

# understanding real estate investment trusts

## WHAT ARE REAL ESTATE INVESTMENT TRUSTS?

For most people, buying commercial office buildings, retail centres, or industrial real estate is simply out of reach financially. A real estate investment trust (REIT) is a corporate structure whereby a number of small investors can pool funds and acquire large property assets or a portfolio of properties, with a professional property manager managing the day to day activities of the trust. The investor owns a proportional share of the REIT, as they do a listed company such as BHP.

Individual REITs can be listed and traded on the stock market. Managed funds may hold shares in a number of listed REIT securities and these funds are offered as investments that provide a diversified exposure to the property sector. REIT managed funds may also invest internationally, in particular in the US, UK, Asia, Japan and Europe where there are well established REIT markets.

## SOURCES OF RETURNS

Returns from REITs come from:

- Dividends generated by the rental income earned by the properties owned by the trusts, and from revenue earned from the management of the assets.
- Income from the gains realised when the managed fund sells listed trusts for a profit.
- Growth from increases in the share price of the listed trusts held, generated both by increases in the value of properties owned by the trusts and by increases in market demand for REITs.

## BENEFITS

**Liquidity** – Many REITs are traded on the stock market and consequently are liquid. It is important to distinguish between listed REITs and unlisted REITs such as property syndicates, which are generally illiquid.

**Consistency of income** – Because REIT rental income often comes from properties with relatively long lease terms, REITs provide a relatively consistent income stream. The income return generally comprises a large portion of the total return and is far more consistent than the capital growth component of the returns.

**Access to global property** – REITs provide access to global property markets. Whereas the Australian REIT

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market comprises around 25 securities with a market capitalization of approximately \$75bn, the global REIT market is currently capitalised at \$500 billion and contains around 280 listed securities. By investing in global REITs, investors can achieve far greater diversification by geography, types of property and management than from just investing in Australian REITs. The global REIT market is growing more strongly than the mature Australian market, providing more

opportunities than the Australia market.

**Inflation hedging** – REITs can be a reasonable inflation hedge. Unlike bonds with pre-determined rates of interest which lose relative value in times of high inflation, the rental incomes received from the underlying property leases are typically adjusted in line with CPI. This makes them less vulnerable to inflation-related devaluation.

**Asset quality** – REIT portfolios comprise some of the highest quality assets within the Australian investment-grade property universe. In addition to a dominant position in the office sector (~80%) and retail sector (~75%), the REIT sector is the dominant owner of industrial investment property and many of the 4 and 5 star hotels in Australia.

**Tax structure** – REITs are structured so that taxable income earned from, say, rental yields is typically 'passed through' the structure, to be distributed to investors as dividends. Another advantage of REITs compared to other investments is that the unitholder does not pay tax on the deferred income portion until their investment in the trust



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is sold. The result is a higher after-tax return. REIT funds are a useful tool in constructing a diversified income stream for investors, particularly where tax-efficiency is a priority.

## RISKS

As with all investing, there are risks. For REITs, the following are some of the key risks an investor should be aware of.

**Volatility** – While REITs and unlisted property funds essentially invest in the same thing - buildings and land - REITs are a lot more volatile than unlisted property. This is because REITs, being listed securities, are priced continuously whilst unlisted property assets are revalued infrequently – only annually in most cases. REITs typically have a price volatility of around 10%pa but this rose to around 45% during the GFC.

**Gearing** – The amount of leverage within REITs has increased from 10% in 1995 to around 40% by the end of 2010. While higher gearing levels contributed to portfolio growth by allowing REITs to diversify into properties that were previously beyond their reach, higher leverage also resulted in a commensurate increase in risk. Some managers were able to develop capital management skills. Most however did not.

**Lower dividends** – Massive capital raisings in 2009 by REITs to repair balance sheets and fix the problems caused by the reckless expansion in 2006-2007 has resulted in a severe dilution of equity in the trusts and a fall in yield. Dividends per share are back to levels not seen since the mid 1990s.

**Sector concentration** – The Australian REIT market has consolidated significantly in recent years from 60 trusts in the early 1990s to around 25 trusts today, with only 20 trusts in the S&P/ASX 200 index. The Westfield Group alone comprises about 50% of the sector's market capitalisation. Hence, true diversification is not possible within the Australian market. In response, Australian REIT managers expanded into off-shore markets. Offshore assets held by local trusts rose from zero in 1995 to 40% of the gross assets held in this sector in 2010. The forays into foreign markets met with mixed success, with some disastrous results due to REIT managers overpaying for assets at the peak of the market. The off-shore expansion has also introduced currency risk to the sector.

**Interest rate risk** – Interest rates impact listed property in a number of ways. Firstly, as interest rates rise, the yields expected on other assets increases. This means that investors will be prepared to pay less for properties yielding a pre-determined rent under lease, and consequently capital values tend to fall. Secondly, interest rates dictate the cost of finance, which also influences the capital value that can be paid for property. Finally, interest rates influence the rate of consumer spending, business investment and the cost of business – all of which impact on property prices and demand.

**Earnings risk** – Many of the larger REITs in Australia trade in the form of stapled securities where an operating business is 'stapled' to the property

vehicle. Consequently, REIT earnings risk ranges from the relatively secure annuity-style management fees (rent) through to the more risky property development and third party construction contracting.

## FINAL THOUGHTS

REITs provide a useful and reasonably consistent source of income to investors, although the capital value of a REIT investment can be very volatile. REITs have long been regarded as good diversifiers of equity risk, but this diversification benefit has greatly diminished in recent years as REITs have become highly correlated with equities.



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