

14<sup>th</sup> Pacific-Rim Real Estate Society Conference  
Kuala Lumpur, Malaysia, 20 to 23 January, 2008

## Textbook Approaches to REIT Management

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**Abstract:** Already well established in Australia and the USA, REIT's are now growing significantly in Asia and Europe.

Previous research proposed an indicative management structure for a REIT and sought to identify a framework of standardizing influences from which forms of good practice may be identified.

Building on such research, the various areas of REIT management comprising Operations are considered in more detail.

Through a review of the principal real estate textbooks that consider aspects of Operations within REIT management, a taxonomy of activities is proposed as an alternative framework from which forms of good practice may be identified.

By identifying a range of forms of good practice, further analysis and research may lead to an hypothesis of best practice for subsequent testing.

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**Keywords:** REIT, management, valuation, governance, accounting, reporting

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With a global market capitalization now exceeding US\$872 billion (NAREIT (2007)), REITs are well established as an investment sector in the USA and Australia, with a growing role in Asia and an emerging presence in Europe as shown in Figure 1.

In Australia, REITs have grown phenomenally from a handful of REITs with a market capitalization of around A\$7 billion in 1992 to 32 REITs in the ASX 300 with a market capitalization of over A\$124 billion, as shown in Figure 2 (UBS (2007)).

REITs now comprise the third largest sector on the Australian stock market and represent over 10% of the total Australian market capitalization compared to 5% in 2000. The largest REITs include Westfield (\$36.98 billion), Stockland (\$11.33 billion) and GPT (\$11.43 billion), with five having in excess of 100 properties in their portfolio (UBS (2007)).

Further, the recent total return performance of REITs in Australia has been very impressive at 34.05% for the year to December, 2006, significantly outperforming Australian equities (24.97%) and Australian direct property investment (17.29%), as shown in Figure 3 (IPD (2007)).

The Australian REIT sector has now evolved to comprise two principal groups, being:

- traditional, property owning REITs, which invest in direct property and pay the net income to unitholders; and
- fund manager REITs, which invest in direct property and pay the net income to unitholders and also undertake a range of further businesses to provide separate sources of revenue, such as funds management or business operations.

Traditional property owning REITs may also be considered to comprise two further groups, being:

- sector specific REITs which invest in the traditional sectors of commercial, retail, industrial and hotel property, as well as those which invest in emerging sectors, such as CFS Retail or Commonwealth Office; and
- diversified REITs which invest in a range of sectors, offering diversification within the REIT such as DB RREEF or Mirvac.

Following the wave of globalization over the last decade, both the traditional, property owning REITs and the fund manager REITs include REITs with overseas property or property related business investments. Several Australian domiciled REITs solely invest in overseas property including:

- Rubicon America Trust, Reckson, Mariner America and Tishman Speyer Office Fund – US office;
- Rubicon Europe – European office; and
- Babcock and Brown Japan Property Trust – Japanese office.

Other Australian REITs invest both in Australia and overseas, including:

- Westfield, Macquarie Country Wide, Centro Property Group and Centro Retail Group – US retail;
- DB RREEF and Mirvac Industrial Trust – US industrial;
- Macquarie Office Trust – US office;
- Goodman Group – Asian industrial; and

- ING Office Fund and ING Industrial Fund – European office and industrial.

Overseas property investment involves such additional complexities as foreign exchange management and tax management, leading to a hierarchy of REIT management complexity as summarized in Table 1.

<b>Principal Group</b>	<b>Offshore / Onshore</b>	<b>Management Complexity</b>
Fund Manager REITs	Mix of offshore and onshore investment	Most complex
	Invest offshore only	↑
	Invest onshore only	↑
Traditional Property Owning REITs – Sector Specific and Diversified	Mix of offshore and onshore investment	↑
	Invest offshore only	↑
	Invest onshore only	Least complex

### **Hierarchy of REIT Management Complexity**

Source: Author

Table 1

### **Indicative Management Structure**

Previous research (Parker, 2007) proposed an indicative management structure for a REIT, as summarized in Figure 4.

Such a management structure proposed that the traditional REIT activities of research/strategy, valuations, transactions and funds, portfolio, asset and property management be considered as a group of “Operations” activities, alongside a group of “Support” activities (being finance, HR, IT and risk management/compliance) and a group of “Investor Facing” activities (being sales, marketing and investor relations).

The consideration of a REIT through the application of a conventional operating company management structure is also consistent with the proposition by Su et al (2003) that the modern REIT may be viewed as a fully integrated, operating company, rather than as a pure closed-end fund.

### **Framework of Standardizing Influences**

Previous research (Parker, 2007) sought to identify a framework of standardizing influences from which forms of good practice for REIT management might be identified. Two principal sources of standardizing influences were identified, comprising:

- the impact of corporate collapses; and
- the impact of globalization.

The impact of corporate collapses, such as Enron in the USA, HIH in Australia and Arthur Andersen worldwide, was contended to have given rise to greater prescriptive codification for issues including independence, probity and corporate governance in differing forms around the

world. In the context of Australian REITs, this was contended to have both exponentially grown and firmly established the functions of corporate governance, risk management and compliance in REIT management.

The impact of globalization, with Australian domiciled REITs investing offshore and offshore domiciled REITs investing in Australia, was contended to have been a source of standardizing influences through the development and implementation of the International Financial Reporting Standards (IFRS) which impacted on REITs in Australia through the Australian International Financial Reporting Standards (AIFRS).

Accordingly, therefore, forms of global standardisation for REITs were contended to be emerging for a range of areas including corporate governance, risk management, compliance and financial accounting.

For other areas of REIT management, other standardizing influences were contended to include:

- IT – with common global software packages such as SAP (financial management), Peoplesoft (HR), DYNA and CIRCLE (portfolio management and asset management) and property management packages;
- Research and strategy – including the role of the IRES family of research societies, global standards such as PISCES and benchmarks such as the various IPD data series; and
- Practice Standards and Guidance Notes – including the role of the International Valuation Standards Committee (IVSC) practice standards and guidance notes with similar country equivalents for valuation, with those for asset management and property management usually being country specific and of varying levels of complexity and comprehensiveness.

It was contended that

- a framework of standardizing influences for REIT governance, support and operations including research, strategy, valuations and property and asset management are emerging in Australia from which good practice may be identified; and
- in the absence of a framework of standardizing influences for REIT investor facing activities and operations including transaction, fund and portfolio management, it may be more challenging to identify good practice.

Accordingly, as an alternative framework from which forms of good practice may be identified, an exploratory literature review of aspects of Operations from the principal textbooks that consider such within REIT management is proposed for consideration.

### **Operations – Principal Text Books**

To date, a literature review to identify forms of good practice in aspects of Operations is only partially complete, with the following principal text books reviewed:

Block RL, Investing in REITs, Bloomberg Press, Princeton, 2002

Dubben N and Sayce S, Property Portfolio Management: An Introduction, Routledge, London, 1991

- Jaffe A and Sirmans CF, Fundamentals of Real Estate Investment, South Western Thomson Learning, Mason, 2001
- Seabrooke W, Kent P and Hebe HHH (Editors), International Real Estate: An Institutional Approach, Blackwell Publishing, Oxford, 2004
- Su HC, Erickson J and Wang K, Real Estate Investment Trusts: Structure, Performance, and Investment Opportunities, Oxford University Press, New York, 2003
- Wurtzbach CH, Miles ME and Cannon SE, Modern Real Estate, John Wiley & Sons, New York, 1994

and the following principal text books identified for review:

- Baum, A Commercial Real Estate Investment, Estates Gazette, London 2002
- Booth, R (Editor) Real Estate Investment Trusts – A Global Analysis, Macfarlanes, London 2006
- Brown, G and Matysiak, G Real Estate Investment – A Capital Market Approach, Financial Times Prentice Hall, Harlow 2000
- Garrigan, RT and Parsons, JFC (Editors) Real Estate Investment Trusts: Structure, Analysis and Strategy, McGraw-Hill, New York 1997
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- Hartigay, S and Shi-Ming, Y Property Investment Decisions: A Quantitative Approach, E&FN Spon, London 1993
- Hoesli, M and MacGregor, BD Property Investment: Principles and Practice of Portfolio Management, Longman, Harlow 2000
- Pagliari, JL The Handbook of Real Estate Portfolio Management, Irwin, Chicago 1995
- Pyhr, SA, Cooper, JR, Wofford, LE, Kapplin, SD and Lapidis, PD Real Estate Investment: Strategy, Analysis, Decisions, John Wiley & Sons, New York 1989

Suggestions of further principal text books for review that consider various aspects of the management of REITs are welcomed. It is also acknowledged that a literature review of relevant journals and conference papers may prove informative.

***Block (2002)***

A descriptive text targeted at the investor in REIT units, rather than at the REIT manager. The text makes extensive use of homespun philosophy:

“A successful REIT’s management will accept risk only where the odds of success are very strong.” (page 13)

and then current time REIT industry examples, but with limited use of property or finance theory or of relevant academic research.

As such, the text neither adds nor discards any of the activities within Operations described in Figure 4.

***Wurtz bach et al (1994)***

An introductory, conversational text with considerable technical detail of generic, rather than specific, application to REITs.

The text distinguishes asset management and property management and considers each in some detail, with asset management including some characteristics of portfolio management. As a generic text, there is reference to the identification and role of “owner’s objectives”, though not enunciated in the context of REITs, being expounded through the principle of maximizing portfolio returns whilst minimizing portfolio risk.

With a focus on the selection between alternative investment opportunities to achieve owner’s objectives, at the individual property level by the determination of an expected rate of return relative to a hurdle rate of return and the use of financial ratios and at the portfolio level by the use of modern portfolio theory, such approaches are enunciated generally rather than in the context of REITs.

As such, the text both affirms the role of portfolio, asset and property management as activities within Operations described in Figure 4 and provides generic guidance as to the activities that may be considered within each, without discarding any of the other activities.

It may be informative to test whether Australian REITs use the decision criteria of a hurdle rate for property selection and modern portfolio theory for portfolio selection in practice.

***Jaffe and Sirmans (2001)***

An introductory, conversational text with considerable technical detail of generic, rather than specific, application to REITs.

The text addresses aspects of funds management (debt/equity mix and risk analysis, which is extensively covered), portfolio management (the development of a portfolio through the principles of diversification rather than ad hoc acquisition of individual investments, with modern portfolio theory as the standard approach to be adopted) and property management.

Transcending funds, portfolio, asset and property management, though not specifically in the context of REITs, the text usefully proposes seven elements of an investment strategy, being:

1. diversification
2. legal environment
3. ownership entity
4. management strategy
5. financing options
6. tax planning
7. decision making criteria, including heuristics, appraisal methods, discounted cash flow and sensitivity analysis

and proposes a five step investment process comprising:

1. identify investor goals, objectives and constraints
2. analysis of the overall investment environment
3. forecast the expected future benefits and costs as cash flows
4. apply appropriate decision making criteria

5. accept or reject the investment, with reference to a target or hurdle rate of return and NPV analysis with discounted cash flow as the standard approach to be adopted

with considerable detailed explanation of each. Within the second step in the investment process, the role of research is considered in the context of both the economy and local property markets.

As such, the text both affirms the roles of research and funds, portfolio, asset and property management as activities within Operations described in Figure 4 and provides generic guidance as to the activities that may be considered within each, without discarding any of the other activities.

It may be informative to test whether Australian REITs use discounted cash flow and modern portfolio theory as standard techniques in practice.

#### ***Su et al (2003)***

A more advanced text focusing on REITs, being well supported by the most recent academic research and in three sections comprising understanding REITs, managing REITs and investing in REITs.

Managing REITs focuses on funds management issues including the impact of financial policies (capital structure, IPOs, secondary offerings, debt and equity mix) and market capitalization on performance and the impact of agency issues (potential conflicts of interest among shareholders, managers and creditors) on shareholder wealth.

As such, the text affirms the role of funds management as an activity within Operations described in Figure 4, without discarding any of the other activities.

#### ***Seabrooke et al (2004)***

Placing REITs in the context of property investment internationally, the text may be distinguished from others by its useful focus on valuations and transactions within Operations.

The authors note that the globalization and integration of the property and capital markets has improved market efficiency and transparency, with an impact on the selection of capitalization and discount rates:

“The determination of discount or capitalization rates is subject to the tyranny of international capital markets as they become more globalised and integrated.”  
(page 175)

Significantly, the text introduces the concept of the “transacting process” extending over weeks or months, with a transaction being a process rather than an event for which the “rules of the game” differ between countries. The process of due diligence is introduced and placed in a capital market theory context as a method of addressing imperfect knowledge and reducing uncertainty in the transaction.

As such, the text both affirms the role of valuations and transactions as activities within Operations described in Figure 4 and provides generic guidance as to the activities that may be considered within each, without discarding any of the other activities.

It may be informative to test whether Australian REITs explicitly consider the impact of international capital markets on the selection of capitalization and discount rates in practice.

***Dubben and Sayce (1991)***

Without specific reference to REITs, a quaint British text within the context of the 25 year FRI lease which is acknowledged to be “isolationist”.

The text touches on portfolio management (including objectives, the establishment of a target rate of return, limited reference to modern portfolio theory arguing that ideal properties are rarely, if ever, available when required, consideration of risk analysis and performance measurement and monitoring) with an emphasis on asset and property management which are extensively considered, including the distinction between “active” and “passive” property management.

As such, the text both affirms the role of portfolio, asset and property management as activities within Operations described in Figure 4 and provides generic guidance as to the activities that may be considered within each, without discarding any of the other activities.

It may be informative to test whether Australian REITs favor the greater emphasis on individual properties acquired when available and combined in a portfolio, rather than the use of modern portfolio theory to identify properties for combination in a portfolio, in practice.

**Taxonomy of Activities Within Operations**

From the text books reviewed to date, a text solely addressing Operations within the context of REITs has not yet been identified.

However, from those text books reviewed, support is found for the following activities previously identified within Operations:

- Research/Strategy
- Valuations
- Transactions
- Funds Management
- Portfolio Management
- Asset Management
- Property Management

Further, from those text books reviewed, no additional activities within Operations were identified and none of the identified activities were discarded.

Though varying between text books, the sum of descriptions of activities within Operations is extensive and capable of taxonomy through the development of a matrix as an alternative framework from which forms of good practice may be identified.

By identifying a range of forms of good practice, further analysis and research may lead to an hypothesis of best practice for subsequent testing with REIT industry participants in Australia. This may include testing the extent of use by REITs in practice of:



- a hurdle rate for property selection;
- modern portfolio theory for portfolio construction;
- discounted cash flow; and
- international references in the selection of capitalization and discount rates

together with other issues identified during the review of the balance of those text books identified together with journal and conference papers.

### **Approach to the Development of a Global Best Practice Framework for REIT Management**

It may be contended that, from a starting point of greater standardisation of approaches, a form of good practice may emerge that is capable of international application.

For both those areas where a framework of standardizing influences is emerging and for those areas which are yet to be standardized, it may also be possible to identify good practice through a literature review of text books and journal and conference papers.

The extent of use of identified good practice by the REIT industry in Australia may then be determined through a survey of REIT managers. Through the combination of the findings of the literature review and the industry survey, a form of best practice may emerge that is capable of international application.

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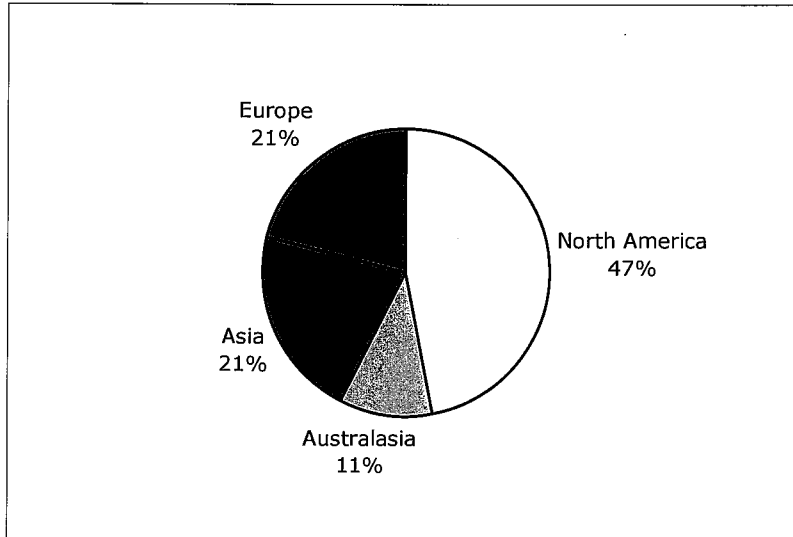
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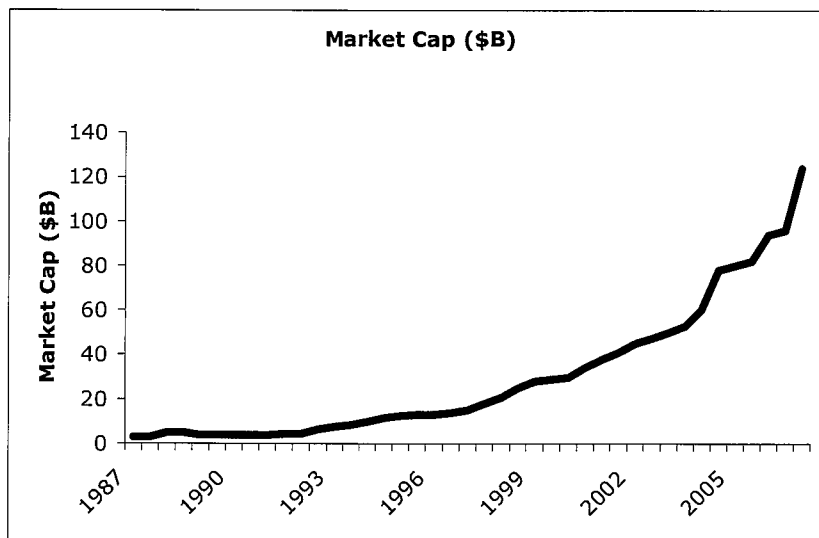
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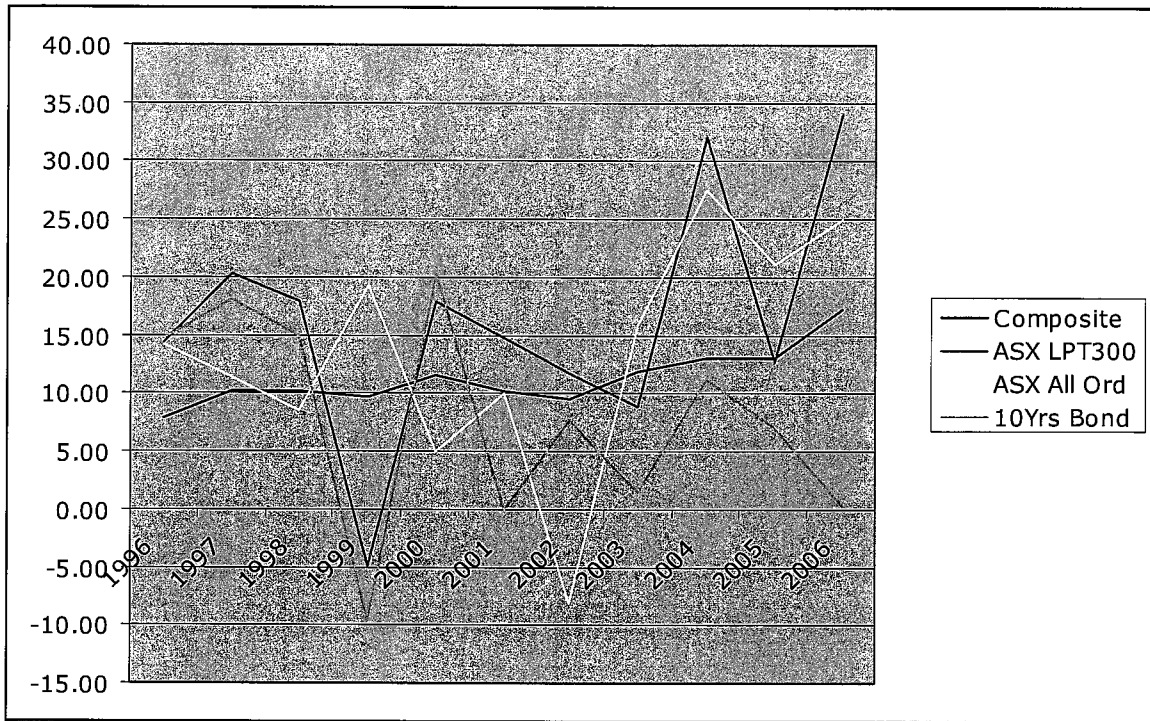
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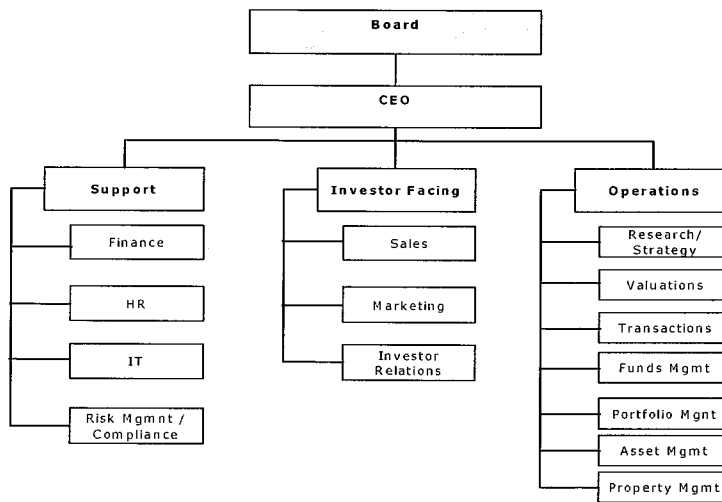
**REIT Global Market Capitalization**  
 Source: NAREIT (2007)  
 Figure 1



**Growth in REITs in Australia**  
 Source: UBS (2007)  
 Figure 2



**Relative Total Returns - Australia**  
 Source: IPD (2007)  
 Figure 3



**Management of a REIT**  
 Source: Author  
 Figure 4