Non-traditional Reits – more than meets the eye

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While investors may not be overly concerned over the differences between a traditional and non-traditional Reit, especially if the Reit continues to deliver sustainable and stable income, the differences are fundamental because they relate to the balance of power among stakeholders and alignment of interests which justify non-traditional Reits to have a different risk-reward profile versus traditional Reits. BT FILE PHOTO

REITS are investment vehicles that invest in a portfolio of income-generating real estate assets and are attractive to investors seeking a passive and stable income stream. Traditional Reits typically hold retail, office and industrial assets that have a long track record of an active secondary sales and rental market.

Non-traditional Reits, on the other hand, hold asset types that are less familiar to investors including healthcare, self-storage, infrastructure, data centres, casinos, prisons, cell-phone towers and other facilities.

The definition of traditional versus non-traditional may change overtime. For example, hospitality Reits were once considered non-traditional at a point in history though they have now become more mainstream. We think hospitality Reits still straddle the fine line between traditional and non-traditional Reits.

The assets of Reits are held via a Reit trustee and are professionally managed by a Reit manager who is responsible for attracting tenants, negotiating rent rates and maintaining the competitiveness of the assets to deliver to stakeholders the optimal outcome.

On the surface, investors may not be overly concerned about the differences between traditional and non-traditional Reits, especially if the Reit continues to deliver sustainable and stable income. However, we think the differences are fundamental because they relate to the balance of power among stakeholders and alignment of interests which justify a different risk-reward profile for non-traditional Reits versus traditional Reits.

How big is the non-traditional Reit market?

By our definition, there are three non-traditional Reits listed on the Singapore Exchange (SGX) with a total market cap of S$7.5 billion and 30 traditional Reits with a total market cap of S$83.4 billion. In addition a handful of stapled groups focused on the hospitality sector are listed in Singapore.

According to the National Association of Real Estate Investment Trust (Nareit) and Uniplan Investment Counsel, at end-June 2019, non-traditional Reits comprised 53.0 per cent of the Nareit index.

We believe one possible explanation for the significantly smaller proportion of non-traditional Reits listed on the SGX is that Singapore has the Business Trust regime, which arguably is a better fit for non-traditional asset owners as it allows business operations to be retained while simultaneously allowing distributions to equity investors from operating cashflows, rather than accounting profits.

For example, a clear demarcation between the real estate portion and business operations for golf courses, ports and infrastructure assets is not as easily achieved.

Making of a non-traditional Reit

Non-traditional Reits came into existence when operating companies with a long track record spun off their real estate assets to generate cash upfront for capital recycling. These companies realised the value of their assets by selling them to investors who invested in a Reit, a form of real estate owning vehicle.

Non-traditional Reits are more common in the US market. Some examples include American Tower Corp (an owner, operator and developer of wireless and broadcast communications real estate), Iron Mountain Inc (a document storage and services company) and CBS Corp (which spun off its billboard operation as CBS Outdoor Americas Inc).

These operating companies (or related parties) then become Sponsors of the Reits, with the operating companies continuing to utilise the assets as Master Lessees of the Reit. For simplicity, let us call these "Sponsor Master Leases" and in our view, the dynamics of Sponsor Master Leases prevalent in non-traditional Reits can be likened to a "sales and leaseback" agreement.

An extensive relationship between Sponsor and Reits exists beyond Sponsor Master Leases. In Singapore, there is no specific regulatory definition for Sponsors yet, even though this was contemplated in 2014.

Going by market practice in Singapore, Sponsors typically refer to the party which spearheaded the Reit set-up prior to the initial public offering (IPO), owns the Reit Manager and property manager, sells properties to the Reit and provides a pipeline of assets for future acquisition by the Reit. The Sponsor may also continue to be a significant unit-holder of the Reit post-IPO.

Unique risks and implications for credit profiles

We think that the most important credit risk differentiator between traditional versus non-traditional Reits is the nature of the income stream of the Reit, rather than a mechanical classification by property type – specifically, whether the underlying property assets of Reits are leased out to third parties at market-based rents or whether the rental payments to the Reit is from a pool of assets that are carved out from existing operations, where rental payments are a synthetic new cash flow stream that was not there prior to the Reit set-up.

Three areas in assessing credit risk

The appropriateness of Master Lease terms as asset valuation may be fully derived from lease terms

The assets found in non-traditional Reits are more specialised with less secondary market activity. Take hospitals for instance – the barriers to entry are higher as healthcare operators need to have specialist skill sets, limiting the pool of market participants.

Given the lack of comparable asset sale and rental market transactions, valuation of a property asset in non-traditional Reits may be fully derived from the rental income it can generate.

Unlike traditional Reits, the resiliency of asset valuation is mostly a function of the stability of the rents received and the counterparty credit risk. Both are linked to the underlying credit health of the tenant.

Master Lessees' counterparty credit risk

The assets in non-traditional Reits are typically under Sponsor Master Leases. While a Reit can benefit from having a longer lease tenor which enhances the stability of income, there are also risks involved. Tenant concentration risk is a concern as Sponsor Master Lessees typically take up a large amount of space within the asset portfolio.

Minimum rent and rental support are sometimes built into Sponsor Master Leases, with the arrangements allowing the Reits to collect rental income that may be higher than what the asset can achieve from the open market. If the underlying business conditions supporting those asset rents deteriorate, the Reit's income stability may be affected. Traditional Reits can also face rental collection issues though these are less susceptible in our view, given their starting base which is tied to market rents, the larger pool of potential new tenants and lower tenant concentration risk.

Mitigating factors to reduce possible conflict of interest

Given the extensive relationship between Sponsors and non-traditional Reits, we see higher corporate governance risk for these Reits, especially if there are no proper mitigation steps to resolve conflicts of interests. In the SGD-bond market, we have not seen instances where bondholders and perpetual holders have the right to remove a Reit Manager and hence are reliant on equity holders to effect change.

In our view, the ability of equity holders to remove a Reit Manager and/or their ability to change directors of the Reit Manager help mitigate conflicts.

Year-to-date, the Sponsor-related parties of a stapled group (comprising a Reit and a Business Trust) were still able to effect directorship changes despite having defaulted on bank loans.

While all Reits in Singapore have a Reit trustee, in practice, Reit trustees do not manage the day-to-day operations of a Reit. In our view, this means Reit trustees may be more effective in performing their duties of safeguarding the interest of Reit unitholders after a breach has occurred, rather than preventing breaches per se.

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