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Introduction

Now in its seventh edition, EY’s Global Perspectives: 2014 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:

- An overview of the REIT initial public offering (IPO) market and what companies should consider before proceeding with an IPO.
- A review of the emerging nontraditional REIT market and key considerations related to REIT conversions.

We hope that you will find this report valuable and helpful in making decisions that will enhance your organization’s success.

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Executive summary

REIT IPOs globally exceeded US$20b in 2013, 55% higher than the pre-financial crisis peak in 2005 and more than double the total seen in 2012.1 The first half of 2014 saw a further US$6.8b raised globally, primarily due to the high level of activity in Spain.2 REIT IPOs now dominate the real estate IPO market as the REIT brand continues to expand and grow globally. More than 70% of capital raised by real estate organizations in the 18 months through Q2 2014 was captured within a REIT wrapper.3 Market conditions allowing, further significant activity seems likely in the second half of 2014. Notable IPOs are planned in the US, Spain, the UK and Japan. India should also become another active market for the expanding REIT market, now that legislation has been approved.

The IPO process remains challenging. REIT IPO withdrawals or postponements are relatively high, although market conditions undoubtedly play a part in withdrawals or postponements. Investors also remain selective about which REIT IPOs to support, and for those not getting the process and offering right, the result can be costly. With this in mind, we revisit the IPO readiness issue and highlight eight critical areas that executives need to consider before starting down the IPO route. We also examine issues within these areas that we believe are especially relevant to real estate management teams planning REIT IPOs.

Another relatively recent phenomenon originating in the US is the growth of the nontraditional REIT sector, which has significantly expanded in recent years. From a market capitalization of less than US$40b in 2011, today the sector is worth more than US$150b.4 That makes it larger than any non-US REIT market. The benefits of attaining REIT status include monetization of real estate, liquidity, tax advantages and strong access to debt and equity capital. Attractive income distributions appeal to a wide range of investors, and, in return, well-run entities gain access to debt and equity capital, often at very favorable costs.

2. Ibid.
3. Ibid.
4. Ibid.
Given the growth of the nontraditional REIT sector and the emergence of more asset types in the overall REIT sector, CFOs of real estate-intensive businesses may wish to assess the strategic and technical aspects of a potential conversion, or spin-off and conversion of part of the business, to a REIT structure. In our report, we review these strategic considerations, which revolve around the potential opportunity to optimize the capital structure, realize value and access capital. We also review the issues to consider on the technical side, which are extensive but ultimately attainable, as evidenced by recent market activity.
Significant global shift spurs strong REIT IPO volume in 2014

Following the record IPO levels of 2013, REIT IPO volumes remain strong in 2014 with US$6.8b raised globally in the first half of the year. This activity has been positive for the sector, stimulating interest in the REIT concept globally, as well as expanding its range of participants.

Today, REIT IPOs dominate the real estate industry, whereas, just five years ago, they were a small component. Currently, REIT IPO volumes account for 72% of real estate IPOs, tripling from just 24% of real estate IPOs in 2006–2007.

The US has seen only a handful of listings in 2014, compared to a very active 2013; however, activity is expected to pick up in the future. This year, REIT IPO activity has shifted significantly to Europe, where Spain is leading the region with more than US$3b of raised capital. The REIT IPO market in Europe will likely remain strong through the second half of 2014, market conditions allowing, with a series of further listings lined up in Spain and the UK. In other parts of the world, Japan also continues to have an active year, while in India, the Securities and Exchange Board recently approved the setting up of REITs, which should open up a new market for IPOs.

The size of REIT IPOs has been remarkably consistent every year since 2009, with transactions averaging approximately US$300m. Large REIT IPOs are still rare in the industry, but getting less so. While there have been only 13 IPOs above US$1b since 2001, 6 of these have been in the last year and a half (2013–Q2 2014), suggesting that investors with an appetite for larger transactions are finding the REIT model increasingly appealing.

REIT IPO volume and number of REIT IPOs

Source: Dealogic

6. Ibid
7. Ibid.
8. Ibid.
9. Ibid.
**Percentage of withdrawn/postponed IPOs – REIT and non-REIT real estate IPOs**

### Percentage of withdrawn/postponed IPOs

- **2013-Q2 2014**
  - REIT IPOs
  - Non-REIT real estate IPOs

### Average size of IPO – select sectors

- **Sector**
  - REIT
  - Non-REIT real estate
  - Energy and power
  - Financial

- **Year**
  - 2008
  - 2009
  - 2010
  - 2011
  - 2012
  - 2013
  - 2014

### IPO volume – select sectors

- **Years**
  - 2014
  - 2013

### Weighted average return of IPOs – select sectors

- **Percent return**
  - 0%
  - 5%
  - 10%
  - 15%
  - 20%
  - 25%

- **Sector**
  - REIT
  - Non-REIT real estate
  - Energy and power
  - Financial

- **One month from IPO listing**
- **One year from IPO listing**
Most active REIT IPO regions

2013 volume/2014 volume

<table>
<thead>
<tr>
<th>Region</th>
<th>2013 US$m</th>
<th>2014 US$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Americas</td>
<td>US$9.6b</td>
<td>US$0.8b</td>
</tr>
<tr>
<td>EMEIA</td>
<td>US$1.8b</td>
<td>US$3.9b</td>
</tr>
<tr>
<td>Japan</td>
<td>US$4.5b</td>
<td>US$1.5b</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>US$4.2b</td>
<td>US$0.7b</td>
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</tbody>
</table>


Most active markets for REIT IPOs

<table>
<thead>
<tr>
<th>Region</th>
<th>H1 2014 Proceeds (US$m)</th>
<th>2013 Proceeds (US$m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>3,013</td>
<td>US 6,277</td>
</tr>
<tr>
<td>Japan</td>
<td>1,494</td>
<td>Japan 4,537</td>
</tr>
<tr>
<td>Mexico</td>
<td>605</td>
<td>Singapore 2,976</td>
</tr>
</tbody>
</table>

Global Perspectives: 2014 REIT report
Considering a REIT IPO

The popularity of the REIT model isn’t surprising; it offers a number of benefits, as mentioned earlier in the report. These include diversification of risk, payment of dividends, liquidity, better performance, transparency and higher returns compared to the broader market.

However, the road to a successful REIT IPO isn’t necessarily an easy one. Although robust activity and interest continue in the sector, our analysis also highlights two ongoing concerns.

Withdrawals and postponements

The first concern is a relatively high proportion of withdrawals and postponements for REIT IPOs. Some 15% of REIT IPOs from the period 2013-Q2 2014 were withdrawn or delayed. While this figure has decreased from the 2010-2012 period, REIT IPOs register more than double the amount of withdrawals and delays as their non-REIT real estate counterparts. The majority of delays and withdrawals have been attributed to market conditions, and while this is undoubtedly valid to some extent, the 150 successful REIT IPOs since 2010, along with the US$50b in capital raised, suggest that market conditions are unlikely to be the sole cause.

The REIT industry, however, remains relatively light on the number of successful IPOs than other sectors, 2013 being an exception. This is the case even though, in recent years, the average capital raised per REIT IPO is on par with companies in the financial and energy and power sectors – about US$300m. The withdrawal or slow success ratio may in part be due to the relative immaturity of REITs in many parts of the world, and is likely to change, given the size of the real estate sector.

Post-REIT IPO market performance

A second concern is that post-IPO market performance in the first year has been relatively poor for REITs. On a weighted average basis, REIT IPOs have returned 3.3% in the first month subsequent to listing. In comparison, non-REIT real estate, energy and power and financial IPOs have returned 17.7%, 14.4% and 18.6%, respectively, in the first month. This suggests that REIT IPOs are being priced accurately in terms of realizing value for companies, rather than rewarding investors for taking the risks associated with underpinning IPOs.

First year returns provide mixed evidence. REITs return 4.9% on a weighted average basis, which is significantly below non-REIT real estate, energy and power and financial companies in absolute terms (10.5%, 13.1% and 20.8%, respectively). However, REITs typically outperform non-REIT real estate and energy and power between the second and twelfth months. Ultimately, returns are still somewhat lacking.

The importance of planning

The number of withdrawals and postponements, along with the lag in the number of successful REIT IPOs compared to other major sectors, seem to indicate that investors remain highly selective regarding which new REIT vehicles to support. For this reason, and to ensure the success of both the IPO and the subsequent listed entity, it is critical to get the pre-IPO planning process right.

11. Ibid.
12. Ibid.
13. Ibid.
14. Ibid.
15. Ibid.
Planning for a REIT IPO

Given the volume of withdrawals and delays that many REIT IPOs confront, companies considering the REIT IPO route should not underestimate the importance of planning and preparation. For most organizations, the process starts approximately 24 months ahead of a potential IPO, with a planning exercise before execution about 12 months prior to an actual IPO. The typical road map is shown in the following diagram.

What is the typical road map of an IPO from the company's perspective?

Source: EY
With regards to advance preparation, there are 8 key areas and more than 15 related issues that companies should evaluate ahead of initiating a REIT IPO process to determine their IPO readiness. Considering these criteria is an important first step in a lengthy and challenging process to determine whether an IPO is a feasible option.

What should companies be considering in terms of IPO readiness?

1. **Strategy**
   - IPO value journey
   - IPO destination
   - Equity story and offering concept

2. **Structures**
   - Issuing company
   - Group structure
   - Maintenance of influence

3. **Taxes**
   - Company level
   - Shareholder level
   - Transaction level

4. **Financials**
   - External reporting
   - Forecasting
   - Prospectus

5. **Systems**
   - Internal controls
   - Enterprise risk
   - Compliance management

6. **Functions**
   - Investor relations
   - Compliance officer
   - Committees

7. **Leadership**
   - C-suite and board of directors
   - Remuneration
   - Corporate governance

8. **Timeline**
   - IPO windows
   - Plan B options
   - Internal resources

Source: EY

**Pre-IPO planning: more critical issues**

Once companies have determined to move ahead in the IPO process, they must consider a variety of issues in multiple areas of the business. In the often-extended process of converting to an IPO, the following checklist is one that CFOs and fellow executives should monitor from the beginning. The success of the IPO process may depend on whether these areas are considered before the process is initiated.

**Preparation**: There is no such thing as over-preparing. The IPO process is complicated and challenging. Sponsors should not underestimate the time and effort required to make an entity public, regardless of how mature the existing business is.

**Financials and reporting**: Locking down historic financials early in the IPO process is essential. This helps avoid scrambling for information and minimizes the “moving parts” in terms of numbers. Audit work can also be undertaken ahead of time. Once public, the financial and reporting burden on the entity is much greater. The demands of moving to quarterly reporting are high – it’s critical to review systems and processes ahead of time.

**Operational**: Early identification of the gaps between the existing private company setup and the likely demands as a listed entity is invaluable. Companies going down the IPO route need to start operating as if already listed ahead of the IPO. How do general council, IT, accounts, treasury and public relations teams stack up against future listed peers?

**Regulatory**: Many still miscalculate the regulatory burden of the IPO process and listed status. Getting the right people, with the right experience, in place across the entity, and doing it early in the process, will help create a team capable of meeting regulatory demands.

Additional work up front is always worthwhile; pre-clear questions/topics with regulators wherever possible. Anticipate likely responses and develop collateral accordingly.

**Strong leadership and staffing**: There is no substitute for a strong CEO and CFO. The responsibility, however, is too vast to rely on a handful of individuals. Management needs a strong team in place; personnel have to take responsibility. Staffing key roles with individuals who have IPO process and listed market experience is invaluable.

**Transparency**: Transparency must exist at all levels. Investors, lenders, analysts and regulators will all be scrutinizing the company. Are you ready to share the level of detail they will demand? How do sensitive topics, such as executive compensation, stack up?
Communication and coordination: In most cases, private companies need to improve their communication and coordination in order to survive the public market. The right systems and people are essential. Organizations need to be able to respond immediately, and internal systems and communication must be able to facilitate demands. Coordination across functional areas is also essential.

Treasury: The move to REIT status will likely involve liquidating existing shareholders, forming new legal entities, establishing a tiered structure and ensuring that appropriate reserves are left in any legacy portfolio to meet ongoing cash demands. REIT rules (e.g., cash distributions) also place an additional burden on treasury functions. Is the treasury function (staff, systems, processes) equipped to facilitate the change required through the IPO process and the subsequent demands of REIT status?

Technology: Technology is essential to support the IPO process and life as a listed entity. Implementing new technology through the IPO process brings an additional layer or complexity, takes time and requires extensive testing. This is an unwelcome distraction. It is better to develop and implement a system capable of meeting listed standards ahead of initiating the IPO process; test it rigorously. This allows the organization to operate controls, processes and risk management functions at a level commensurate with listed status.

The fragmentation and nonuniform application of available technology solutions in the real estate industry means that firms must invest in customizing solutions that fit their business model and reporting needs; otherwise, there are likely to still be a number of manual steps in the process. Some common customizations are building system-to-system interfaces between front- and back-office systems and the development of a data warehouse for more robust analytics. This complicates the technology model, controls environment and reporting processes for real estate organizations.

Controls: formalize and document: Many private real estate companies have good controls, but “listed” status will require them to formalize and document controls, processes and compliance. By documenting controls, organizations can assess processes and often rationalize and ultimately automate them.

Don’t just establish a control environment; test it rigorously ahead of time to identify and rectify major weaknesses. Establishing policies and procedures across the business is also important. Third-party providers need to be held to the same code of ethics as are used internally. Finally, do you meet exchange requirements in areas such as internal audit functions?

Forward-looking information: Listed status will require a more robust process for the provision of forward-looking information and guidance. Is the entity equipped to create and provide this level of guidance?

Audit evidence: Prepare for life as a listed entity, not just for the IPO. For REITs, that likely means documenting ongoing capital market activity. Will a historical audit of an entity be required as part of a fundraising exercise? Will the IPO be followed with a debt issuance or secondary sale? If so, audit work can be performed ahead of time, allowing the focus to remain on operations and pressing forward with the strategy.

Cost: A balance must be struck between short-term costs and being IPO ready. Prepare and plan in order to get the structure right the first time; identify what is needed and when, develop hiring plans and consider the role technology can play.

Governance structure: Many private real estate boards are inadequate for life as a listed entity. Governance of the REIT starts at the board level, so the quality and makeup of the board is critical to the future success of the company. It is important to have a robust and diverse board of directors, from a variety of backgrounds and with a range of different experience.

Tax: REITs are creatures of the tax code and, as such, compliance with qualification tests—both initially and on an ongoing basis—is essential. Assessments need to be made around real estate assets, qualifying rents, non-customary services, taxable REIT subsidiaries, an earnings and profit (E&P) study, built-in gain tax on assets and other deferred tax items, distribution and dividend planning, and compliance monitoring.

Some element of restructuring is inevitable. This needs to be considered in order to accurately identify the nature of the actual REIT, which will likely differ somewhat from the company today in terms of portfolio, operations, financing, etc. From here, a clear and consistent strategy can be developed and communicated to investors.

Post IPO: It is one step to become a public company; it is another step to then operate successfully as one. Organizations need to be prepared for the latter. REIT status can, for example, place an additional burden on accessing debt and equity capital to fund expansion due to the requirement to distribute a high percentage of income. This means that the IPO is likely just the start of a series of capital market transactions. The infrastructure must be in place to support the ongoing demands of the business.
Nontraditional REITs
Nontraditional REIT market almost quadruples to US$152b

The US nontraditional REIT market has almost quadrupled by market cap from US$40b in 2011 to US$152b today.\(^\text{16}\) As a sector, that is larger than the current Japanese REIT market and Australian REIT market.\(^\text{17}\) The number of listed equity REITs in the US is 177, excluding private or mortgage REITs, and 34 of these are nontraditional REITs.\(^\text{18}\)

The performance of the mainstream US REIT sector has revealed a significant benefit in the creation of new subsectors coming from non-core areas. These areas include real estate assets, such as cell towers, data centers, certain energy infrastructure, manufactured homes, single-family homes, outdoor advertising, document storage, timber, prisons and gaming facilities.

Nontraditional REIT market cap by subsector (US$b)

Additional “REIT-able” sectors are emerging as more organizations join the ranks of existing nontraditional REITs. A recent application for REIT status involved fiber and copper telecommunication lines.

Strategic and technical aspects of a REIT conversion

The benefits of attaining REIT status include monetization of real estate, liquidity, tax advantages and strong access to debt and equity capital. Attractive income distributions appeal to a wide range of investors, and, in return, well-run entities gain access to debt and equity capital, often at favorable costs. This allows them to fund and grow their businesses. While the nontraditional sector is in its infancy, the securitization of real estate into public market wrappers remains a global theme led by the US.

Although there are advantages in attaining REIT status, it is not a simple road to success. Companies considering REIT status should do several things before proceeding, including the following.

Monitor strategic and technical issues: Given the growth of the nontraditional REIT sector and the emergence of more asset types in the overall REIT sector, CFOs of real estate-intensive businesses may wish to assess the strategic and technical conditions for a potential conversion, or spin-off and conversion of part of the business, to a REIT structure.

Focus on process: REIT conversion is a process and involves careful planning like any significant or strategic transaction. Therefore, potential participants need to monitor and consider any moves from both a strategic and technical perspective.

Know when to convert: The timing of market entry is susceptible to the ebbs and flows of both the real estate market and the broader equity markets. But over the long term, REIT status has proven to be a highly effective structure for real estate organizations that are able to meet shareholder demands.

Source: SNL Financial

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\(^\text{17}\) Ibid.
\(^\text{18}\) Ibid.
Key considerations in the REIT conversion process

Nontraditional REIT conversion framework

| 1 | Assess strategic value |
| 2 | Evaluate technical aspects |
| 3 | Formulate conversion plan |
| 4 | Execute |

Source: EY

For companies interested in a potential REIT conversion or spin-off transaction, there are two important areas of concern to think about: strategic considerations that question “does this make sense from a capital restructuring perspective?” and technical considerations, which address the question “can this be done?” The following table summarizes both the strategic and technical considerations for REIT conversion.

### Strategic

| Optimize capital structure |
| Divest one or more business lines |
| Focus on core business/competencies and growth |
| Tailor capital structure to business and real estate operations: lower leverage, high return on equity, asset light operating company and relatively higher leverage, yield-orientated real estate |

| Realize value |
| Isolate and/or monetize value of real estate |
| Potentially obtain higher multiple and value for sum or the parts versus the current whole company |
| Harvest gains to recycle capital |
| Generate cash to repay debt, return to shareholders or expand |

| Access capital |
| Potentially further access public debt and equity markets |
| Potentially raise capital at attractive pricing |
| Access new/different investors - real estate specialists |
| Capitalize on value attributed to stable, high-yield assets |
| Capitalize on value attributed to long-lived assets |

| Control |
| Monitor the potential for loss of some control over real estate locations; mitigate through effective structuring and lease terms |
| Need to align with external shareholder expectations to operate effectively as a REIT |

| Operational restrictions |
| REIT distribution requirements reduce ability to retain cash flow in REIT |
| Adopting REIT strategy can be time-consuming and costly |

| Other |
| Potential to be included in REIT indices to attract mainstream investors |
**Technical**

| Asset testing | • Do assets constitute real estate assets for REIT purposes?  
| • Do goodwill or customer-related intangibles constitute real estate?  
| • What is the breakdown of assets between real and personal property?  
| • How should foreign-owned assets be structured?  
| • What is depreciation for REIT testing purposes?  

| Income testing | • Will income from leases/licenses constitute qualifying rents?  
| • Possible exclusions for rent based on net income, related-party rent or impermissible services?  
| • Will income from services constitute qualifying rents?  
| • Are there other income streams?  
| • Third-party property management income?  
| • Licenses or services?  

| Services rendered | • Must be identified and analyzed  
| • What constitutes customary services with respect to non-core REIT assets? Consider impermissible services performed by a TRS service  

| Tenant and non-tenant services | • Restructure contracts with existing customers  
| • Seamless transition while maintaining REIT status can be difficult  
| • Are any services bundled?  
| • Any tenant discounts on services?  
| • Any services provided by independent contractors?  

| Tax | • Private Letter ruling from IRS often needed to confirm REIT status  
| • REIT? UPREIT? Spin-off?  
| • TRS subsidiary planning and allocation of G&A expenses  
| • Structuring foreign operations  
| • Legal entity and contract structuring  
| • REIT qualification requirements  
| • Modeling for TRS taxable income  
| • Transfer pricing study and earnings stripping limitations  
| • Tax strategy for acquisitions and growth going forward  

| E&P | • Elimination of company corporate E&P  
| • E&P study  
| • E&P purging distribution; may be achieved with combination of cash and company stock  

| Post-election | • Monitor/planning to address IRC section 1374 built-in gains tax  
| • Gain deferral on assets  
| • Election “out?”  
| • Net operating loss and capital loss carry forwards?  
| • Deemed liquidation of company subsidiaries  
| • Impact of any deferred tax items  
| • Direct and indirect subsidiaries – may trigger income and gain associated with prior deferred intercompany transactions  
| • Capital structure planning  

| Financial reporting | • Carrying over-basis accounting  
| • Registration statement:  
| • REIT shell balance sheet audit  
| • Historical financials of predecessor  
| • Pro forma financial information – REIT conversion  
| • SEC review of registration statement and financial information  
| • Potential need for Form 10 filing (in spin-off)  

| Accounting | • Carve-out accounting  
| • Fair value of property at the time of carve-out  
| • Funds from operations  
| • Net income measure of REITs  
| • Evolving accounting literature on leases and fair value  
| • Setting up new REIT company: people, processes and technology  

Source: EY
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