitholders i.e owners of the trust.

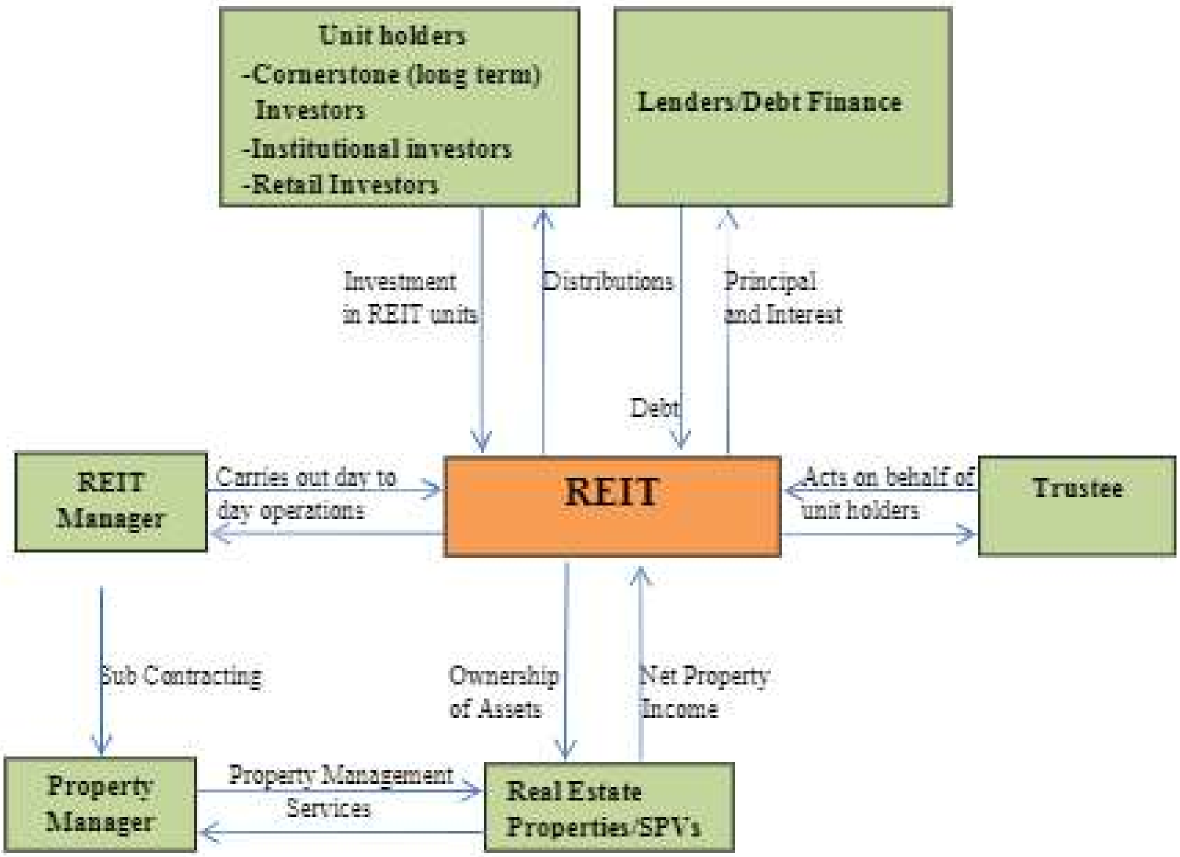
REIT Structures – Umbrella Partnership REIT (UPREIT) and Traditional REIT:-

- UPREIT structure created to shield owners contributing real estate assets to the REIT from capital gains taxes on contributed property

  - Transfer is then partnership shares for partnership shares, and this is not a taxable event for the owners.

- UPREIT owns a controlling interest in a limited partnership that owns the real estate, as opposed to a traditional REIT structure in which the REIT owns the real estate.

Typical REIT Structure



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