

Real Estate Investment Trusts And Fundamentals of Real Estate Investments : A Case of Turkey

Dr. G. Cenk AKKAYA

Dokuz Eylül Üniversitesi, İİBF, İşletme Bölümü, İZMİR

Dr. Nilgün Kutay

Dokuz Eylül Üniversitesi, İİBF, İşletme Bölümü, İZMİR

Dr. Mine Tükenmez

Dokuz Eylül Üniversitesi, İİBF, İşletme Bölümü, İZMİR

ABSTRACT

A real estate investment trust (REIT) is a corporation or a business trust that combines the capital of many investors to acquire (or provide financing for) various real estate assets. Investors get a share of the earnings, depreciation, etc. from the portfolio of real estate holdings that the REIT owns. REITs were created to provide investors with the opportunity to participate in the benefits of ownership of larger-scale commercial real estate or mortgage lending. Finally, REITs is that they are probably the best inflation hedge around.

Keywords: Real Estates, Real Estate Investment Trusts, Real Estate Finance, Corporate Real Estates, Financial Analysis of Real Estates

Gayrimenkul Yatırım Ortaklıkları ve Gayrimenkul Yatırımlarının Temelleri: Türkiye Örneği

ÖZET

Gayrimenkul yatırım ortaklıkları (GYO) birçok yatırımcı tarafından oluşturulan ve çeşitli gayrimenkul yatırımlarının finansmanı için sermayesini sağladığı bir işletme ve ortaklık bütünüdür. Yatırımcılar GYO'nun oluşturduğu portföyden belirli oranlarda hisse almaktadırlar. GYO yatırımcılara sınırlı sermayeleriyle büyük ticari gayrimenkul projelerine yatırım yapmalarını ve bu projelerin sağladığı faydalardan yararlanmalarını sağlamaktadır. Bu bağlamda GYO'ları enflasyon karşısında yatırımcıları koruyan önemli bir araçtır.

Anahtar Kelimeler: Gayrimenkul, Gayrimenkul Yatırım Ortaklıkları, Gayrimenkul Finansmanı, Gayrimenkul Yatırımlarının Analizi

Introduction

Real estate ownership is a large and profitable part of economy. The real estate management industry is becoming increasingly competitive as developers and others enter the property management business. This industry consolidation is still accelerating. Real estate investments are profitable vehicles for investors. The diversification can substantially reduce the risk of a real estate portfolio. Investors who want to implement on real estate diversification strategy have two possibilities: they can invest directly, by buying actual buildings, and they can invest indirectly, by buying the shares of listed property companies.

1.Features of Real Estate Investments

Several characteristics of real estate distinguish it from alternative investments (stocks, bonds, foreign exchange, etc.). Real estate does not uniquely

possess these characteristics, but they are important in determining the prices and quantities transacted in markets. These characteristics include (Chinloy: 1987):

- Differences in information: In real estate transaction, there are differences in information between parties-buyer and seller.
- Localized markets: Markets are local in scope for the physical properties, and trading on a national bourse does not take place.
- Heterogeneous properties: All properties are not the same, with numerous differences in characteristics.
- Illiquidity: Real estate is not mobile or portable, and transaction is difficult because of legal institutions, and the large indivisibility of size .
- Tax Treatment: Real estate is accorded favorable or unfavorable tax treatment, and tax advantages can be key factors in an investment decision.
- Supply restrictions: It is often noted that 'they aren't making more land.' Land is relatively, if not perfect, inelastic supply.

2. Dimensions of Real Estate Investment Trusts

A real estate investment trust (REIT) is a corporation or a business trust that combines the capital of many investors to acquire (or provide financing for) various real estate assets (Deloitte & Touche;1997). Appearing first in the 1994, there are now 9 REITs in the Turkey (The financial indicators about these REITs are given in the appendix A).

A REIT is a company that invests its assets in real estate holdings. Investors get a share of the earnings, depreciation, etc. from the portfolio of real estate holdings that the REIT owns. REITs are becoming a strategic business and planning tool for a corporation's real estate (Friedman;1998). REIT vehicle is a topic of current interest to inventors in and portfolio holders of real estate (Meretsky;1998). A REIT is essentially a corporation or business trust that combines the capital of many investors to acquire or provide financing for all forms of real estate.

The investors have a much more liquid investment than this do when directly investing in real estate. REITs are mutual funds for real estate. The REIT industry raises important capital for the industry, the housing market and related industries and for retail services industries.

REITs traditionally pay out all of their taxable income and, in many cases, 90% of their funds from operations in the form of dividends and distributions to shareholders (Landy:1996). A corporation or trust that qualifies as a REIT generally does not pay corporate income tax. This is a unique feature and one of the most attractive aspects of a REIT. This means that nearly all of a REIT's income can be distributed to shareholders, and there is no double taxation of the income to the shareholder.

A REIT must (Notification of REITs of Turkey, 2001):

- be a corporation, business trust or similar association,

- be managed by a board directors or trustees,
- have shares that are fully transferable,
- initial capital not less than 1 trillion Turkish Liras,
- the share of each real estate or real estate project in the portfolio must not be less than 10 percent,
- invest at least 75 percent of the total assets in real estate assets,
- invest at most 10 percent of the portfolio to real estate certificates and asset backed securities
- invest at most five percent of portfolio to stocks and type A (invest at least 25 percent of the portfolio to domestic companies) mutual funds
- invest at most 10 percent of portfolio to foreign real estates and real estate backed securities

REITs were created to provide investors with the opportunity to participate in the benefits of ownership of larger-scale commercial real estate or mortgage lending, and receive an enhanced return, because the income is not taxed at the REIT entity level. This means that a diverse range of investors can realize investment opportunities otherwise available only to those with larger resources. In addition to avoiding double taxation and requiring a small minimum investment, REITs also offer investors (NAREIT;1998):

- Current income: usually stable and often provides an attractive return;
- Liquidity: shares of publicly traded REITs are readily converted into cash because they are traded on the major stock exchanges;
- Professional management: REIT managers are skilled, experienced real estate professionals;
- Performance Monitoring: a REIT's performance is monitored on a regular basis by independent directors of the REIT, independent analysts, independent auditors, and the business and financial media. This scrutiny provides the investor a measure of protection and more than one barometer of the REIT's financial condition.

An investor may invest in a publicly traded REIT, which in most cases is listed on a major stock exchange (for instance, Istanbul Stock Exchange), by purchasing shares through a stock broker. An investor can enlist the service of a broker, investment advisor or financial planner to help analyze his or her financial objectives.

3. Structures of Real Estate Investment Trusts

The REIT industry has a diverse profile; which offers many attractive opportunities to investors. There are three different investment approaches for REITs; equity, mortgage, and hybrid.

Equity REITs: Equity REIT own real estate. Their revenue comes principally from rent. This type of REITs are the most common. Investors have a relatively steady dividend payout, and the real estate often provides capital appreciation.

Traditional investments include office buildings, houses, apartments, and shopping centers, but some new equity REITs are formed existing properties and real estate partnerships through an Umbrella Real Estate Investment Trusts (UPREIT) (Deloitte & Touche; 1997). UPREITs are different from traditionally equity REITs. UPREITs are a limited partnership structure is utilized, with the REIT functioning as general partner. Both holders of real estate partnership interest and REITs can benefit from the UPREIT. The REIT benefits by acquiring real property without having to generate capital to purchase the property.

Mortgage REITs: Mortgage REITs loan money to real estate owners. Revenues are derived from interest earned on mortgage loans. Also some mortgage REITs invest in residuals of mortgage-based securities. Mortgage REITs generally do not own property, and income can be affected by fluctuations in interest rates and loan defaults.

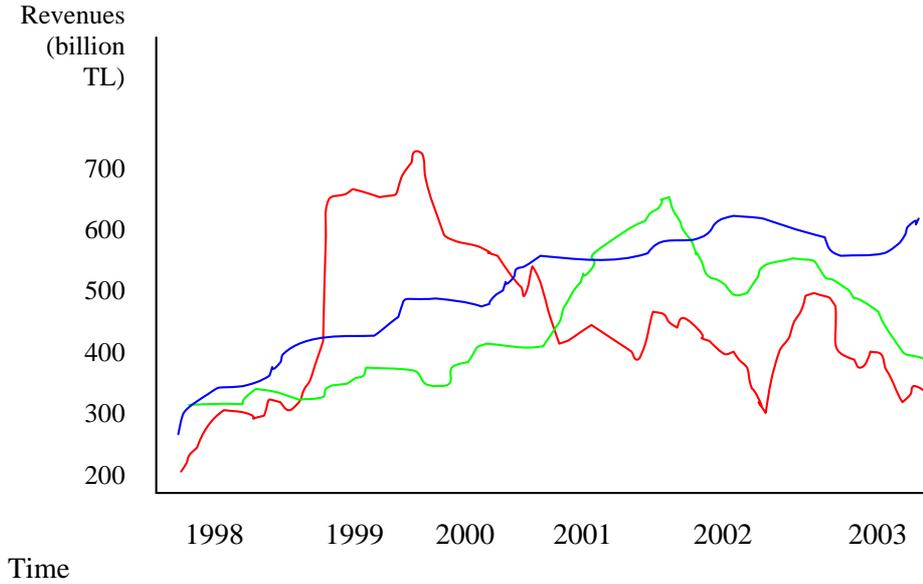
Hybrid REITs: A combination of equity and mortgage REITs, hybrid REITs own property and also loan funds to owners of real estate. Hybrid REITs has all advantage of equity REITs and mortgage REITs. While it has the potential for both capital appreciation and loss, it also provides income but does not mature with a repayment of principal. It can provide the long term investor with an attractive yield at relatively low risk, and an opportunity to diversify into income-generating commercial real estate (Irwin;1998).

4. The Financial Model of Real Estate Investment Trusts

An interesting thing about REITs is that they are probably the best inflation hedge around. Far better than gold stocks, which give almost no return over long periods of time. They almost always lack the potential for tremendous price appreciation (and depreciation) that the investors get with most common stocks.

Real estate looks attractive for some macroeconomic reasons. Because of high interest rates and construction costs, real estate a profitable investor tool for investors. Real estate revenues are much more than foreign exchange and stock exchange markets.

Investors would be hurt by interest rate increases. But interest rates usually rise with inflation, and inflation could result in higher asset values for the properties held in the REIT. An economic slide that would adversely affect the ability of tenants to pay their rent is a risk. There is a stock market downturn. While some real estate as an industry independent of the stock market, the REIT market remains dependent on the continuing inflow of capital through unit purchases. If the broader market began to trend downward, the REIT market could go with it (Irwin;1998).

Figure.1. Real Estate Revenues

Reference: Tusiad,2002

— : Istanbul Stock Exchange
 — : Foreign Exchange
 — : REITs revenues

There are two different type of real estate funds, open end funds and close end funds. Open end real estate funds advantage is liquidity. New investors can acquire interests in properties purchased with additional capital. The value of the portfolio is adjusted, usually quarterly, based on outside appraisals or on a internally-provided determination of value. New investors buy a fund at the adjusted portfolio values.

Close end funds were first available in the late 1970s in United States. As investors became apprehensive about using property appraisal to value funds units when money was moved in and out of the fund. With a close end fund, an investor buys into the fund at real estate market values, holds the units for a predetermined period and receives proceeds from the sale of properties at the end of the period. The illiquidity of this close end structure is justified because of the long term nature of real estate investments and because it is a means of overcoming the appraisal problem involved in open end funds. The illiquidity issue is also somehow diffused by the market for the sale of close end funds units that exists (Raijen;1998).

The benefits from this form of REIT include: increased predictability of return, as there is no risk of dilution of security holder's interest; a guarantee that security holders will receive the current benefits of property ownership, as all cash flow is distributed; and, the ability of security holders to participate in any appreciation in the portfolio properties on a current basis (Meretsky;1998).

REITs provide a suitable investment vehicle for investors of limited financial means who can pool their resources and invest in real estate properties without the major commitment of time and capital required for direct ownership.

There are three different ways of estimating real estate values for REITs. **Market approach;** The value of a particular property should not differ greatly from realistic asking prices and recent sale prices of similar real estate. Thus a check of the market and recent transactions should give some guide to what a particular property is worth. **The cost approach;** real estate values may also be based on the cost of equivalent land and construction. The construction cost should include the cost of funds tied up while property is being built and allow for the differential values of new versus used structures. Thus valuations based on replacement costs (Branch;1989). **The income approach;** this valuation based on expected future dividend and rental income of the real estate.

The Income Approach: An Example

Borrowing cost : 18%
 Alternative yield on low-risk investment: 14%
 Percent down payment required: 25%
 Weighted average cost of capital: $0.25 \times 14\% + 0.75 \times 18\% = 17\%$
 Risk premium : %7
 Total cost of capital : $17\% + 7\% = 24\%$
 Current rental income : \$ 3000 or \$ 36.000 per year

Estimate current and future property expenses
 Property taxes : \$ 5000 per year
 Repairs : \$ 300 per year
 Total \$ 5300 Per year

Expected holding period : 4 years
 Expected selling price : \$ 150.000 (a modest increase over the current asking price of \$ 140.000)

Net income per year : \$ 36.000 - 5300 = \$ 30.700

	Net yearly income		Constant *
Year 1	\$30.700	x	0.806 = \$ 24. 744
Year 2	30.700	x	0.650 = 19. 955
Year 3	30.700	x	0.524 = 16. 086
Year 4	30.700	x	0.423 = <u>12.986</u>
Total			\$ 73.771

*: From the 24% column in present value table

Present value of expected sales price : \$ 150.000 x 0.423 = \$ 63.450

\$73.771 + \$ 63.450 = \$ 137.221

The present value is less than asking price (\$ 137.221 versus \$140.000), and thus the property seems relatively unattractive.

5. Corporate Trends and Real Estate

There are several possibilities a corporate has when investing in direct real estate, which includes undeveloped land, residential rental properties, office buildings, shopping malls and industrial properties.

Although real estate usually is the biggest financial investment companies make, in the past firms seldom thought of it as a strategic asset. Generally, companies should sell their property if the return from investing profits from a sale is greater than the cost of leasing the property. Selling provides other financial and accounting benefits (Schriner;1997). It provides cash income and tax benefits.

Most of the companies expect a return on capital of between 10% and 30%. Therefore, if company invested 100 TL billion in a facility, it'd expect an annual return of between 10 TL billion and 30 TL billion on it.

But real estate investors, usually expect a lower return, between 8% and %15 annually for their investment (Schriner;1997). If the return from investing the profit from the sale is higher than the cost of leasing the facility, the investor should sell.

Most companies invest to REITs for diversification (Geurts, Nolan; 1997). REITs protect firms against risk. There are two elements of investment risk: systematic and unsystematic. Systematic risk is nondiversifiable. But unsystematic risk is diversifiable. Therefore REITs can protect against unsystematic risk via diversification. Examples of diversifiable risks are events such as lawsuits, strikes and unsuccessful marketing programs. These risks are specific to a particular company, and thus by investing in REITs, companies can reduce risk.

Conclusion

The real estate management industry is becoming increasingly competitive as developers and others enter the property management business. A real estate investment trust (REIT) is a corporation or a business trust that combines the capital of many investors to acquire (or providing financing for) various real estate assets.

The investor gets a share of the earnings, depreciation from the portfolio of real estate holdings that the REIT owns. Thus, the investor gets many of the same benefits of being a landlord without too many of the hassles. The investors

also have a much more liquid investment than the investor do when directly investing in real estate.

REITs provide a suitable investment vehicle for investors of limited financial means who can pool their resources and invest in real estate properties without the major commitment of time and capital required for direct ownership. Finally, REITs is that they are probably the best inflation hedge around. Companies and investors can invest this profitable investment tool.

REFERENCES

- Branch Ben;** Investments Principles and Practices, Longman Financial Services, Second Edition 1989
- Chinloy Peter;** Real Estate Investment and Financial Strategy; 1987
- Deloitte & Touche,** Understanding REITs, Personal Finance Advisor, July 1997
- Friedman M. Steven;** The REIT as a Strategic Real Estate Tool, Commercial Investment Real Estate Journal,1998
- Geurts G. Tom, Nolan Hilary;** Does Real Estate Have A Place in the Investment Portfolio of Tomorrow, Review of Business, Vol.18 Issue.4, 1997
- GYO,** Esaslar Tebliği, 2004
- Irwin Hal;** REITS and The Real Estate Resurrection; CMHC Mortgage Market Trends Third Quarter,1998
- Landy W. Eugene;** Benefits of Dividend Reinvestment Plans and Shareholder Investment Plans for Shareholders, Real Estate Investment Trusts and the Economy; 1996
- Meretsky Jason,** Real Estate Investment Trusts: An Analysis of the Investment Vehicle and Income Tax Implications, University of Toronto Faculty of Law Review vol.53 No.1,1998
- NAREIT,** NAREIT/PREA Property Investment Strategy, Real Estate Symposium, 1998
- Raijen Van Laura;** Real Estate Investment Structures, Working Paper, 1998
- Schriner A. James;** Real estate: hidden wealth for a company? It might be smart to sell your property- and lease instead, Industry week, Vol.246 No.18; 1997
- Tacirler Menkul Değerler A.Ş., 2004, www.tacirler.com.tr
- Tusiad, Türkiye Ekonomisi 2002 Raporu, 2003