Real Estate Investment Trusts

Overview of Real Estate Investment Trusts:

A Real Estate Investment Trust (REIT) is a listed company or listed pooled investment vehicle that invests in real estate, typically with the intention of earning passive rental income from the underlying property investments –if a company, then this is its core revenue generating segment. SA REITs are listed on the Johannesburg Securities Exchange (JSE), and they provide investors with a means to gain exposure to the Real Estate Sector without the need to invest directly (i.e., private, direct investment in real estate). Several advantages of REITs include enhanced liquidity, exposure to property for as little as the price of common stock, lower taxes, regulatory oversight and transparency, and greater liquidity than the underlying property investments themselves, as the shares are traded in public equity capital markets.

One of the most often cited advantages REITs, however, is their tax advantaged status: there are no capital gains taxes when the REIT sells underlying properties, investors are not taxed on dividends in the form of a dividend-withholding tax, and the REIT is allowed to deduct at the corporate level all distributions to investors –which is high because REITs must maintain a high dividend ratio (typically around 80% to 90% of earnings). SA REITs listed on the JSE are requires to maintain a minimum pay-out ratio of 75%.

The SA REIT Association is a representative umbrella body comprised of voluntary members of all the listed SA REIT Companies and Trusts. This association is modelled on NAREIT (National Association of Real Estate Investment Trusts) in the United States and EPRA (European Public Real Estate Association) in Europe. SA REIT was established in 2013, to represent the interests of the sector.
More than 25 countries in the world use a similar REIT model including the US, Australia, Belgium, France, Hong Kong, Japan, Singapore and the UK. Regulations and tax laws vary marginally from jurisdiction to jurisdiction. In some jurisdictions capital gains tax is also waved for REITs.
Most SA REITs own several kind of commercial properties like shopping centres, office buildings, factories, warehouses, hotels, hospitals and even, to a lesser extent, residential properties, in cities and towns across the country. Some even invest in properties in other countries.[1]

History of SA REITs[2]:

While SA REITs only became a reality on 1 May 2013, the listed property asset class has a rich history in South Africa. The sector dates back to 1969 and was established to allow individual and institutional investors to invest in a diversified portfolio of investment grade properties on the same basis as if they had bought the properties directly.

All SA REITs own income-producing property. Prior to SA REIT legislation there were historically two forms of listed property investment entities in South Africa: property loan stocks companies (PLSs) and property unit trusts (PUTs). Both were able to adopt the REIT regulatory framework set out by the Johannesburg Stock Exchange (JSE). The structure is flexible and allows SA REITs to be managed internally or externally, and caters for different equity structures that may exist, such as A- and B- linked units that have different rights that existed in some property loan stock companies.

Benefits to Investing in REITs:

- Both share price returns (capital gains) and income (dividends and other shareholder distributions) provide a great inflation hedge. Property prices are strongly correlated with the business cycle, meaning that the NAV of a REIT's underlying property investments should track inflation, and in turn, the price of a REIT share should follow. Regarding income/dividends, because of escalation clauses in lease agreements of the underlying properties, dividends tend to also track inflation (assuming constant NIM and dividend pay-out ratios). Escalation clauses underpinning the underlying property lease agreements are usually about 8%, while South African CPI is typically around 6.5% inflation on the high end.

- REITs are able to pool together over $100million in investment capital, enabling them to create a large diversified portfolio that individual investors would not otherwise be able to replicate. As little as R100 can by a pro rata share on a diversified real estate portfolio consisting of shopping centres, office buildings, factories, warehouses, hotels, hospitals and residential properties. Mutual funds/unit trusts do the same with traditional equities and bonds, but unlike these securities, buying the relevant properties outright is typically in the unaffordable range.
- The diversification of REITs can be both geographic and between sub-classes of real estate, e.g., commercial property, farm and timberland, and residential real estate.
- REITs have both bond-like and equity-like characteristics.
    - Like bonds provide a more predictable, steady stream of coupons, REITs have a high pay-out ratio of dividends; in addition, revenue, earnings and consequently dividends tend to be predictable because of the existence underlying lease agreements.
    - Like Equity provides strong capital gains (stock price gains), the price return component of REITs is also substantial.
    - SA REITs' trailing 12-year compound annual growth rate (CAGR) was 27.15, as of December 2013. At this point, the 10 year CAGR had well outperformed SA equity, SA Fixed Income, and developed market REITs.
- Direct (private) investment in real estate, e.g., buying and selling a shopping centre, involves legal costs, title deed transfer delays, and liquidity risk.
- Investors need not worry about management of the underlying properties.
- There is high regulatory oversight of REIT's (via FSB, JSE and the Companies' Act).
- Investors are assured of transparency in this alternative asset class.
- Considering an investors overall asset allocation, adding SA REITs is an effective diversifier. Correlations with the broader equity market are low at 0.3, so adding REITs to a portfolio may reduce overall volatility and possibly provide return enhancement.
- If a REIT is included in an investors RA, pension, provident or preservation fund, no taxes are paid at the individual level on capital gains and distributions. South African investors also do not pay dividend withholding taxes. They will, however, pay personal income taxes on these distributions at their own marginal tax rates.
- Taxes are low at the corporate level because REITs are allowed to deduct all distributions made to shareholders for tax purposes. Selling underlying property investments also does not trigger capital gains tax at the REIT level.

Requirements for a company or trust to have REIT status[2]:

- Must own at least R300million of property
- Maximum LTV of 60% (debt must be below 60% of its gross asset value)
- At least 75% of the firm's revenue must be from property owned or investment income from indirect property ownership (e.g., via investment in another REIT)
- Must have a committee to monitor risk
- Not enter into derivative instruments that are not in the ordinary course of business
- Pay at least 75% of its taxable earnings available for distribution to its investors each year

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Types of SA REITs[3]

There are two distinct types of REITs in South Africa, namely 'company REITs' and 'trust REITs. As the REIT regulatory framework was implemented in 2013 existing property loan stocks (PLSs) would have been eligible to apply for company REIT status, while property unit trusts (PUTs) would have been eligible to apply for trust REIT status.

Effectively, trust REITs are unit trusts/mutual funds have met REIT requirements to include exclusive investment in real estate, while company REITs are companies.
Obvious differences are that taxes paid depend on the firm's tax rates: trusts are subject to trust rates while companies at company rates; trust REITs do not need to comply with the requirements of the companies Act; shareholders of company REITs enjoy voting rights and the ability to participate in corporate events;

and company REIT's are subject to relevant bankruptcy proceedings and possible distress, along with requirements of the Takeover Regulations Panel. These are summarized along with additional differences in the table below.

The table below summarizes the differences between company REITs and trust REITs:

Key Features of Company REITs and Trust REITs*	
Company REIT	Trust REIT
·In a Company REIT shareholders are active participants. They enjoy the full protection of the Companies Act and Takeovers Regulations Panel. They can vote on specific issues in a general meeting. Shareholders vote for the company to be a REIT	·An existing PUT will become a SA REIT upon application to the JSE and after providing evidence of its compliance with the JSE Listing Requirements and that it is registered with the Registrar of Collective Investment Schemes
·The company has the REIT structure recorded in its memorandum of incorporation	·Investors' interests are protected by a trust deed and the trustee, whose role it is to ensure compliance with the Collective Investment Schemes Control Act and to safeguard investors' assets
·Company directors are responsible for its ongoing compliance with the JSE's listing requirements and the Companies Act	·The Trust REIT needs to meet all JSE listing requirements but are not subject to the Takeovers Regulations
·Companies can have external or internal management and/or property administration	·Trustees report to the Registrar and must meet all the requirements of the Collective Investment Schemes Control Act
	·Must have an external asset and property manager in terms of the Collective Investment Schemes Control Act
*Source: http://www.sareit.com/docs/SA_REIT_brochure.pdf	

References:
1. *http://www.sareit.com/docs/SA_REIT_brochure.pdf*