Global perspectives

2013 REIT report

EY

Building a better working world

Contents

Now in its sixth edition, EY's ***Global perspectives: 2013 REIT report*** is intended to help real estate investment trusts (REITs) and other property investors understand the market and its drivers and make more informed decisions.

This year's report includes:

- A review and discussion of four important areas REITs must consider to succeed
- An interview with Steve Sterrett, Chief Financial Officer of Simon Property Group
- An overview of emerging REIT markets
- Insight from the EY professionals who work with our largest REIT clients, as well as statistics from our survey of REIT CFOs.

We hope that you will find this report valuable and that it helps you make decisions that will enhance your organization's success.

Howard Roth
Global Real Estate Leader
EY

Robert Lehman
Global Real Estate Investment Trust Leader
EY

Executive summary

The real estate investment trust ("REIT") concept now exists in over 30 countries worldwide.[1] REITs globally have seen their market cap grow from $300b in 2003 to just over $1t as of September 2013.[2] The REIT concept has become increasingly recognized and accepted as a mainstream investment sector and a route for investors to access high value, illiquid real estate assets.

The industry contains a highly diverse collection of companies operating at a local, regional, national or global level, and across this spectrum, examples of both good and bad practices exist. In some cases, good practices are specific to a particular market and hard to replicate elsewhere, but in many cases, we believe the broader themes that have made companies successful are applicable and can be duplicated by other organizations, regardless of their location.

As REIT regimes mature and grow as an investment sector, companies have to continue to identify and implement best practices. This facilitates improved operations and leads to better results. We believe this is applicable to all REITs, from the industry leaders to local operatives.

1. European Public Real Estate Association, http://www.epra.com/regulation-and-reporting/taxation/reit-survey/, accessed on 9 September 2013.
2. SNL Financial, http://www.snl.com, accessed on 9 September 2013.

Methodology

This paper provides examples of best practices in the four key areas of REIT operations that we see as key to long term management success. They are:

- The effectiveness of the platform
- The allocation of capital
- Transactions
- Financing the business

EY believes REITs that increasingly move from an entrepreneurial style of managing their business to a more mature, efficient approach will lead the industry going forward. Efficiency and effectiveness are becoming important differentiators across the sector.

The information presented in this year's report is based on interviews with EY partners who work on our largest REIT accounts around the world.

The interviews were conducted over several weeks in July and August 2013, and they focused on the previously mentioned areas that we believe to be of special interest to REITs: platform effectiveness, capital allocations, transactions and financing. Where relevant, the interview information has been supplemented with data from a survey of more than 80 REIT CFOs conducted in July and August 2013.

In addition, we also interviewed our partners in emerging REIT markets in China, India and Mexico and have included their insights.

Platform effectiveness

The nature of the real estate industry is such that there is no single platform infrastructure that singularly facilitates operations in all situations. Different subsectors of the real estate market require different operational approaches, and given the regulatory and reporting requirements for publicly traded REITs, the platform requirements for these organizations can be unique.

The overwhelming trend is for REITs to increasingly move from an entrepreneurial style of managing their business to a more mature, efficient approach. Whether by choice or inertia, all REITs are being affected. Efficiency and effectiveness are becoming important differentiators across the sector, given the focus on cost reduction, risk management and increased operational effectiveness.

During our discussions, our partners revealed several major takeaways for the sector as a whole and for organizations thinking of converting to REITs. Specifically, there are three trends that we think are contributing to better platform and infrastructure effectiveness:

1. **Operational effectiveness** – creating a clearly defined and effective organizational structure and implementing processes that result in better-quality outputs
2. **Efficiency and cost reduction** – improving processes, often through automation, streamlining and/or centralization, so that operations are run in a better and more cost-effective way
3. **Risk management** – managing risks throughout the business to mitigate the possibility of unexpected problems or to better position an organization for the unexpected

When these activities are successfully combined, the result is an effective platform capable of facilitating the many complex aspects of running a major real estate business.

1. Operational effectiveness

The objective of "operational effectiveness" is, of course, to produce better-quality outputs, whether that be investor reports, management reports, financial statement reports, or other data or reports produced by the organization. Reviewing and aligning the organization's structure is often one component of this process. Many of the best organizations have taken steps to ensure that they are functioning according to the needs of today, rather than with an historical alignment that may no longer be relevant. Alignment of the organization should be considered in conjunction with a holistic look at processes and technology, and these three areas should be assessed and aligned in conjunction with each other.

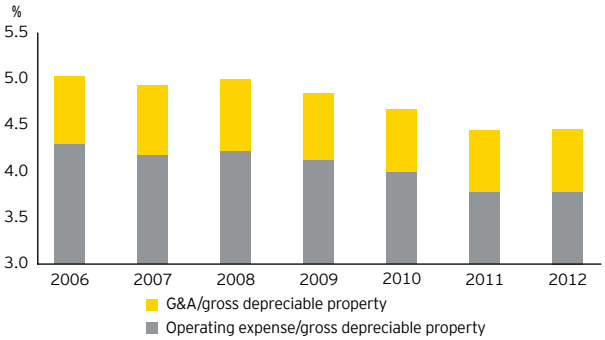
Our interviews revealed that the largest REITs monitor and review their platforms on a constant basis. They look for small, incremental improvements as well as transformative upgrades. Where change is needed, the review process is comprehensive and implementation thorough. This includes a complete review of staffing and associated processes to best align resources to an upgrade.

2. Efficiency and cost reduction

Strengthening and improving processes so that operations are run more effectively, and with less redundancy and rework, leads to greater efficiency, and this in turn facilitates cost reductions.

Evidence shows that REITs have taken steps to do this. Operational, general and administrative costs in the US REIT sector have declined from 5% of un-depreciated book value of property in 2006 to 4.5% in 2012.[3] The benefit is clear: un-depreciated book value of property has risen by 35% since 2007, while the associated cost of operating the enlarged portfolio has risen by 22%.[4]

Figure 1. Costs/gross depreciable property

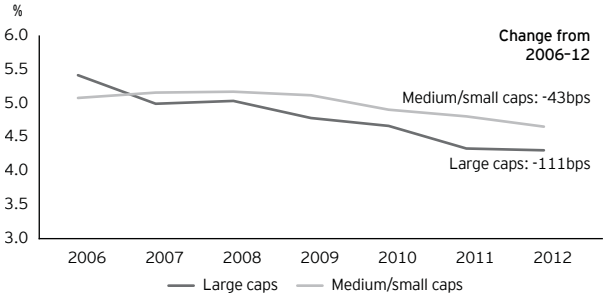


Source: SNL Financial, EY analysis

3. SNL Financial, http://www.snl.com, accessed on 12 August 2013, and analysis by EY.
4. Ibid.

Realizing economies of scale appears to be a contributing factor: large-cap REITs have made more progress than smaller rivals.

Figure 2. Costs to gross depreciable property (large caps vs. medium/small caps)



Note: "Large cap" is defined as having a market cap above US$8b. Results exclude health care and lodging sectors. Both subgroups have added a similar amount of gross depreciable property across the period.

Source: SNL Financial, EY analysis

Some of the best practices we see in this area include:

A. Standardizing process and controls and centralization

Within larger REITs, we typically see an increasing level of focus on process centralization or some hybrid centralized/decentralized model. While "Real estate is a local business" has been the adage in the industry for years, organizations are increasingly coming to the conclusion that this does not necessarily apply to the back office. Yet determining the most appropriate structure for each organization depends significantly on an organization's activities, geographic reach and strategic goals. However, given organizations' increasing level of focus on cost management, consistency across the organization and centralized control, organizations are moving to the centralized model for processes where it may make sense, such as rent collections and accounts payable.

B. Procurement

We believe that large-cap REITs benefit significantly from utilizing their purchasing power and leveraging this across their portfolio.

For smaller REITs, there are three primary options:

1. Develop and maintain deep relationships with a core group of service providers and use them to ensure the most competitive price is achieved for any service requirement
2. Enter into long-term contracts to ensure a fixed-cost service with thresholds based on level of spend
3. Utilize aggregation tools where smaller like-minded businesses can work together to procure products. Several technologies and service providers exist in this domain and are increasingly becoming prevalent in the industry

C. Outsourcing

For some REITs, the shared service center (SSC) model, or the outsourcing of certain process-oriented activities such as lease administration or aspects of accounting, can play a valuable role in achieving both consistency and cost savings.

Today, larger REITs that use SSCs typically locate them onshore but in lower-cost markets; however, REITs may increasingly look to explore offshore options. Either way, the intent is to staff these locations with highly skilled individuals that have a focus in one or a few process areas. They are also often restricted in scope to purely back-office functions with a direct link to local offices, which perform the front-office functions.

Generally, we see centralization — from corporate location to controls and property operations — being used as a way to reduce operational overlap, decrease cycle time, improve quality of output and enhance overall control of risk.

D. Automation/technology

Many REITs are using technology to facilitate a more proactive approach to managing the business. A number of large-cap REITs are currently integrating new or improved IT platforms. This has become a more feasible option as technology options in the real estate industry have improved over the years.

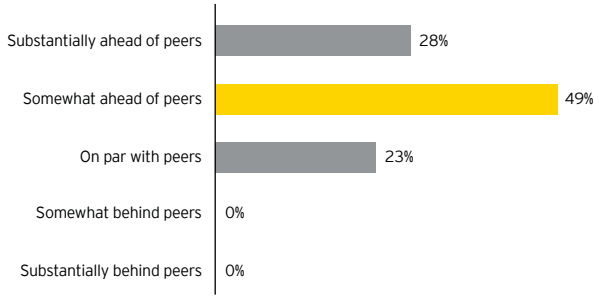
Technology can be used in almost every facet of operations, from systems and processes to specific applications. It has uses from sales to property management (automating tasks, identifying renewal dates and tracking lease terms) to the finance function (financial reporting, consolidations, REIT legislation testing and tax submissions) or support for the investment management process. A comprehensive system, tailored to a REIT's specific needs, should also facilitate better internal reporting and better provision of information to key stakeholders.

E. Data

We believe that large-cap REITs have reduced costs by implementing cost savings achieved by applying better knowledge. Extensive portfolios can be mined in a variety of ways to provide information into all aspects of operations, from tenant or end-user trends to measures such as power usage.

Huge potential benefits can be realized at both an operational and financial level, and a recent survey from the Economic Intelligence Unit highlights the importance of leading in this area.

Figure 3. Financial performance of companies "good" with data



Source: Economic Intelligence Unit survey of 530 senior executives across industries, conducted in February 2013

Data also presents risks. This is particularly the case around the collection, collation and distribution of relevant metrics. There is also the potential to overload individuals. One approach we advocate is to develop a "data dictionary" that clarifies what exactly is being created, how it is aggregated, why it is relevant and how it is used, and to follow that process consistently. We believe building relevant key performance indicators are important and distributing role-relevant data to people is crucial in the effective use of data.

3. Risk management

REITs are mainstream listed companies that need to take a holistic view of risk. The concepts of a robust internal audit program and enterprise risk management (ERM) are not new concepts outside of real estate but are only now being adopted by REITs. It can provide an overall framework in which different aspects such as portfolio risk, business risk and compliance can be identified, monitored and mitigated on a continuous basis.

In the real estate industry, establishing a process to identify and monitor risk is important, as is reducing risk itself. Certain risks such as asset concentration or tenant exposure are important, whether an organization is large or small. But most important is identifying risks and gauging each organization's tolerance for the risk. One lesson learned from the recent economic crisis is that risks exist in places that few recognized. In our opinion, the organizations that will weather the next crisis are taking actions to identify, assess and monitor risks on a go-forward basis.

Capital allocation

Decisions around capital allocation and how to best utilize finite capital resources are crucial for all businesses. Considering the capital-intensive nature of real estate and the illiquidity of individual assets, this process gains even more significance for REITs. Publicly listed organizations face the extra spotlight of reporting requirements and the instant judgment of highly liquid equity markets.

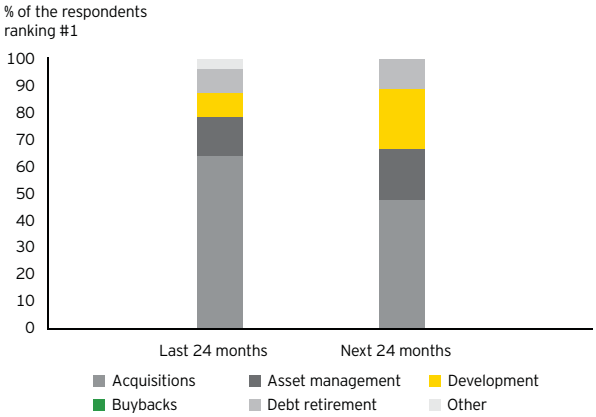
We see our clients favoring a structured approach when making capital allocation decisions, and they also consider joint ventures — with their challenges and opportunities — as a significant component of the capital allocation decision process. We also outline the likely destination for REIT capital, primarily in the US, in the next 24 months.

1. Capital allocation intentions

A. Acquisitions still the priority

Acquisitions have been and, according to our survey, will remain the primary focus of capital allocation for many in the REIT industry. However, both asset management initiatives and development are seen as increasingly important destinations for REIT capital in the next 24 months.

Figure 4. Primary destination for capital



Source: EY REIT survey

B. Development expenditure rising

Many large-cap REITs will increasingly make use of their development capabilities to deliver new products, while others are looking to extend or enhance existing projects. Larger REITs are already moving to increase development activity.

According to company 10-K filings, development costs and construction in progress were higher in 2012 than in either 2010 or 2011 for 9 of the largest 15 REITs. We estimate that development and construction costs for these 15 companies exceeded US$3b in 2012, up from US$2b in 2010.

There are few concerns over the development capabilities of large-cap REITs, as they typically have strong operational controls and significant experience in this area. One of the most notable themes we highlight was how large-cap REITs are rigorously monitoring and tracking development expenditures. They are very disciplined around controls and processes, with any new information immediately incorporated into budgets and reviewed by senior management.

C. Debt retirement

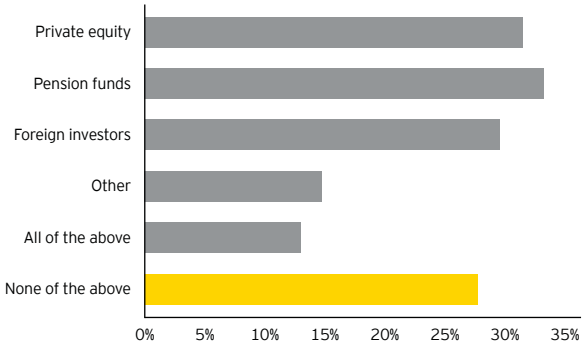
Debt retirement has been an important focus in recent years. Ten percent of respondents to our survey rated it as their number one priority over the last two years, and the same number expect it to remain so going forward. Debt loads appear to remain an issue for more than just a handful of operators. We explore the financing situation further on page 17 of this report.

2. Joint ventures

Joint ventures remain a much-debated area within the REIT industry, which is confirmed by our survey responses. For some, they form a core part of the capital structure, but for many others they are rarely used and low on the priority list.

The REIT industry appears to have no particular preference toward any segment of the real estate market as a viable joint venture partner.

Figure 5. What type(s) of companies do you expect to partner with in the future? (please select all that apply)



Source: EY REIT survey

REITs are often very specific about their requirements for joint ventures. They typically operate the assets, and where joint ventures are sought, they are looking for long-term, relatively passive partners with the scope to fund their future share of asset management or development expenditures. Pension funds, insurance companies and increasingly sovereign wealth funds are often natural partners.

Among large-cap REITs, there appear to be four primary uses for joint ventures:

- To mitigate specific asset risk for very-high-value properties
- To broaden portfolio reach by exchanging holdings in mutually desirable assets
- To facilitate international operations
- To provide access to operational partners in areas beyond the core competencies of the specific REIT

We see a number of large REITs, typically operating at a national level, that have been looking to buy out joint venture partners. According to this group, joint ventures are perceived to bring few benefits for mainstream assets when REITs have fully functional operating platforms and excellent access to capital.

However, for some REITs, joint ventures may be worth maintaining in some capacity to act as a defensive measure. A long-standing relationship with a major pension or sovereign wealth fund could be invaluable as an alternative source of capital in difficult times.

REITs that operate globally appear to be much more willing to use joint ventures and funds. Partnering with local operators or utilizing third-party capital is a favored approach to diversify balance sheet risk, gain local expertise, and help mitigate the challenges of moving capital on- and offshore.

3. The decision-making process

Many real estate organizations have historically operated around a core group of talented individuals. Many of these teams remain in place, a situation seen often in the largest REITs.

Balancing the competencies of senior executives is increasingly important. For example, more finance specialists have joined REIT teams in Australia in the past three to four years. This has brought greater sophistication around both financing and capital allocation, which we see as a very positive move when allied to the strong core of existing real estate competencies.

A significant number of large REITs operate their business around an investment committee structure that comprises the most senior executives. Board approval may also be required.

The breadth of this committee varies, as does its reach. It is often composed of representatives from acquisitions, development, construction, asset management, research, finance and treasury alongside the CEO, CIO and CFO. Supporting this committee is a well-developed, clearly outlined structure to ensure all collateral is fully developed with input from all relevant areas of the business. We believe the best organizations utilize their connectivity to rigorously develop all materials requiring review.

In addition to the investment committee's role in the capital allocations decision process, some REITs operate ongoing audit procedures around approved projects. Any significant deviation from an approved outline requires resubmission to the investment committee. In such a capital-intensive industry, this approach is used to constantly monitor allocation decisions. Good practices highlighted in various organizations include the continual review of projects and not being afraid to terminate projects when significant deviations occur.

One of the great benefits of this structure is that it utilizes the advantages of the platform without diminishing the input of senior executives whose often-unrivaled experience is invaluable.

Q&A

Rick Sinkuler, EY's Global Real Estate Markets Leader, recently sat down with Steve Sterrett, the Chief Financial Officer and Senior Executive Vice President of Simon Property Group (Simon), an S&P 100 company and a leader in the global retail real estate industry.

Steve Sterrett
CFO and Senior Executive Vice President
Simon Property Group

Rick Sinkuler
Global Real Estate Markets Leader
EY

Q&A with Steve Sterrett, Simon Property Group

They discussed the current state and future outlook of the REIT sector, and Simon's place in it. Highlights of their conversation follow below.

Rick Sinkuler
You now have 20 years as a leading public company – what has Simon done to help set itself apart?

Steve Sterrett
There are two or three things that stick out in my mind. First, over the past 20 years, we have had a consistency of strategy and leadership. That's only a positive if the leadership delivers positive results, of course, but David Simon, our CEO, has run the company very well for 20 years, and other key positions have been stable, as well. There is a lot to be said for the quality of our leadership.

Second, our growth has been smart growth. When we went public, we knew who we were and that we had a retail-only focus. Our projects have always gone through a rigorous underwriting process, and while we've made mistakes, overall we've had a clear and consistent vision, and that's helped.

Third, we also were and are aware that our business is very capital intensive and that access to capital is important, so we built a strong, fortress-like balance sheet and obtained an investment-grade rating early on to increase our ability to access capital, and we continue to make that a priority.

Sinkuler
Is it normal in the industry to have your top executives stay on for so long?

Sterrett
It is unusual, and I think it says a lot about the attractiveness of Simon's culture and David's ability to get people comfortable with the organization. For example, our current president, Richard Sokolov, came to us through our first significant transaction, with DeBartolo Realty Corporation, in 1996. Rick was the CEO of DeBartolo, and he stayed on to become our president and COO, which he still is, almost 17 years later. Another of our top-level people came from the second major acquisition we made, which was a privately held company. Their CEO joined us, moved to London, and was the head of our international business for 12 years.

People like working for the top company in the industry. Simon is more than twice the size of any other retail real estate company and an unequivocal leader in the industry. There's a certain cachet that comes with that.

Sinkuler
A lot must have changed in the past 20 years. What are some of the most significant changes, and how has Simon adapted?

Sterrett
It has changed – significantly! Think about this, when REITs were sold to the public as part of the wave of IPOs in the early 1990s, we were income-oriented vehicles, and the shareholder base was substantially retail investors. When Simon went public 20 years ago, our total portfolio was US$3b. Since then, the sophistication of real estate investors has increased significantly, and the sector has become mainstream, which I think is the biggest change. Simon now owns an US$85b portfolio, and 16 REITs are a part of the S&P 500 list.

Also, the environment has changed and become much more global. For example, the EU did not even exist 20 years ago. With the internet and smartphones, the world has become flat and our business has become international. REITs have gone global, something that was never a thought in the 1990s. There's been a change in demographics, too. Twenty years ago our primary market was baby boomers, and now it is Gen Xers and Millennials. As a consumer-facing organization, we have to continually adjust.

Sinkuler
You've navigated through one of the largest downturns in our careers — what did you do differently, and what can we learn from you?

Sterrett
I think there are a lot of lessons learned. It's important to understand that trees certainly don't grow to the sky; there are always cycles, and you have to plan for that. We had been through the S&L crisis and market downturn and had that experience, so we made some hard decisions very quickly, and likewise, when we were in the middle of the crisis and saw the green shoots beginning to show on the other end, we were able to ramp back up faster than our competitors. We were ahead of the curve on both ends. It also helped that our balance sheet was always healthy because we planned ahead for this type of situation.

Sinkuler
How will Simon keep the momentum going?

Sterrett
There are a few things we're doing. We're in an interesting time right now, with construction of retail real estate at a 50-year low in the US. There is not the population growth in the US to support the construction of new malls. We focus on two opportunities: enlarging some of our best-performing shopping centers with additional retailers, restaurants and entertainment, and developing outlet centers that serve a different market need.

Also, we are growing our presence internationally — in Canada, the Pacific Rim and Europe, among others. The competitive nature of retail in the US has been second to none, and we have knowledge that we can export from doing business here. We bought 29% of the second largest shopping center owner in Europe, and we just announced a deal where we will partner with a major European outlet developer to own, manage and develop outlet centers in Europe.

As our international footprint continues to grow, JVs are always a possibility. Although we have a lot of expertise in the US, there is a local component to real estate (including how to build and get entitlements). We could hire people to help us with that, but there is comfort in working with a local partner that has a lot of experience in the area.

Sinkuler
Do you have any tips on choosing the right partner?

Sterrett
Choosing the right partner requires that you to do your homework. We've done a good job of choosing good partners in the past, and research has made the difference. Choosing the right local partner makes all the difference in the world.

Sinkuler
What is Simon's greatest operational strength?

Sterrett
We have a relentless desire to do better and are always asking how we can improve. David has a saying I like: he wants all of our people to treat our assets like they're the owners. The senior management also has most of our net worth tied up in the business, and that gives us an incentive to manage our assets and our cash as if it was our own. We focus on cash flow and are constantly looking for ways to increase it. If we can do that, that means our earnings and dividends will go up, and the market will reward us with the value they are placing on our stock.

Sinkuler
Any insights on how the retail industry will change going forward and what that will mean to Simon?

Sterrett
Assets change constantly; our primary job is to make ours better with each passing day. Retail is always changing; If you look back even 10 years ago, Apple and Microsoft didn't have retail outlets. Now, technology companies have become a major component of the retail real estate sector, with the major players committing to retail space.

Going shopping is a social activity. Industry studies have shown that Millennials would rather go shopping at a mall than buy online, even though they are the first generation to have grown up with technology at their fingertips. Today, in addition to shopping, malls are also about entertainment. In an omnichannel world, the physical space of a shopping center is going to play an extremely important role in the distribution of goods.

We in the retail real estate sector have two jobs: to identify the best locations and to make them fresh and appealing so people want to shop there. Outside of that, we really are capital allocators. As leases come to expiration, we have to decide whether we want to renew the lease; we allocate more capital and space to retailers who are doing well, and less to retailers that may be losing their way.

Sinkuler
How is Simon using technology and the data it creates?

Sterrett
Our business is a very data-rich environment, so we can do things like compare the performance of our tenants' operations and our expenses across properties and locations. Being able to identify best practices and apply them quickly makes a major difference. For example, we've been able to decrease our utility costs substantially across our portfolios by doing this. Also, by evaluating all the data we have at our fingertips from other properties, we can evaluate the performance statistics for a potential acquisition. The mobility of data has also become important, too. Every one of our salespeople has an iPad, and they use them to show properties, in a way that was

not possible five years ago, including pulling up lease plans and providing 360-degree views. I've always viewed the airline and hotel industries as having the most dynamic pricing models. We don't have to be that sophisticated, but understanding what a tenant's productivity is, and what the value of our space is, helps us place the right tenant in the right space. The revenue maximization approach is something we have gotten better at, and the data that's available now has really helped.

Sinkuler
What are your expectations for interest rates? How do you see that affecting the REIT industry?

Sterrett
The average rate for the 10-year treasury is 3.5% over the past 10 years – and that's low, historically. I don't know if rates will go up or down, but there's one thing to consider: the sectors that have led the country's recovery, housing and cars, depend on low interest rates to do well.

We have less floating rate debt outstanding now than we ever had – about 92% fixed and 8% floating – and we've been on a mission for three years to lock and extend duration wherever possible.

Sinkuler
What is your view on market fundamentals in the US and Europe going forward?

Sterrett
It's been a very mild recovery in the US. GDP growth is about 2%, but our retail sales have done better than that. At the same time, Europe has been muddling through their version of the recession that we experienced in 2008–09. I expect Europe to recover over time, and because there is much less retail square footage per capita there, and thus, less competition, I think the retail recovery in Europe could ultimately be stronger than in the US.

Sinkuler
What is Simon's perspective on investing in emerging markets? Are there any emerging markets that Simon favors?

Sterrett
We announced a JV in Brazil, and we like that market, but we are actually focusing more on developed markets. Our retailers sell things that people want as opposed to need – our portfolios for the most part are not made up of staples like grocery stores and drugstores. This means that our shoppers tend to have more disposable income, which makes developed markets like Japan, Korea, Singapore, US, Canada and Europe more attractive.

Sinkuler
What is Simon's future outlook for the REIT industry?

Sterrett
The sector has clearly become much more mainstream than it was 20 years ago. We're seeing new types of REITs being created and new types of real estate being securitized, which I think is a good thing. The fact that the REIT sector is larger as a percentage of the US GDP is good.

The industry has been successful at doing what it was created to do – it's given the average investor a chance to invest in commercial real estate, and to do it in a tax-efficient manner that has also produced returns. If you look at 15- to 20-year returns, real estate has outperformed the broader market. Based on that past history of success, I expect the industry to continue to grow.

Sinkuler
If you look back, is there any one thing you would do differently?

Sterrett
I think you can always second-guess yourself. We did sell debt and equity very expensively in 2009 to "punch a hole" in the capital markets and convince the world that REITS had access to capital. We said at the time that we hoped it would be the most expensive capital we would ever have to raise. There have also been a few acquisitions we tried to do that we ultimately weren't able to complete, but that happens in any industry.

Sinkuler
If there was one message about Simon that you'd want readers to take away from this interview, what would it be?

Sterrett
It would be this: that because of everything we've talked about, Simon truly is a world-class company today. We think about it a lot in the context of the real estate industry, but if you look at our equity market cap, we are the size of some of the largest and most-respected brands in the world. We've been able to create a company that is truly world class – among all companies, not just real estate.

REITs were relatively new to the public markets 20 years ago, and the industry was small. Over the last two decades REITs in general and Simon in particular have been a very good place to be invested.

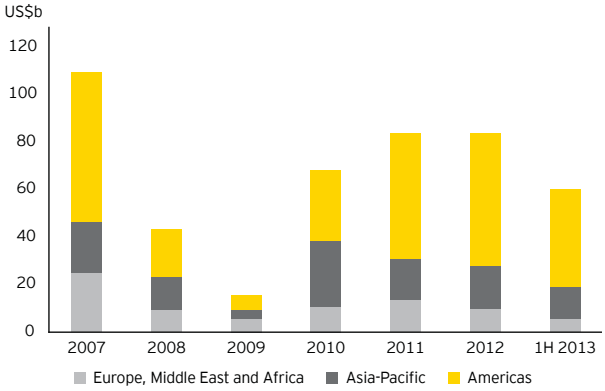
Q&A

Transactions

The global REIT industry has been a major participant in transaction markets in the last three years. Real Capital Analytics (RCA) estimates that REITs accounted for 14% of transactions by volume in 2012, and that percentage rose to 20% in the first half of 2013.[5]

5. "Global Capital Trends, 2012 Year in Review and Mid Year Review 2013," Real Capital Analytics.

Figure 6. Global REIT investment volumes



Source: Real Capital Analytics, EY analysis

The drivers of deal flow and REITs' intentions are important not only to the sector but to real estate markets generally. Our survey and the insight provided by our REIT partners provide some clarity about their plans, as well as the scope for transformative acquisitions involving the REIT sector in the next 24 months and the prospects for disposal activity.

Most large-cap REITs are likely to undertake acquisition activity through the remainder of 2013 and into 2014 at levels similar to or slightly below that of recent years. For some, the drop in activity is a result of being particularly active in recent years, but for many it is more a reflection of the challenges of identifying suitable and appropriately priced targets at this point in the cycle. They are, however, poised to act should a suitable opportunity arise.

1. Drivers of deal flow

The REIT industry is so extensive and diverse that a multitude of factors can drive acquisition strategies, such as sector, geography, quality, portfolio gaps, asset management potential and opportunistic pricing.

However, geography is a near-universal influence among the large-cap REITs. Most are very clear about the markets they want to operate in; they research them thoroughly, know them in detail and don't deviate from this. Indeed, exiting non-core markets is one of the principal reasons given for disposal activity.

Our survey highlights that almost 30% of respondents expect their organization to expand into new markets in the next 24 months. This is a surprisingly high percentage when compared with the geographic focus noted among the large-cap companies. With 25% of survey respondents also expecting to exit certain markets in the next 24 months, the REIT industry as a whole is likely to remain a valuable source of deal flow on both the buy and sell side. We believe that the broader industry is much more likely than the major players to shift its geographic focus.

2. Transformative acquisitions

Transformative acquisitions from industry large-caps seem unlikely. Recent activity in this area and the need to complete the integration process may be one reason. Other suggestions included market conditions being less conducive or that a transformative acquisition did not necessarily fit with the current strategy of the business. While the REIT sector has seen major deals in recent years, it does not appear that this is a precursor to greater activity in the short term.

Generally, however, this is an area where "never say never" is an important caveat. The three principal reasons for this are:

- Many of these organizations have successful track records of undertaking and integrating transformative acquisitions.
- REITs are always looking for the right assets to complement their existing portfolio, and most of the major players have the financial capability to make transformative acquisitions.
- The majority of organizations are strong when it comes to integrating large/transformative acquisitions, and are considered very capable in this area.

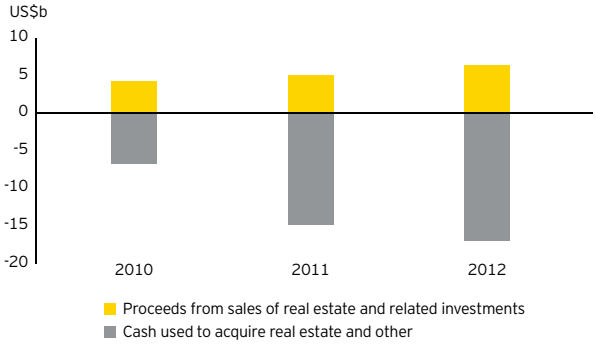
Most large-cap REITs have undertaken large or transformative acquisitions at some point in their history. There are numerous components to successfully delivering a transformative acquisition, but we see several criteria of successful deals in the REIT industry:

- A board with the mindset to do such a deal
- Communication with and support from investment markets
- A team that can truly execute the strategy
- A well-structured platform with clear and open reporting lines that ensures all aspects of the pursuit team are working in unison and sharing relevant information
- A clear and well-laid plan for post-closing integration, including decisions concerning asset and staff retention

3. Recycling/disposals

As the chart below highlights, cash flow from sales of real estate, while almost 50% higher in 2012 than in 2010, has been dwarfed by cash used to acquire real estate in 2011 and 2012.

Figure 7. Cash flow from investing activities



Source: Company 10-K filings, EY anslysis

We see a wide variety of factors contributing to disposal activity, but the three most common reasons given, which we do not expect to change in the near term, were as follows:

- Offloading substandard assets (where capital expenditure is not deemed worthwhile) in order to improve the overall quality of the portfolio
- Exiting non-core markets
- Recycling capital into higher-value opportunities

There are two additional possible catalysts to greater activity across the sector as a whole: sector rotation and opportunistic sales. Sector rotation by investors away from REITs could negatively impact pricing and the cost of capital. This may influence strategy and potentially hold/sell decisions. Opportunistic sales could perhaps come from a family-controlled REIT taking a slightly contrarian view of the current real estate cycle and the potential for a larger-than-forecast rise in interest rates. If this were to contribute to a significant outward shift in cap rates, or even a curtailing of the economic recovery, a sale of the business today at a premium level could be a desirable outcome.

Financing

REITs have become increasingly sophisticated in their management of debt. Important lessons from the financial crises have been learned and implemented.

Themes such as refinancing debt, pushing out maturities, laddering profiles, fixing the cost, diversifying sources, improving credit ratings and capitalizing on accommodative markets remain evident. To date, 2013 has largely been a year of "more of the same" in these areas for the major global REITs. Effective capital management is seen as a matrix that involves managing the many moving parts to create an overall position of strength.

We believe that generally speaking, the largest REITs have been doing and continue to do the right thing in this area. Most are maintaining the strategy that has served them well in recent years.

The interest rate question is becoming increasingly important to the sector, particularly in the US, but few major REITs have taken steps to specifically mitigate the impact. However, all are managing their debt loads in a way that recognizes the potential for rates to rise.

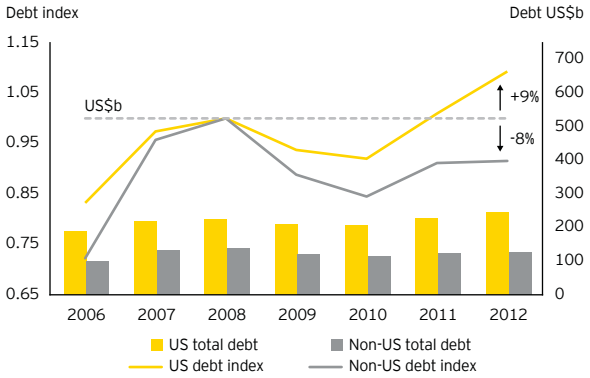
In this section we examine the current volume of debt evident in the REIT industry. We outline how the maturity profile of the largest global REITs has changed – providing a benchmark for the sector – and consider what they are doing to minimize the cost of debt in a way that is conducive to broader business strategy. Finally, we provide some pointers on what the sector has done to mitigate the potential interest rate issue and offer an update on the current state of secondary equity raises globally.

1. Volume of debt in the sector

Analyzing the debt load of 98 REITs globally with market caps in excess of US$2b, we estimate that this group had debt on their balance sheets of about US$372b at the end of 2012, up from the previous peak of US$361b in 2008.[6]

REIT debt levels fell significantly after 2008, but as the chart on this page shows, this marked a relatively brief interlude, and debt has been rising since 2010.[7] REIT debt globally ended 2012 up 15% from its 2010 low.

Figure 8. REIT debt – US vs. non-US



Note: 2008 = 1

Source: SNL Financial, EY analysis

Globally, a few notable trends continue to develop:

- US REITs, which account for approximately two-thirds of the global REIT debt profile, have expanded more rapidly than non-US REITs, with the overall burden rising 18% from 2010.[8]
- US REITs ended 2012 with 9% more debt on their balance sheets than they had in 2008.[9]
- Across the same period, non-US REITs have 8% less debt on their balance sheets.[10]

In general, large-cap REITs' current volume of debt appears reasonable given current market conditions/business activities. It is important to manage this area closely, however. Identifying, measuring and monitoring key metrics were considered particularly important to help manage the "debt matrix."

6. SNL Financial data, http://www.snlfinancial.com, accessed on 29 August 2013.
7. Group made up of 98 REITs with market caps above US$2b and in existence since 2006.

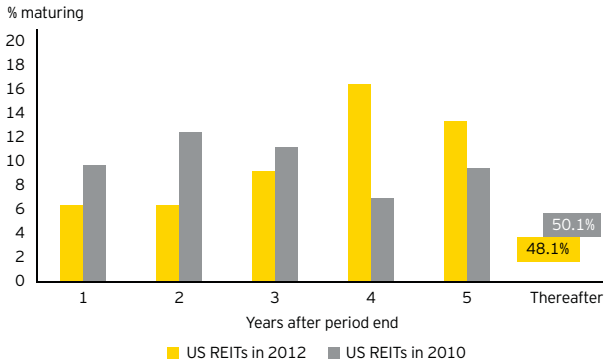
8. SNL Financial, http://www.snl.com, accessed on 29 August 2013.
9. Ibid.
10. Ibid.

2. Maturity profile

Maturity profile and cost are two of the most significant issues currently, according to our discussions, ahead of diversification, accessibility and volume.

REITs have continued to ladder their debt maturities to diversify their risk profile over time. As the chart below highlights, the profile among the largest US REITs has materially altered since 2010.

Figure 9. Debt maturity profile



Note: The analysis is based on the top 14 US REITs by market cap, excluding GGP and including Prologis/AMB prior to merger.

Source: Company 10-K filings, EY analysis

Among our largest global clients, EY partners suggest maturity profiles are "a manageable concern." Importantly, they considered the "concern" to be not so much a specific issue, spike or risk but more an ongoing, day-to-day focus for REIT management.

3. Cost of debt

Minimizing the cost of finance is something REIT management teams can directly influence through their business activities. This is not, however, typically done at the expense of maturity, diversification, volume or structural risks (short term over long term or floating over fixed). Rather, it is about creating the most favorable business structure/profile to facilitate all operations, of which accessing capital is one very important component.

Two key areas to consider are:

A. Credit rating

Gaining and maintaining a strong credit rating is an important requirement for many. One significant barrier is the negative impact of encumbered assets. Many of the larger REITs will proactively dissolve acquired debt even where it involves paying penalties. Undertaking more opportunistic acquisitions can also be an impediment in this area.

B. Accessing mature capital markets

Some global REITs also favor utilizing more mature capital markets. Often this means tapping the most liquid US debt markets. Naturally foreign exchange (FX)/hedging costs need to be balanced against the potential gain available to non-US operators.

4. Interest rates

The interest rate question is becoming increasingly important to the sector. Few major REITs have taken steps to specifically mitigate the impact, but all are managing their debt in a way that recognizes the potential for rates to rise.

We outline some of the initiatives seen across the sector:

- **Extending profiles** – pushing out the maturity profiles has been a feature of major global REITs in recent years. We estimate that 22% of overall debt at the major REITs is now due within three years, compared with almost 34% in 2010.[11]
- **Laddering the profile** – see above.
- **Opting for fixed over floating** – fixed-cost financing now dominates the debt profiles of the sector majors. As of the end of 2012, we estimate fixed rate financing accounted for approximately 86% of debt.[12]

11. According to company 10K filings.
12. EY analysis from company 10k filings, based on a sample of 13 large-cap US REITs.

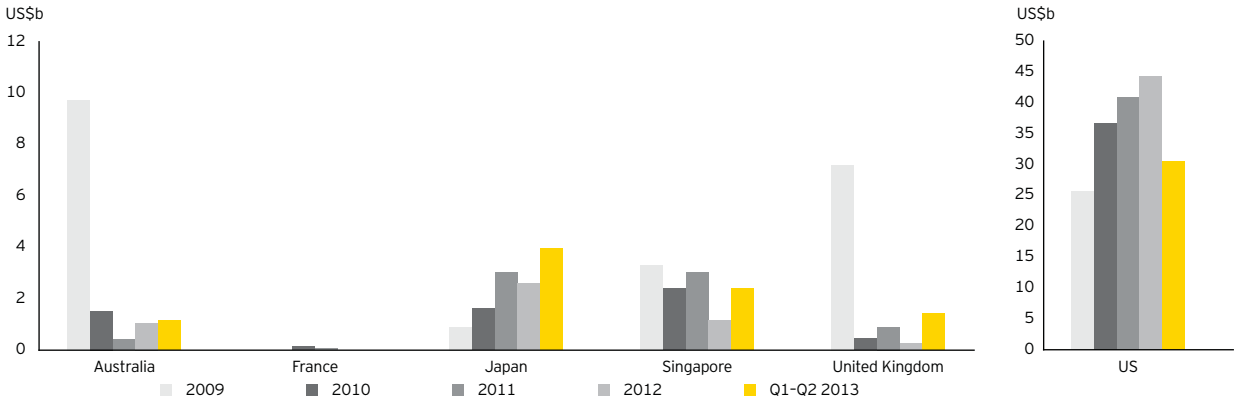
- **Diversifying sources** – our survey suggests unsecured debt is the favorite capital source, but US REITs, for example, have also been significant issuers of preferred equity in recent years. SNL Financial suggests that preferred equity offerings have risen from 3.16% of capital offerings in 2010 to 13.93% in 2012.[13] The first half of 2013 saw 23 REITs complete offerings in the US, raising US$4.5b.[14] Preferred equity can offer financial flexibility, but, as SNL Financial reports,[15] rates in the US may be increasingly prohibitive given the recent rise in the Treasury yield. Results from our industry survey support this view, with preferred equity seen as a distant fourth method of access capital in the next 24 months, behind unsecured debt, secured debt and common equity.
- **Maintaining lines of credit** – maintaining lines of credit to both facilitate short-term operations and potentially provide bridge financing is important, but then refinancing into longer-term sources is a favored approach of many mature REITs.
- **Improving the credit rating** – see above.

5. Equity raises

Market performance has stalled somewhat for the global REIT industry, with SNL reporting 12-month total returns for their global REIT index of 3.6%.[16] Three-year total returns, however, stand at 38.6%.[17] Many REITs have been trading at levels conducive to raising equity. REIT investors have been prepared to back the public/private market differential when the opportunity arises, especially when a REIT can highlight accretive opportunities into which to deploy capital.

The result has been US$39.4b of equity raised globally through secondary offerings in the first half of 2013.[18] This equates to 80% of the 2012 volume. US markets have remained particularly active, but the first half of 2013 saw REITs in Australia, Japan and the UK all raise more equity than in either 2011 or 2012. The total in Singapore exceeded 2012 but was marginally below 2011.

Figure 10. Secondary offerings



Source: SNL Financial, EY analysis

13. Jim Stevens. "Market and bond yields must stabilize before preferred equity offerings return." SNL Financial, 22 August 2013.
14. Ibid.
15. Ibid.
16. SNL Financial Global REIT Index, http://www.snl.com, accessed on 29 August 2013.
17. Ibid.
18. Ibid.

Select emerging REIT markets

Mexico

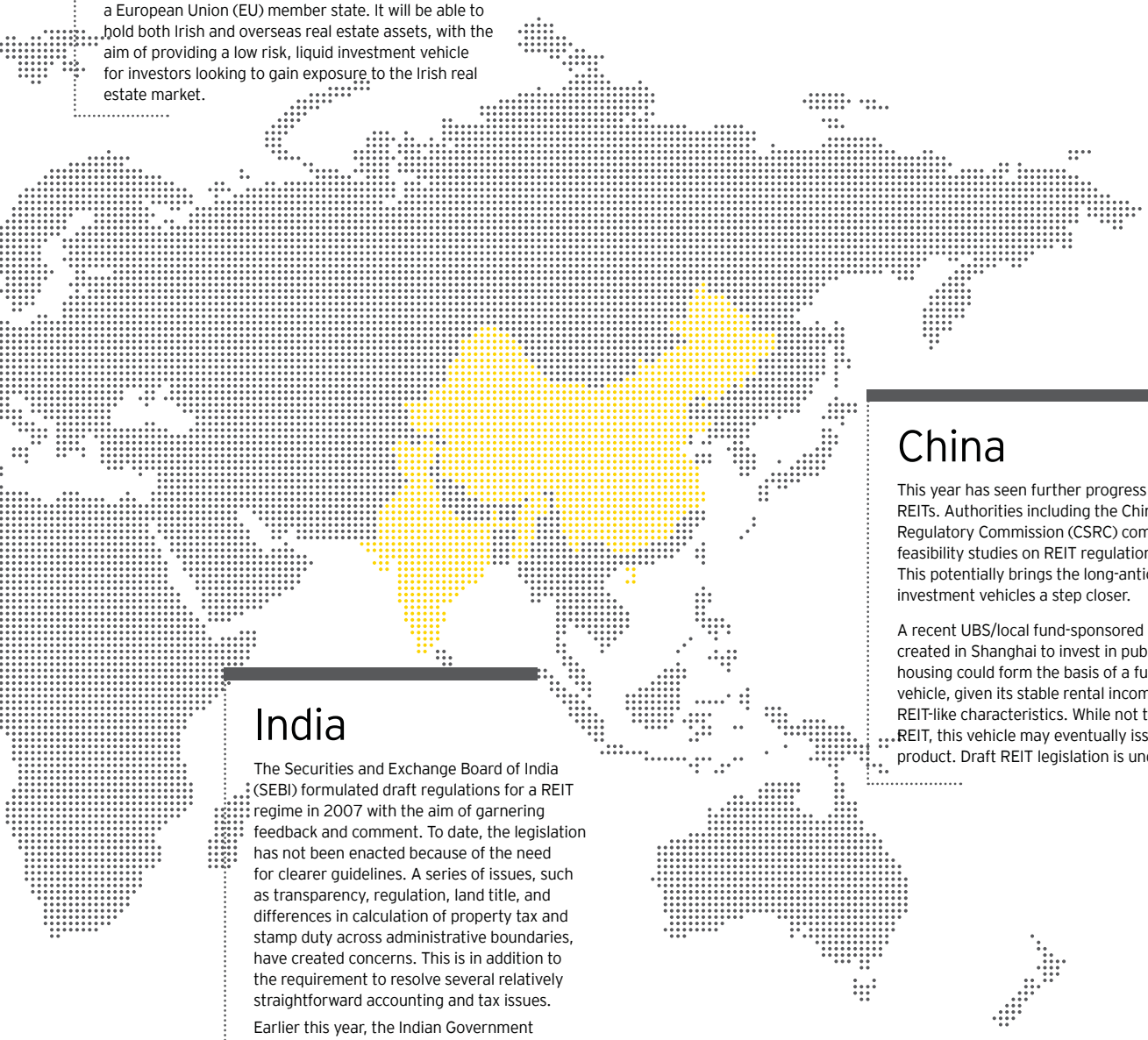
REITs have existed in Mexico since 2004, when FIBRAs (Mexican REITs) were first introduced. A lot of uncertainty, especially around certain tax components of the legislation, remained after they were introduced, and this limited their initial take-up. In 2011, Fibra Uno made the industry's first successful IPO through the Mexican stock exchange, marking a step change. Five further offerings have followed, with more expected before the end of 2013.

There has been a lot of interest in the FIBRA market, with recent IPOs being well-received. Investment by FIBRAs must be held for at least four years, with 95% of the prior year's taxable income distributable to holders. More than 75% of FIBRA portfolios must be in real estate, with the balance held in government bonds. With local real estate markets performing strongly and portfolios generally well-occupied, investors have been attracted to the asset class. To date, the majority of investment has come from domestic capital, with the cash-rich pension industry a particularly strong contributor.

Ireland

As announced in last December's Irish Budget, Ireland's 2013 Finance Act contains measures facilitating the establishment of Irish REIT structures, with the main objective of attracting international investment into the Irish property market. REITs are a globally recognized standard for investing in real property assets and, as expected, the Irish legislation, for the most part, follows the regime developed in the United Kingdom.

In Ireland, a REIT will be an Irish incorporated company that is required to be listed on the Irish Stock Exchange or the main market of a recognized stock exchange in a European Union (EU) member state. It will be able to hold both Irish and overseas real estate assets, with the aim of providing a low risk, liquid investment vehicle for investors looking to gain exposure to the Irish real estate market.



China

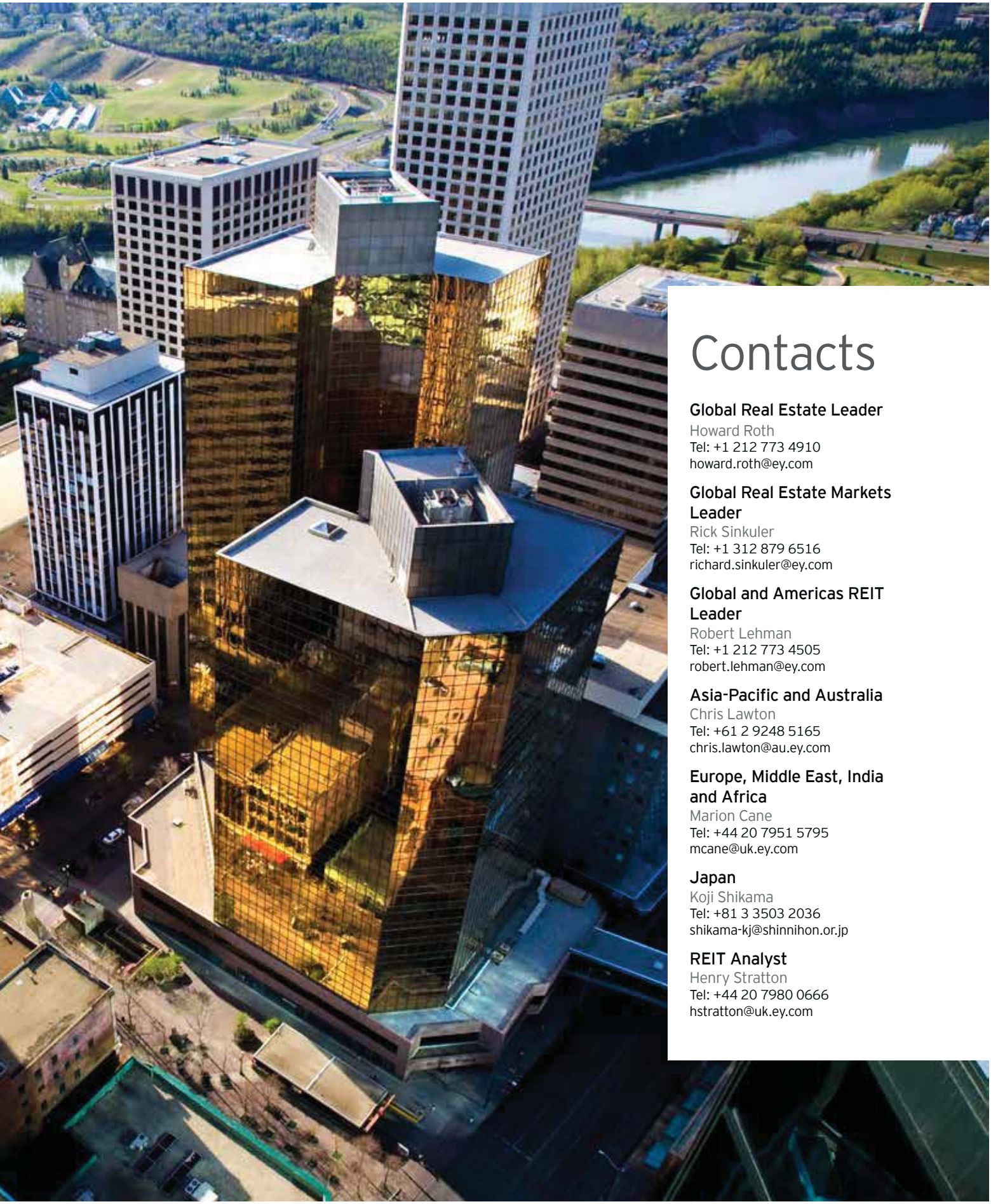
This year has seen further progress on Chinese REITs. Authorities including the China Securities Regulatory Commission (CSRC) completed feasibility studies on REIT regulations in May. This potentially brings the long-anticipated investment vehicles a step closer.

A recent UBS/local fund-sponsored product created in Shanghai to invest in public rental housing could form the basis of a future REIT vehicle, given its stable rental income and REIT-like characteristics. While not technically a REIT, this vehicle may eventually issue as a REIT product. Draft REIT legislation is under review.

India

The Securities and Exchange Board of India (SEBI) formulated draft regulations for a REIT regime in 2007 with the aim of garnering feedback and comment. To date, the legislation has not been enacted because of the need for clearer guidelines. A series of issues, such as transparency, regulation, land title, and differences in calculation of property tax and stamp duty across administrative boundaries, have created concerns. This is in addition to the requirement to resolve several relatively straightforward accounting and tax issues.

Earlier this year, the Indian Government reconsidered the legislation and sought feedback from the industry.



Contacts

Global Real Estate Leader
Howard Roth
Tel: +1 212 773 4910
howard.roth@ey.com

Global Real Estate Markets Leader
Rick Sinkuler
Tel: +1 312 879 6516
richard.sinkuler@ey.com

Global and Americas REIT Leader
Robert Lehman
Tel: +1 212 773 4505
robert.lehman@ey.com

Asia-Pacific and Australia
Chris Lawton
Tel: +61 2 9248 5165
chris.lawton@au.ey.com

Europe, Middle East, India and Africa
Marion Cane
Tel: +44 20 7951 5795
mcane@uk.ey.com

Japan
Koji Shikama
Tel: +81 3 3503 2036
shikama-kj@shinnihon.or.jp

REIT Analyst
Henry Stratton
Tel: +44 20 7980 0666
hstratton@uk.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's Global Real Estate Center
Today's real estate sector must adopt new approaches to address regulatory requirements and financial risks, while meeting the challenges of expanding globally and achieving sustainable growth. EY's Global Real Estate Center brings together a worldwide team of professionals to help you succeed — a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Center works to anticipate market trends, identify the implications and develop points of view on relevant sector issues. Ultimately it enables us to help you meet your goals and compete more effectively.

EYG no. DF0165
CSG/GSC2013/1149167
ED 0114

ey.com/realestate