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Corporate Governance Issues Relevant for the REIT Business Model

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Abstract

The publication attempts to look at the corporate governance (CG) practices specific to the REIT industry in the Asia-Pacific context. It begins with a comprehensive explanation of how the major categories of stakeholders play out their unique role in safeguarding the CG of their REITs. Following that, I will explore the common CG sensitive hotspots such as during asset appraisal, during the design of trust manager's incentive, during connected-party transaction and last but not least during rights issue. Against this background, I map out the potential risks inherent within the existing REIT structure as well as providing some plausible solutions from industry practitioners.

Keywords: CG, corporate governance, REIT

Many listed companies are professionally led by full-time management which may not be the majority shareholders of the listed companies. By that very nature, there will be an embedded principal agency conflict (Anandarajah 2012). Even for family management dominated listed companies, external minority shareholders often find themselves at the losing end when corporate decisions are made to specifically benefit the controlling family.

Against this background, CG rises to the occasion and becomes commonly presented as one of the most important topics (Fung 2014) for any serious investor. Afterall, an external investor has no access to material non-public information to monitor the quality of management. The presence of a robust CG structure therefore becomes very crucial to safeguard the interest of external shareholders.

In this publication, I will look at CG issues specific to the REIT business model which usually originate from ownership, board and management remuneration, and internal control within the REIT structure.

The key entities within the REIT structure include the following (Pica 2011).

- Manager – the entity responsible for the strategic operation of the REIT.
- Adviser – the entity responsible for advising on real estate acquisition and/or disposal opportunities.
- Trustee – the entity responsible for holding the properties in the trust on behalf of the unit holders and exercising due diligence.
- Sponsor – the originator of the properties that have been injected into the trust.

REIT manager: in most Asia jurisdictions[1], REIT managers are externally appointed. The manager is paid a fee by the REIT for their services rendered. In theory, the manager owes a fiduciary duty to act in the best interests of the unitholders (Capozza & Seguin 2000). In practice however, such separation of control from ownership has increased the potential of high agency cost. Indeed, empirical evidence from Capozza & Seguin (2000) demonstrates that REITs with external managers tend to use more debt leverage than REITs with internal managers which accounts for their underperformance in the long run.

[1] *With the exception of Australia.*

REITs in Singapore also adopt this external manager set-up. To deal with the potential agency problem, Singapore regulator has put in place several measures, as follow.

- Unlike REITs in the US, debt gearing for REITs in Singapore have been limited to no more than 45% (Song *et al.* 2015). This mandate effectively prevented the external asset manager from overleveraging.

- Making it compulsory for REIT managers to fully disclose all the fees related to acquisition and divestment, especially the portion that would be payable to the asset managers as incentives (Song *et al.* 2015).

Under Singapore regulatory rulings, the REIT manager must be a corporation with a physical office in Singapore. It must be headed by a CEO and at least two other full-time professional employees (Pica 2011). The REIT manager also need to possess at least 5 years of relevant professional experience. It is also mandatory for the REIT manager to abide by the Code of CG[2] for listed companies. On top of that, details of the manager's remuneration must be included in the management agreement upon appointment (Anandarajah 2012). These details include the following:

- The list of commercial services to be undertaken by the manager.
- Basic remuneration.
- Incentive remuneration and the respective calculation methodology.
- Any incentives paid to the manager during property acquisition and disposal as well as the respective calculation methodology.

Under existing legal framework, the fee arrangement cannot be pre-contracted for more than five years. Also, the compensation provision for early termination, if any, cannot exceed the sum of the fixed component of unearned management fee over the remaining term of the contract (Song *et al.* 2015). In addition, the compensation provision for early termination will be void if the manager's termination is due to fraud, insolvency, or negligence of duty.

[2] *MAS, Section 8.5, in Securities and Futures Act (CAP. 289): Guidelines on Criteria for the Grant of a Capital Markets Services Licence and Representative's Licence (1st October 2002, updated 14 May 2010):11; www.mas.gov.sg/resource/legislation_guidelines/securities_futures/sub_legislation/Licensing_Guidelines_may_2010.pdf).*

In the case of Hong Kong, the REIT manager is bounded by the trust deed[3] and owed a fiduciary duty to both the unit holders and trustee (HKEX 2013). Per the Securities and Futures Ordinance, REIT managers must obtain their licenses from SFC. REIT managers are restricted on the number of REIT they could manage at any time (SFC 2017). Also, there are specific requirements with regards to the qualifications of key personnel. And even though REIT manger could delegate the property management work to a third party, the fiduciary duty owed to unitholders still rest fully with the REIT manager.

To further enhance the structure of CG, the content on the trust deed can be tailored made to mitigate potential agency cost (Pica 2011). First, there must be clear and unambiguous narration of what constitute reasonable manager performance. The details should include tangible key performance indicators, reliable external performance benchmarks as well as specific explanation of the situations in which the asset manager could be ousted. Once all these have been put in place, it would be difficult for asset manager to erect significant barriers for self-entrenchment purpose.

Second, reasonably rewarding outstanding asset manager with equity position in the REIT could align their interests with that of unit holders (Pica 2011). But this should not come at a cost of significantly diluting existing shareholder base. One way of ensuring this interest alignment would be the giving out of incentive-in-kinds where instead of paying out cash bonus to outstanding asset managers, the reward can be substituted with shares of the REIT brought from open market using the REIT's operating expenses. To strengthen the interest alignment further, a reasonable lock-out period should be imposed on the shares rewarded to encourage long-term holding (Pica 2011).

Third, external manager should not have any representation on the board as this would limit the board's capacity to exercise its power independently (Pica 2011). On top of that, it should be stated explicitly on the trust deed that external manager should not have any role in appointing the REIT senior executives. Such power should rest with a contingent of independent directors. Similar governance risk mitigating structure should be used when adjusting the salary (Fung 2014) and bonus of these senior executives.

[3] *Trust deed details the specific way the REIT should be operated. Trust deed sets the parameters for the manager to operate within. Such details include under what conditions and in what manner should a manager be removed. It also provides information on the powers of the trustee and manger as well as any fees payables to them. In Hong Kong, the trust deed must be filed with the SFC.*

Finally, the role of the audit committee should be made relatively explicit (Pica 2011) in that they should be the sole entity directing the operations of crucial internal control functions, especially internal audit. At the minimum, internal audit division should always skip both the external manager and internal senior executives to report directly to the audit committee. When all else fails, internal audit should function as the last line of defense (Rodrigo & Smith 2015) against dubious interest behavior. The absolute independence of both the audit committee and internal audit is therefore very important.

REIT adviser: in Singapore, the adviser may or may not be independent from the manager (MAS 2016). The adviser mainly functions as the agent of the REIT to seek for yield accretive real estate acquisition and/or disposal opportunities. Prior to coming on board however, approval from the REIT trustee must be obtained. To qualify as a REIT adviser, the entity must have at least five years of relevant experience (MAS 2014) in handling real estate assets. In the case of Hong Kong, there has been no specific mention of the role of a REIT adviser (SFC 2014) under existing regulatory guidelines.

REIT trustee: in Hong Kong and Singapore, the trustee possesses fiduciary responsibility towards unit holders. Trustee carries out due diligence to ensure that the manager has been operating within the parameters set out on the trust deed and local laws (Pica 2011). The trustee is usually a bank or subsidiary of a bank and is paid a fee based on a percentage of the REIT's net asset value. Both the trustee and manager of an REIT must be operationally independent of each other to minimise conflict-of-interest (Pica 2011). In Hong Kong, however, both trustee and manager could be under the same holding company if certain conflict-of-interest conditions have been complied with (Pica 2011).

REIT sponsor: in Hong Kong and Singapore, the sponsor usually plays a dominant role during and after an REIT's IPO (Pica 2011). Indeed, one of the major reasons for the formation of a REIT is capital recycling (Song & Tan 2016) where after having injected their real assets into a REIT, the sponsor can retrieve a huge sum of capital back for redeployment. This has been one of the main reasons why REIT sponsors are usually the owners of multiple properties, property developers and/or an operating business with heavy investment in properties.

In both Hong Kong and Singapore, REIT sponsors usually retain substantial shareholding of the REITs post listing. Following that, an independent asset management subsidiary is set up by the sponsors to provide fee-based

management services to the REITs. REITs that fall under this structure is known as captive REITs (Sing 2005).

With this captive structure, the REITs can secure a future pipeline of new properties. For if the captive REITs have been guaranteed of the first right-of-refusal by their sponsors, future property disposal from their sponsors must be routed to the REITs first (Sing 2005).

Another subtler advantage is the watch-dog role undertaken by the sponsor. Since the sponsor has retained a substantial shareholding in the REIT, there is strong motivation to ensure that the REIT manager has been making decision based on the sponsor's best interests (Pica 2011). Minority shareholders could then piggyback on this extra pair of eyes for their benefits.

Nonetheless, certain potential CG issues co-existed within the captive REIT structure as well. First, during property sale from the sponsor to the REIT, there is a chance of over valuation which may benefit the sponsor at the expense of minority shareholders (Cline *et al.* 2013). Second, the sponsor may influence the REIT manager to make decisions that benefit themselves, again at the expense of minority shareholders (Bohjalian 2016). Third, if both the asset manager and the property management company are wholly owned subsidiaries of the sponsor, the sponsor can capture the entire stream of fees paid out by the REIT on operational services.

Indeed, some of the external REIT managers are wholly owned subsidiaries of the sponsor. By structuring the REIT in this manner, the sponsor can enjoy regular cash flow through these subsidiaries. And by detaching the asset manager away from the balance sheet of the REIT, accounting figures such as ROE and ROA can be "artificially" improved (Chen *et al. 2014*).

This undetached connection between the sponsor and REIT (Pica 2011) has been a potential breeding ground for conflict-of-interest among captive REITs. Indeed, Hsieh & Sirmans (1991) uncovers empirical evidence of significant underperformance by captive REITs relative to their non-captive counterparts in the US.

In dealing with this potential problem, Singapore regulator put in place several measures, as follow.

- Making it compulsory for REITs to elect a board of independent directors (Nestoras 2007).
- Optimal disclosure of relevant information during property acquisitions.

- Demonstrate sufficient prudence and undertake thorough due diligence analysis prior to each property acquisition (Pica 2011).
- Detail explanation of why the management had considered an acquisition to be yield accretive (Pica 2011).
- Requiring two independent valuations of the target acquisition.
- Connected party transactions are permitted but must be fully disclosed.

Real asset appraisal: real estate as an asset class made up the bulk on the asset side of a REIT balance sheet. Because of that, there is legal mandate for REITs to appoint independent valuator to appraise their real assets on an annual basis (Marriott & Smith 2017) at least. In Singapore, the valuator must disclose to the trustee whether it has other pending business transactions. And in both Hong Kong and Singapore, REITs cannot appoint the same valuator to value the same property for more than two consecutive years (Marriott & Smith 2017).

Incentives of trust manager: it has been a common practice to bind part of the bonus incentives of the trust manager to the REIT's NAV. The argument is that trust managers will be motivated to grow the asset under management (Pica 2011), for the benefit of unit holders. This practice however is not without demerits. First, it may encourage the manager to embark on an acquisition spree (Pica 2011). During property market peak where valuation is sky high, managers may acquire properties that are yield erosive in the long run. The historical experience of MacArthur Cook Industrial REIT draconian share dilutive recapitalisation saga during 2009 was a classic example.

Back then, the Australia asset dominated REIT had difficulties refinancing their debt immediately after the Global Financial Crisis and opted to tap onto extremely share dilutive equity raising exercises to salvage their financial distress. Before the Global Financial Crisis, the REITs had been relying on "cheap money" to execute a series of real assets acquisitions.

Second, tying the remuneration of manager with the size of NAV may encourage short termism behavior (Staples 2015) at the expense of forgoing long-term benefits. When the manager becomes overly concern with the size of NAV which correlates with changes in market forces and property cycle, the sustainability of rental yield may be compromised (Staples 2015). Due to the competitive nature of the industry, it typically requires a lot of effort and focus to upkeep rental yield. Therefore, it would be ideal if the remuneration

of the REIT manager can be tied up with yield sustainability (Pica 2011) instead.

Connected-party transaction: in Hong Kong, connected-party transaction is defined as any transaction involving any connected person as defined in Section 8.1 of the REIT code or which involved two or more REITs managed by the same manager (Pica 2011). The definition of connected person and/or parties include:

- REIT manager.
- Property valuator.
- Trustee.
- Significant unit holder which is defined as any entity that owns more than 10 percent of total outstanding units.
- Director, senior executive, and officer of holding company and associated company from all the above entities.

For connected-party transactions, announcement must be made unless the value of the transaction does not exceed HK$1 million (Pica 2011). A summary of these transactions must be published during the next interim and/or annual report. And if the transaction exceeded more than 5 percent of NAV, unitholder approval must be obtained through an ordinary resolution and voting by poll. All the connected parties in these transactions must abstain from voting (APREA 2011).

In Singapore, the relevant regulation has been relatively similar and came with a more detailed list of what needs to be disclosed during connected-party transactions. These details include but are not limited to the identities and relationships of the related entities, details on pricing, asset, valuation and expected impact on rental yield (Pica 2011).

Two independent valuations are required for each connected-party transaction, out of which one must be appointed independently by the trustee. During asset acquisition, the eventual transaction price cannot be higher than the higher of these two valuations to safeguard the interests of minority stakeholders. For the same reason, during asset disposal, the eventual transaction price should not be lower than the lower of the two valuations (Pica 2011).

Rights issue: to take advantage of the corporate tax transparency inherent within trust structure, REITs must distribute more than 90 percent of net profit to unit holders. Together with regulatory limitation on debt gearing,

REITs often had to rely on issuing new units to raise the required capital during asset acquisition. In Hong Kong, all new rights issues must be offered on a pro-rata basis before they can be issued to new unitholders (HK Financial Services Development Council 2013).

If the new issues of rights are not offered to existing unitholders on a pro-rate basis, the process is known as non-preemptive rights issuance (ISS 2016). For both Hong Kong and Singapore, the legal rulings governing non-preemptive rights issuance have been quite similar:

- More than 50 percent of shareholdings must agree to it during AGMs or EGMs.
- The total new units issued during the current financial year cannot increase the total number of units outstanding from the previous financial year by more than 20 percent.
- Maximum discount for the exercise price of the rights issuance is 20 percent in Hong Kong and 10 percent in Singapore.

Once the mandate for non-preemptive rights issuance has been passed, it is valid for one year or until the next AGM in Hong Kong. For Singapore, the mandate is valid until the next AGM.

Potential risks inherent within the REIT structure

Functionally, the REIT is akin to a pooled fund set up exclusively to invest on income-producing real estate. As previously mentioned, there is strict legal mandate on the minimum percentage of a REIT's asset that must be held in the form of income generating real estate. In Singapore, this percentage has been 75 while that in Hong Kong has been 90. Because of that, REITs are exposed to the same systemic trends and shocks in the respective property markets (Sing 2005).

For public REITs, their pricings are relatively correlated with general stock market volatility. A study by Ghosh *et al.* (1996) demonstrated that the pricing volatility of US public REITs during the 1980s had been relatively uncorrelated with stock market movement. Post 1990s however, US public REITs started to behave more like stock. This implies the diversification benefit from adding REITs to a portfolio of public equities has diminished over time (Glascock *et al.* 2000). The correlation with market equity movement though existed has not been very strong for public REITs in both Hong Kong and Singapore (Kim & Schindler 2011).

The regulatory mandate[4] for REITs to distribute more than 90 percent of its earnings has been a double-edged sword. For a start, this mandate ensures that if the underlying real assets of the REIT have been profitable (HK Financial Services Development Council 2013), unit holders are assured of a stable stream of rental income.

On the other hand, managers of REITs also needed to grow[5] the underlying portfolio of real assets. Since most of the organic cash flow from the underlying real assets cannot be retained to fund new acquisition, REITs must seek funding from external sources.

Two common channels are available for REITs to obtain external funding – incurring new debt and issuing new equity. REITs in Hong Kong and Singapore have been subject to a gearing limit of 45 percent[6]. In practice, REITs seldom gear themselves close to this upper limit (Linklaters 2006). The reason being the value of their underlying real assets is not a static value. During the annual asset appraisal cycle, value of their underlying real assets changes with market conditions (Marriott & Smith 2017). If the gearing ratio of a REIT is close to 45 percent and the newly appraised value of its real assets declined, the REIT will be forced to either sold off some of its assets or raise additional equity capital at short notice to bring down its debt ratio. Both types of corporate actions can seldom be completed at short notice. Even in the rare occasion when it is possible, the cost[7] and expense[8] would have been exorbitant.

Because of that, Debt as a source of funding new acquisition has typically been used up to around 35 ~ 38 percent (Kaspar & Roth 2016) of total asset. Beyond that, REITs will seek for external funding through issuing new equity. That typically will be achieved through a rights issue.

The rights will usually be issued on a pro-rata basics whereby all existing unitholders will be given a first right of refusal to apply for their allocated units. To encourage subscription from existing unitholders, the rights is priced at a slight discount to open market share price. This discount rate usually ranges from 5 ~ 10 percent (Galloway 2014).

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[4] *To retain its tax transparency status, this 90 percent distribution ruling must be maintained at all times.*
[5] *REIT manager can of course opt to maintain status quo and refrain from making any acquisition. There are however two drawbacks with this behavior. First, it will deprive the managers out of an opportunity to earn a fee from asset acquisition. Second, REITs management might face pressure from unitholders if they opt to adopt this no growth approach.*
[6] *This gearing is measured as a percentage of total assets.*
[7] *Being illiquid assets, selling at short notice would occur at fire sale pricing which is detrimental to unit holders.*
[8] *Investment banking fees incurred for new equity capital raising at short notice is costly.*

After a right issue, existing unitholders are faced with two choices – either to cough up more money to buy the allocated rights or forfeit their allotments and suffered the agony of having their existing units diluted (Sloactive 2015) once the new units become tradable in the secondary market. Because of that, rights issue has occasionally been touted as a legitimate channel for REIT manager to "extort" extra funding from existing unitholders (Morningstar 2011).

Aside from having to seek extra funding from existing unit holders during acquisitions, there is another significant risk associated with property acquisition by REITs – yield destructive acquisition. According to Marra *et al.* (2017), real asset acquisitions by REITs usually occurred in cluster, and during the peak of property cycle. As a result, what initially appeared to be a yield accretive acquisition may deteriorate into an overvalued purchase that eventually chipped a huge dent off the REIT's balance sheet (Marra *et al. 2017*).

The potential risk from real asset acquisitions does not end here - there is always the possibility that connected party transactions involving the sponsor injecting real estate into the REITs be carried out in a manner[9] and timing[10] that may benefit the sponsor at the expense of minority unitholders. Pica (2011) and Linklaters (2006) analyse such cases in Hong Kong where even though the acquisitions had followed strict legal procedures and provided sufficient disclosures, both research papers question the underlying intent behind the sponsor.

Another potentially more damaging risk during asset acquisition originates from equity capital raised through issuing new units to institutional investors (Liang 2010). This type of rights issue is fundamentally different from the pro-rata rights issue mentioned previously. First, existing unitholders are not given any first rights-of-refusal (Cambridge Industrial 2006) to purchase any of the new units issued. Second, to attract the interest of institutional investors, the rights issue is usually priced at a steep discount from market price (HKEX 2016). In other words, existing unitholders have no recourse other than to wait for their share units to be diluted once the new issue becomes tradable in the secondary market.

[9] *Asset acquisitions might unduly award REIT manager a certain percentage of the underlying assets that does not commensurate with the service rendered. If the manager is a subsidiary of the sponsor, the intention of doing so is undoubtedly questionable.*

[10] *The sponsor being both the asset seller and controlling unitholder of the REIT have strong asymmetric information advantage.*

During each financial year, REITs in both Hong Kong and Singapore after obtaining more than 50 percent majority approval at shareholder meetings will be able to issue new units to institutional investors so long as the new units issued does not exceed 20 percent (HKEX 2013) of the total outstanding units as per the end of the last financial year.

The reason given by the REIT management for doing so usually revolved around the need to get onboard new institutional investors for strategic purpose. Marra *et al.* (2017) laments that the “strategic purpose” reasons seldom held any strong grounds. And if the REIT has been captive and the new institutional investors were related to the sponsor, Cline *et al.* (2013) questioned the real intent behind.

As per asset acquisition, there is also potential for questionable corporate practices during asset disposal (Chen *et al.* 2014). Similar to during asset acquisition, connected party transactions during asset disposals is legal so long as the proper disclosures have been adhered to (Pica 2011).

For REITs listed in Hong Kong and Singapore, most of their underlying real assets are in developed economies (Song & Tan 2016). The rental yield from these properties seldom exceeds 4 percent. To generate a decent yield of 6 to 8 percent, REITs must use debt financing (Chen *et al. 2014*).

Debt tenure for REITs comes in bullet maturity form and is usually much shorter than that of retail housing loans (Song *et al. 2017*). Indeed, debt tenure for REITs seldom exceeds 5 years in practice whereas the average maturity of retail housing loans usually exceeds 15 years (Phillips & So 2016).

Because of that, REITs must refinance and re-negotiate their debt with their creditors once every few years (Pica 2011). Given the short tenure of their debts, REITs prefer to stagger their loans across a range of maturities so that they do not end up having to refinance a huge portion of their debts all at one time (Pica 2011). The above is however an ideal situation that may not always be possible in practice. First, REITs typically go for the best financing option that is available (Phillips & So 2016), which may have occurred during low interest rates era. It would have been more cost effective for REITs to secure as much as possible a portion of their debt financing during such point in time.

If interest rates continue to remain low, it will be business as usual. But once interest rates shoot up and it is time to refinance their loans, these REITs may become insolvent. How REITs spread out their loan financings across different maturities is therefore very important. Also, the terms and

conditions of each loan differs drastically. For debt that is based on a floating rate, financing cost may escalate before maturity. For debt that is based on fixed rate, the average financing cost at inception is higher than that of a floating rate loan (Chen *et al. 2014*). Making a good judging call on the loan type at the point of inception is therefore very important.

As observed, REITs' debt financing capability could incur a big impact on their solvency. To secure good financing deals from commercial bankers, REITs must be in good standings among the potential creditors. Quality credit ratings aside, good personal relationships with bankers are crucial as well (Pica 2011). This has been the major reason why professionals with established track records of working in the investment banking industry have been highly sought after in the REIT sector (Phillips & So 2016).

Moving on, conflict of interest issues may arise during the hiring of the property management company as well as during the selection of anchor tenant. To begin with, the property management company may be related to the sponsor or REIT manager. So long as sufficient disclosures have been made, the above arrangement remains perfectly legal.

Investment analysts of REITs therefore pay a lot of attention to examine the details of the fees structure negotiated with the property management company as well as the rental contract signed with the anchor tenants (Chen *et al.* 2014). They also benchmark these terms and conditions with similar arrangements in other REITs.

The aggregate level of fees paid for property management functions is disclosed in the IPO prospectus and annual reports. Best practice (Pica 2011) dictates that any performance fees should be paid no frequent than once a year and should be based on a "high-on-high" basis.

This implies that the performance fees will only be payable if the REIT manager has grown the NAV per share to the point that it has exceeded the NAV per share on which performance fees were last calculated. This method has been commonly used in the hedge fund industry and has also been known as the high-water-mark method (Henderson 2016).

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