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Aligning interests in Reit fee structures

An understanding of Reit management fees' framework and components can help gauge how well interests of unitholders and their managers are aligned

BEYOND dividend yield, what determines the quality of Singapore's favourite asset class, real estate investment trusts (Reits)? We examined that question in an article in *The Business Times* in October 2019. One consideration we highlighted: The benefits of portfolio diversification in reducing return volatility. We also stressed the need to put the presence of income support and asset tenures, among other factors, under the microscope. But what about structural considerations? How can we gauge how well the interests of Reit unitholders and their managers are aligned? It's a critical question and requires an understanding of the framework and components of Reit management fees.

Reit management structure

Reits may be externally or internally managed. In Singapore, all listed Reits are externally managed. In general, this means a third party earns a fee in exchange for carrying out its managerial duties. An internally managed Reit, on the other hand, hires staff to perform those functions.

A simplified externally managed Reit structure, depicted in the chart (above right), demonstrates the relationship between unitholder and manager.

Are the incentives of externally managed Reits off balance? Since their management is outsourced, there is a sense that there is more potential for misaligned interests between manager and unitholder.

The ideal fee structure

To align Reit manager and unitholder interests requires an appropriate manager fee structure. The ideal framework ensures that managers work to generate the most returns for unitholders. So how can that be accomplished? Broadly speaking, pegging fees to distribution per unit (DPU) growth incentivises managers to expand and maximise DPU. But pegging fees to assets under management (AUM) may encourage managers to grow the asset base even when the acquisitions are not yield-accretive.

The latter case demonstrates a principal-agent issue: The Reit manager agent makes decisions on behalf of the unitholding principal but is not incentivised to maximise returns.

Reit fee structure: An overview

Reit managers can earn different kinds of fees: base management, acquisition, divestment, and performance management. At a high level, the benchmarks used to calculate the first three are similar across the Reit space. Performance management fees, we've found, tend to have the most variation.

1. Base management fees: This is usually calculated as a percentage of the Reit's deposited properties as of the latest valuation. In Singapore, that percentage mostly runs from 0.1-0.5 per cent annually. This recurring income is the return managers earn for managing the properties and should be reasonable enough for them to operate effectively. But the quantum should not be so high as to dissuade them from asset enhancement initiatives (AEI), optimising the Reit's portfolio mix, and other value-adding activities.

2. Acquisition and divestment fees: Acquisition fees are usually 1 per cent of the purchase price, while divestment fees tend to run about 0.5 per cent of the sale price. Such fees encourage capital recycling. This may generate value for unitholders when properties with growth potential are acquired and mature ones divested. To benefit unitholders, these acquisitions should be yield-accretive and divestments above book value. Of course, even in transactions that don't benefit unitholders, managers still earn these fees, which may incentivise them to acquire and divest at the expense of their unitholders. This, obviously, creates the potential for conflicts.

3. Performance management fees: This component rewards Reit managers for good performance. The fee's benchmarks vary among Reits, depending on the presence of hurdle rates and the fee's proportion of the total fees earned by the manager.

Benchmarks for performance management fees

Net Property Income (NPI): At first glance, benchmarking performance management fees against NPI would seem to encourage Reit managers to both boost revenue and optimise costs. But aside from improving the profitability of existing properties, the manager may be incentivised to acquire more to raise NPI. Financing acquisitions may dilute earnings per unit or increase the Reit's leverage.

Distribution per Unit (DPU): Benchmarking fees against DPU takes into account how much financing was used for acquisitions. Reits tend to distribute at least 90 per cent of their taxable income for tax exemption purposes. But they can exercise some discretion in determining the actual distribution of the Reit beyond the manager's performance.

Proportion of asset base, earned after crossing a DPU growth hurdle

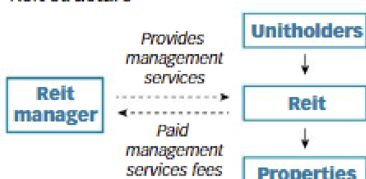
While the DPU growth hurdle may encourage Reit managers to enhance DPU, hurdle rates require special attention. Hurdle rates in performance management fees require the Reit manager to achieve a certain level of growth before the fees can be earned.

For example, the manager may only be paid if DPU growth exceeds 10 per cent over the preceding year. It might seem that hurdle rates reward Reit managers for maximising returns to unitholders. But what if the manager doesn't think the hurdle rate is reasonably achievable?

They might ignore performance management fees and focus on growing the Reit's AUM to increase their base management fees.

Misaligned interests?

Simplified externally managed Reit structure



Source: CFA Society Singapore

Performance management fees as a proportion of total management fees

As a general rule, base management fees generate recurring income for Reit managers, while performance management fees encourage them to add value for unitholders. A manager's actions and how much risk they undertake can depend on how much of their total fees are based on performance. According to back-of-the-envelope calculations, performance management fees in Singapore Reits range from 0 to approximately 60 per cent of the total.

Some have called for Reit fee structure to be weighted towards performance fees. At the extreme is a 100 per cent performance fee and 0 per cent base management proposal. That's probably a bad idea. After all, the global financial crisis came about, in part, because of excessive risk-taking by investment bankers. Their typical performance bonus far exceeded their base pay. We know how that played out and we certainly do not want a similar outcome for Singapore Reits.

What is the ideal Reit fee structure?

This question opens a Pandora's box. Opinions vary, even among investment professionals in Singapore. What about fee structures that evolve over time? Maybe they adjust as the Reit grows its asset base or if the nature of the Reit changes. How should the fee structure adapt to accommodate this evolution? What would the process look like?

In 2014, the Monetary Authority of Singapore (MAS) considered requiring that Reit manager performance fees be calculated according to a particular methodology. The guiding principle of the proposed approach was fostering stronger alignment between manager and unitholder interests. Of course, MAS understood how big a challenge it faced given all the various Reit business models.

We may not have conclusive answers at this juncture. But there are several common principles on which we can generally agree. We favour a structure that incentivises Reit manager performance and growing DPU over the longer term, which demonstrates that principal and agent interests are aligned. Finally, the fee structure should also consider the value the capital recycling process delivers to unitholders when determining the fees paid to Reit managers.

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