Source: *The Business Times*, p17
Date: 30 May 2022

Are Reits really real estate?

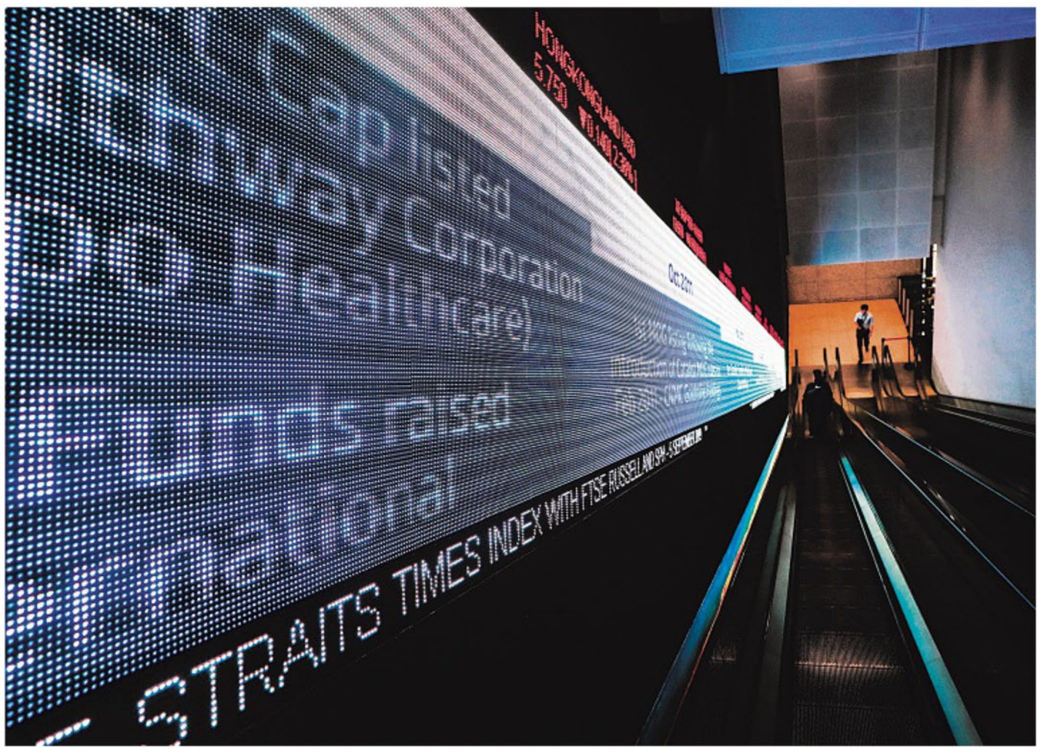
They are not perfect substitutes as values of underlying, physical assets and values of Reit units are determined via different considerations. BY DAVID DICKINSON AND SING TIEN FOO

THE securitisation of real estate in the form of Real Estate Investment Trusts (Reits) entailed the conversion of a capital good into a financial instrument that could be widely traded. From a lumpy, relatively illiquid asset, real estate now enjoys versatility and tradeability similar to that of stocks.

Two decades ago in 2002, CapitaLand Mall Trust made its debut on the Singapore Exchange, heralding the advent of the real estate investment trust here. It is now listed via the vehicle known as CapitaLand Integrated Commercial Trust after merging with CapitaLand Commercial Trust in November 2020.

Today, Singapore's Reit (S-Reit) market hosts 36 Reits and 8 real estate-related business trusts, with an estimated market capitalisation of S$113.55 billion as at May 20, 2022. From an initial S$734.31 million on Aug 15, 2002, equity funding for S-Reits has grown by more than 150 times, and is now a mainstay among various asset classes.

Hence, as we mark the 20th anniversary of S-Reits, it is timely for us to reflect upon this investment vehicle and see how far it has grown from its brick-and-mortar roots.



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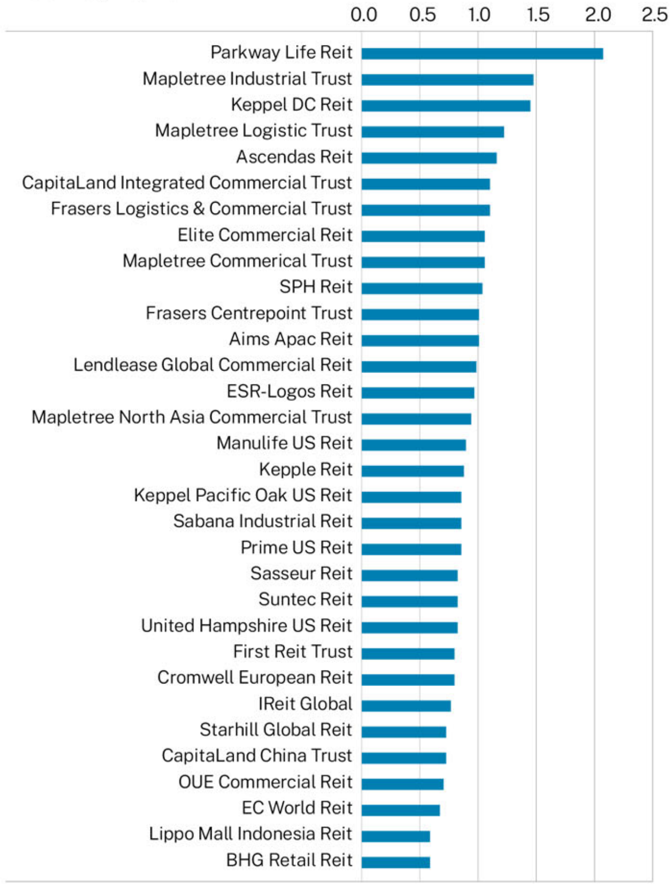
Price to book ratio of S-Reits

As at May 20, 2022



Source: Refinitive, David Dickinson and Sing Tien Foo

Structure of a Reit vehicle

Before 2002, investors could only access the public (indirect) real estate market in Singapore by buying shares of listed property firms, such as City Developments, Fraser Property, GuocoLand and other developer firms.

The establishment of the S-Reit market offered investors an alternative public vehicle to gain exposure to a focused type of income-generating commercial real estate. Development activities of S-Reits are capped at 25 per cent of the deposited assets, meaning that Reit managers had to focus on rental and other sources of revenue.

S-Reits are more tax-efficient public real estate vehicles than publicly listed property counters. Reits enjoy the double tax transparency treatments in Singapore, whereby income at source from assets in Singapore and income distributed to retail investors are fully exempted from taxes. However, the tax-exemption benefits come with costs in terms of restrictions imposed on the Reit structure. First, a Reit has to distribute 90 per cent or more of its income back to investors as dividends. Second, a Reit cannot borrow more than 50 per cent of its total asset value. These restrictions imply that S-Reits will need to raise external capital to fund the growth of their asset portfolios.

The Reit structure facilitates efficient pass-throughs of cash flows from the source (net rental income) directly to investors as dividend payouts. If markets efficiently price the rental cash flows, the capitalisation rate in the real estate (private) market is expected to equal the dividend yield (net of management fees) in the stock (public) market. Under this ideal circumstance, Reits can indeed be regarded as equivalent to real estate.

Technically, the market price of a Reit unit should be close to, if not equal to, the book value per Reit unit, which is computed as total assets less total liabilities, then divided by the number of Reit units. In other words, we should expect the price-to-book ratio (PB) to approximate to one. However, the data (as at May 20, 2022) show that Reit PB ratios vary widely from 2.07 for Parkway Life Reit to 0.58 for Lippo Mall Indonesia Reit and BHG Retail Reit.

> **Even if real estate values are correct, a volatile stock market could drive short-term prices of Reit units away from them. This might be due to "sentiment" or perhaps "noise trading" associated with less informed investors.**

The results raise many puzzles: Is a Reit equivalent to its underlying assets? How has it performed relative to physical property, and how do investment considerations differ between them?

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To explain these questions, we need to recognise the unique dual market structure for Reits. The values of the underlying, physical assets and values of Reit units are determined via different considerations. Physical asset values are obtained from the less efficient private real estate market, while Reit unit pricing is determined by the more efficient stock market.

One source of deviations in PB ratios could come from how underlying real estate values are assessed in the private market.

Property information is not easily accessible in the tightly held commercial real estate (private) markets with few transactions. In a standard discounted cash flow (DCF) framework, licensed valuers must determine rents and capitalisation rates when estimating real estate prices. Assessing the values of specialised properties, such as hospitals and healthcare facilities, can be even more difficult given the dearth of comparable real estate. Furthermore, the revaluation of the underlying property assets is not continuous and therefore can lag behind changing economic, capital and property market conditions. This is one reason why PB ratios rarely equal one.

In Singapore, Reits usually outsource real estate management services to third-party asset and property managers. Asset managers are paid a base fee and a performance fee. This model is typically known as an externally-advised model.

To add value to real estate portfolios, managers carry out asset enhancement initiatives (AEIs) to enhance space efficiency and increase cash flows. They diversify risks by acquiring real estate in local and overseas markets. Reit managers could also reduce operating costs, for instance, by conducting joint promotion and marketing activities, among others.

That the value of the whole is greater than the sum of its parts is a widely accepted premise. The fundamental values of real estate could be different when valued as a standalone asset than in a portfolio. Reits could reap the scale economic benefits by holding a sizeable real estate portfolio.

The second source of price deviations of S-Reit units comes from the public market. Even if real estate values are correct, a volatile stock market could drive short-term prices of Reit units away from them. This might be due to "sentiment" or perhaps "noise trading" associated with less informed investors. However, if the stock market is efficient, S-Reit unit prices should mean-revert (convert) back to underlying asset values (fundamentals) in the long term.

Real estate is illiquid because it takes a long time to find a suitable buyer or seller in a private market. Investors may not be able to buy or sell physical real estate freely and frequently in private markets and transaction costs are very high relative to trading S-Reit units in the public market. Therefore, institutional investors will expect liquidity premiums when investing in physical real estate compared to S-Reit units, and will often plan to hold properties for much longer periods than might be the case with S-Reits.

When price deviations exist in the private and public markets, Reit investors and managers will move in and out between the two markets to arbitrage away any abnormal returns. Therefore the PB ratio should average close to one over the longer term. S-Reits with office and retail real estate assets tend to have smaller price deviations between the private and public markets.

Why are some S-Reits' assets priced at significant premiums, such as Parkway Life Reit and Keppel DC Reit, where their PBs exceed one, whereas other S-Reits see their real estate assets significantly discounted?

The heterogeneity in PB ratios for S-Reits may imply that Reits are not perfect substitutes for physical real estate investments. However, we cannot invalidate that Reits are still an attractive vehicle that allows a broad band of investors to gain exposure to the physical real estate market.

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