

Opportunities and challenges facing the US REIT industry

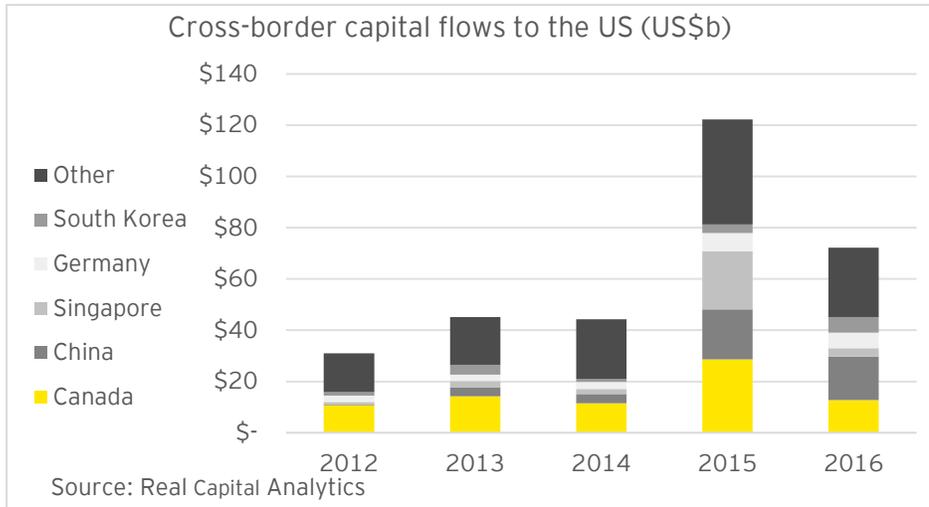
Nine years on from the beginning of the global financial crises, the opportunities and challenges facing the US real estate investment trust (REIT) industry and the US real estate market in general are accentuated by the relatively mature state of this real estate cycle. At the same time, however, this cycle is unique by virtue of the role that disruptive technology, changing demographics and globalization are playing. At both a market and operational level, these dynamics are changing how people live, work and play and the real estate they use as a result. As these changes continue to occur at an accelerated pace, it is certain that the utility of real estate will change in the coming years at a more rapid pace than in the past.

Impending US tax reform is a major challenge.

The US REIT industry could face a significant challenge from potential US federal income tax reform. Relative to other industries, real estate has historically made good use of tax-advantaged vehicles, including REITs and partnerships, to reduce or eliminate so-called double taxation. In many instances, real estate investors (individuals, private equity and companies) have been willing to accept a heightened degree of tax complexity to benefit from these vehicles and to defer taxation upon disposition (e.g., through like-kind exchanges and other strategies). While the debate concerning the exact nature of the changes to US tax reform is ongoing, a significant reduction in corporate tax rates and certain income from partnerships that is currently proposed could affect decision-making related to the type of investment vehicle chosen by real estate owners. For existing US REITS, once there is more clarity as to potential changes in US tax law, management teams will need to evaluate the resulting impact on taxable income, cash flows and dividend yields from real estate, as well as on the opportunity for tax deferral planning. These issues are central to the valuation of real estate ownership and operations and capital allocation decisions.

Capital flows have changed the real estate transaction market, and competition for assets is now intense.

Capital flows, and particularly those from outside the US, are impacting real estate transaction markets. In 2016, China displaced Canada as the top foreign investor into the US real estate market. The depth, breadth and variety of capital sources from non-US investors has seen more than 600 entities participate in transactions in the last 24 months.¹ Competition for assets, and not just trophy buildings, is more intense than ever. New entrants often have specific investment priorities and return hurdles and in certain cases are prepared to price assets at higher levels than incumbents as a result. US REITs and other domestic investors who wish to compete in this environment may need to explore a variety of options (e.g., joint ventures, co-investment arrangements) to lower their cost of capital. This will likely further change the composition of the US real estate investment market in the coming years.

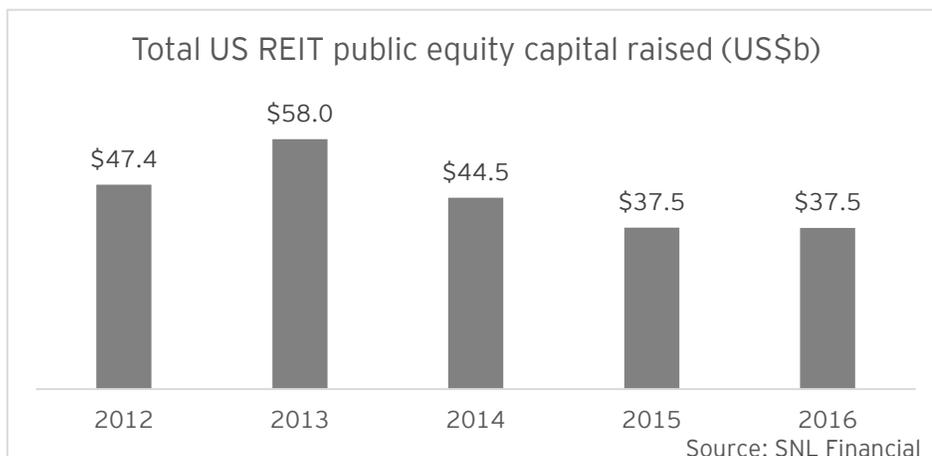


Consistent and reliable access to common equity has become more challenging for the industry ...

Access to capital remains a critical business priority for all REITs. However, recent years have seen REITs raise less equity capital (US\$37b in 2016 vs. US\$58b in 2013)². Much of this is due to the dislocation between public and private market pricing, which became more prevalent in 2015, meaning the opportunity to raise public equity capital is currently not as reliable as it has been historically. Whether a result

of the global shift towards passive investing or increased concern about the maturity of the real estate cycle, this may impact the ability of even best-in-class operators to raise public equity going forward.

However, the increasingly deep and diverse global real estate investor base is also creating opportunities for high-quality operators to introduce new partners into their capital structures and to sell assets at premium valuations. REITs may wish to consider accessing alternative sources of capital by aligning themselves more closely with the significant amount of both domestic and overseas capital seeking yield. Partial sales and/or joint venture arrangements remain viable alternatives to raising public market equity.



... and preferred sectors or companies could raise a disproportionate amount of capital as a result.

This public/private market pricing dislocation comes at a time when institutional investors remain awash with capital and under-allocated to real estate. Sectors in high demand will have an opportunity to attract capital

¹ Real Capital Analytics, rca.com, accessed May 2017.

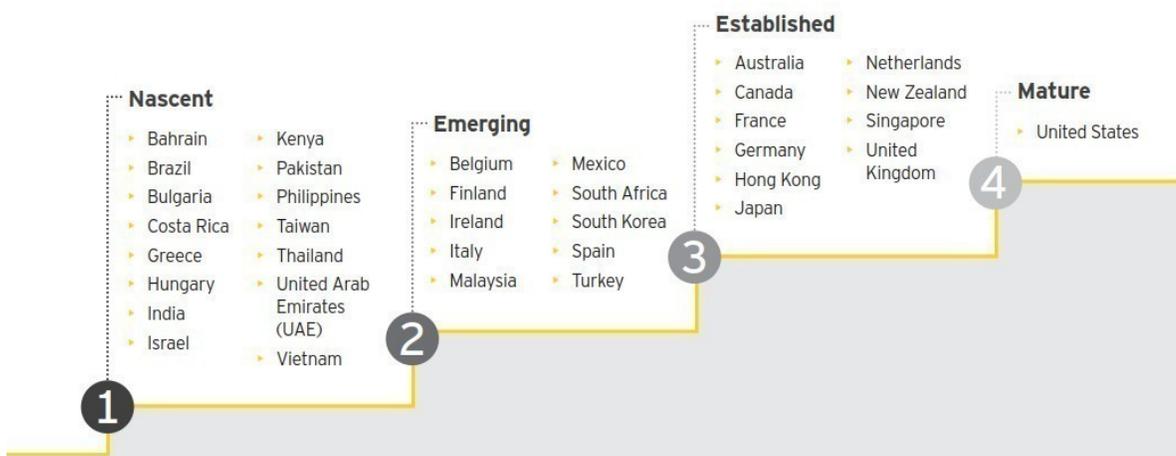
² SNL Financial, SNL XL Database, accessed May 2017.

at favorable market prices. There may also be certain instances in which individual companies in less favored sectors can take advantage of the reduced competition and further differentiate themselves from peers.

Real estate and REIT markets globally are maturing rapidly and may provide increased competition for investment ...

Globally, the REIT concept is gathering pace. There are now 36 REIT markets with a total market cap of approximately US\$1.6t³. Real estate markets and REITs all over the world are maturing fast, driven by evolving demographics, consumption and saving trends that are pushing more capital into the hands of institutional managers and national funds, which in turn are raising their real asset allocations (10.3% in 2017 vs. 8.9% in 2013)⁴. As real estate markets and vehicles mature and capital becomes more diversely distributed, we can expect to see a higher proportion of capital move towards fast-growing markets, potentially reversing the “flight to quality” trend of recent years. This may in time impact the volume of capital targeting the US market.

REIT jurisdictions – maturity



Source: EY

... but US REITs have a huge head start and should be well-placed to capitalize on the opportunity.

From a REIT perspective, however, the next three to five years are likely to continue to favor the US. With a market capitalization of almost US\$1t⁵, the listed US REIT market is by far the largest and most mature globally. Investors will continue to look to the listed US REIT market as a leader not only in terms of access to high-quality and well-aligned portfolios but also from a financing, operational and governance perspective. Best-in-class US REITs will remain flagbearers for the industry and core holdings in any global portfolio. More mature global real estate markets will also open up the possibility for US REITs to export their expertise overseas and invest in different markets around the world. This opportunity should generate the next wave of growth.

Technology is a game changer for both companies and the markets in which they operate.

Technology will continue to create both challenges and enormous opportunities, and it is not just about disruption. Technology will help the real estate industry design more sustainable buildings, making better use of water and energy resources. Reduced operating costs and better safety features should result. It will also help real estate owners better understand the standing of specific assets within a certain submarket, enhancing their ability to make informed buy,

³ SNL Financial, SNL XL Database, accessed April 2017.

⁴ Cornell Baker Program in Real Estate and Hodes Weill & Associates, 2016 Institutional Real Estate Allocations Monitor, October 2016.

⁵ SNL Financial, SNL XL Database, accessed April 2017.

hold or sell decisions. Technology will also be highly disruptive, however, in fundamentally redesigning the way tenants in all industries use real estate. This is challenging management teams to stay abreast of trends that evolve rapidly. For those unable to keep pace, the risk of asset obsolescence is very real with negative implications for portfolio value and the business generally.

The accelerated pace of change being seen in our markets makes obsolescence more relevant than ever before. Lenders are already weighing in on the issue of obsolescence as part of their process in determining how to underwrite assets. The industry will likely see ratings agencies follow suit. This may have important implications for a key REIT financing mechanism, affecting both an organization's ability to access debt financing as well as the pricing of that debt.

Positioning the business to respond and capitalize on technological change will be a differentiating feature ...

While technology will raise the specter of asset obsolescence, the opportunity for well-informed and savvy management teams is significant. Tracking the ongoing evolution of technology and how it impacts a portfolio is important. But forecasting the specific nature of changes is and will remain extremely difficult. Building flexibility into your portfolio, financing, operations and management outlook is critical.

... as will implementing technology into all aspects of a REIT's operations.

Technology is also creating both challenges and opportunities within business structures. Robotic process automation and artificial intelligence will become increasingly accessible tools to aid and optimize business processes. Cybersecurity and, in particular, the crossover between information technology and operational technology are critical to mitigating risk and protecting both REIT and tenant brands. Brand loyalty has been a casualty of today's digitally enabled world, which makes protecting it all the more important. This matters to tenants but also to REITs, which need to remain trustworthy, and become landlords of choice with whom tenants will prefer to partner. One of the greatest threats to REITs comes from the complex operating systems present in their own buildings. Accessing a REIT's internal platform or even accessing a tenant's platform via a specific building's operating system is increasingly viable. Keeping a building's operational technology secure will be a huge challenge in the future. It will be a requirement, however, as the opportunity to maximize the benefit of smart technology in order to make energy and ultimately cost savings (and further improve the efficiency of REIT platforms) is likely significant.

Data analytics and smart technology will be two other evolving priorities. Data analytics can provide unprecedented insight into the business, and smart technology will drive building efficiency, delivering not only cost benefits but enhancing usability of space.

Building flexibility into assets will likely become increasingly important in order to adjust to the fast-evolving trends and changing uses for space that will emerge in a digitally enabled world. REITs are both long-term owners of property and perpetual life vehicles, which make adopting these technologies both valuable and potentially critical to long-term success.

Corporate governance has risen up the agenda ...

REIT investors are increasingly challenging organizations around corporate governance. For some REITs this is evidenced through the role of activist investors, but investors generally are more engaged around governance issues. Board composition, transparency, accountability, diversity, experience and alignment are essential elements of governance. Communication and alignment with shareholders is critical, and the best exponents will be well-placed to maximize future opportunities.

... and keeping abreast of regulatory change will remain important.

The regulatory environment will continue to evolve with important implications for real estate companies. New rules may not necessarily be game-changing for companies, but regulations introduce another element to both landlords' and tenants' decision-making processes around their current and future ownership and use of real estate. Areas such as lease accounting, fair value calculations and the potential change in jurisdictional tax laws (e.g., possible repeal of 1031 exchange rules) are good examples of this.

Flexible, accommodating and nimble businesses owning adaptable buildings will be winners in the future. Listed US REITs will need to remain flexible in order to navigate a dynamic market environment, and buildings need to be adaptable to future uses. Capital structures need to be able to accommodate the changes occurring in our markets, and the business must remain agile in order to capitalize on the rapidly evolving world.

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