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STRATEGY NOTE

REAL ESTATE INVESTMENT TRUSTS - REITs

A Liquid Alternative to an Illiquid Asset Class

NBK CAPITAL
INVESTMENT STRATEGY & ADVISORY

HIGHLIGHTS

- The benefits of a REIT are straight forward when compared to owning a property outright **such as liquidity and exposure to a diversified pool of assets** while drawbacks include **susceptibility to market sentiment and equity volatility and management's limited ability to reinvest in existing assets.**
- From 2007 to September 2017, the **number of global REITs has increased from 348 to 736** with **the average global REIT value increasing 17.8% from USD 2.02 billion to USD2.37 billion.**
- **Despite there not being a clear outperformer between REITs and major equity indices**, a main reason for including REITs in a portfolio **is to gain exposure to a diversified pool of income generating real estate**. **The yield on REITs is clearly greater than that obtained from equities.**
- The GCC real estate market is full of **stable and mature residential and commercial assets. The abundance of assets will promote REIT growth, while the different type of assets will allow for specialization.**
- Institutional and individual investors and real estate developers and owners **all stand to benefit as the GCC REIT market expands and matures. Investors will ultimately gain liquidity**, a fundamental need in today's geopolitical landscape, **while investing in a preferred asset class.**

BACKGROUND

Real estate is a favored asset class among GCC citizens. The general perception is that it is a safer investment given it is tangible and less volatile in comparison to equity and fixed income. However, the inclusion of income generating real estate in a portfolio can be difficult. Real estate investments can be expensive and time consuming, as it tends to require a long-term commitment, creates an illiquid position, and diversification is not easily achievable. In 1960, the US introduced Real Estate Investment Trusts (REITs) with the aim of providing all investors with access to liquid and diversified income generating real estate. Almost 60 years later, the REIT market has grown to USD 1,747 billion. REITs have helped investors meet asset allocation requirements while providing steady cash flow and liquidity.

REITs in the region have picked up over the years, with Dubai being the first to introduce regulations in 2006, followed by Abu Dhabi, Saudi Arabia, and Bahrain. Several private and non-traded REITs subsequently came into existence, with the first GCC REIT listing in Dubai in 2014. As of Q3 2017, eight REITs are listed and tradable in the region.

The REIT market is set to grow in the region given the abundance of suitable assets and the need of investors to access real estate in a liquid and efficient form. In addition, REITs may provide alternative sources of funding through capital markets. In due time, a legislative framework governing REITs will be implemented across all GCC jurisdictions offering a form of liquidity to an illiquid market.

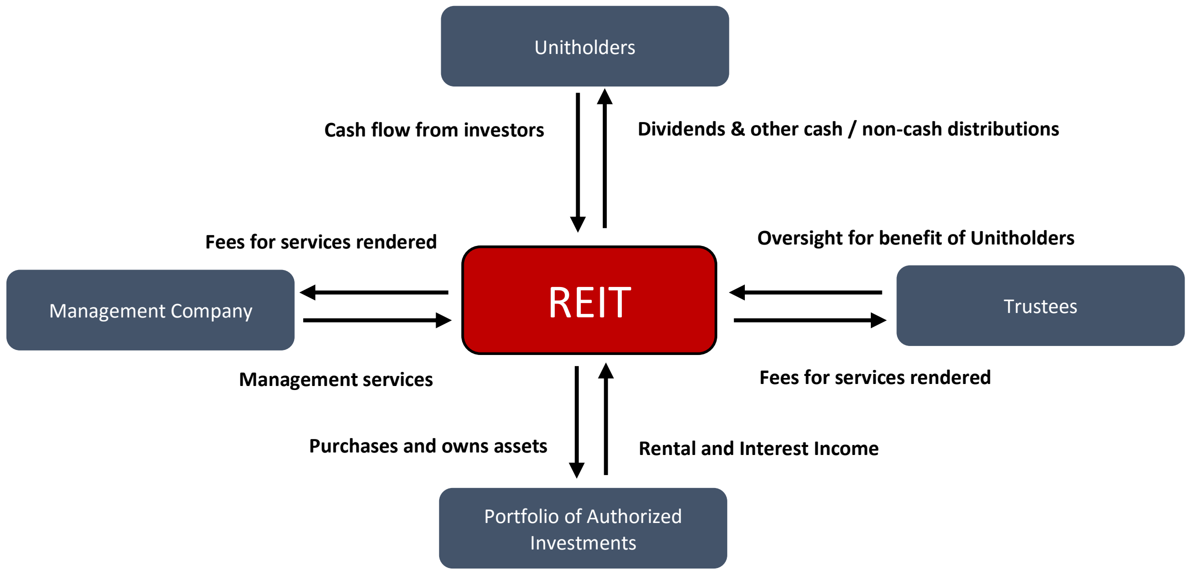
UNDERSTANDING REITs

Overview

A Real Estate Investment Trust is an investment vehicle whose sole purpose is to invest in real estate or real estate related products. The vehicle issues financial instruments or securities, similar to company shares, which investors can purchase and sell. REITs provide investors with direct exposure to real estate, as well as liquidity and higher dividend yields. The liquidity aspect is only available through traded REITs. The higher dividend yield comes from the structuring of the trust where the majority of taxable income or net profits, generated from underlying assets, should pass through the company directly to the shareholders. The REIT structure itself is exempt from paying taxes, hence eliminating double taxation at the corporate and shareholder level.

In order for a real estate fund to qualify as a REIT, certain requirements need to be fulfilled and maintained. These requirements will differ from one jurisdiction to another. The criteria set by regulators can include, but is not limited to, the minimum distribution of taxable income or net profit, the maximum amount of leverage, the minimum number of shareholders, and a restriction on the maximum amount deployable in development properties. For example, Abu Dhabi and Dubai have minimum distribution requirements of 80%, whereas Saudi Arabia and Bahrain have the minimum set at 90%, similar to the US.

Chart 1: REIT Structure & Operations



Source: NBK Capital

There are three types of REITs – equity, mortgage and hybrid. An equity REIT, which is the most common type of REIT, purchases, owns, and manages income-producing real estate. Equity REITs hold residential or commercial property, such as retail, office, hospitality, and healthcare, and its main source of income is rental income. A mortgage REIT does not directly invest in real estate properties. Instead, the REIT lends money to real estate property owners and developers, or acquires property mortgages or mortgage-backed securities. A mortgage REIT generates yield for investors from interest income. The third type of REIT is the hybrid REIT, which operates as a combination of an equity and mortgage REIT.

REIT structures can be private, non-traded, or traded. Private REITs do not register with a government regulator, while non-traded and traded REITs are registered and subject to significant regulation.

Table 1: Differences between REIT Structures

Criteria	Traded	Non-Traded	Private
Investment Period	Open Ended	Closed Ended	Closed Ended
Valuation	Market price	Pre-defined at time of sale	Pre-defined at time of sale
Liquidity	Exchange listed	Limited	Limited
Volatility	Exchange listed	None	None
Governance	High	High	Low
Transparency	High	High	Low

Source: Steadfast REITs

The Good, The Bad

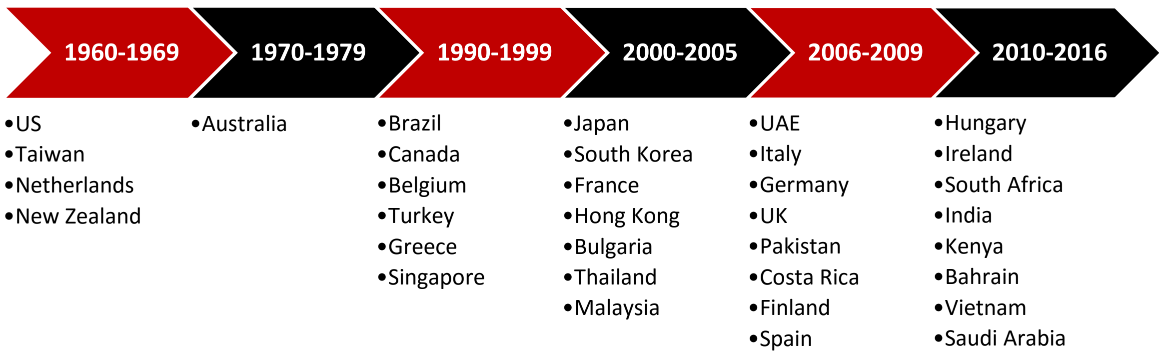
The benefits of a REIT are straightforward when compared to owning a property outright. A REIT provides investors with exposure to a diversified pool of real estate assets at a fraction of the cost and time required to purchase and manage the underlying assets outright. In addition, the heavy regulation provides for strong governance and enhanced transparency, reducing counterparty and concentration risk associated with a single manager and single property. REITs also provide a steady cash flow in the form of distributions and in the case of traded REITs, are liquid. From the perspective of portfolio asset allocation, REITs supply a potential natural hedge against inflation and permit investors to undergo tactical and strategic changes and rebalancing with respect to their real estate exposure.

For traded REITs, the major concern is susceptibility to market sentiment and equity volatility. As equity markets rise or fall, REIT valuations tend to follow. REITs are also, by their nature, exposed to cyclical downturns and increased property taxes, as well as the inability of management to reinvest returns as shareholders hold a majority claim to the taxable income or net profit. Furthermore, REITs are not necessarily suitable for all investors seeking exposure to real estate, specifically those investors with a higher risk appetite. REITs, as mandated by regulators, have pre-set limits in place when investing in non-income producing or development projects, hence limiting exposures to development risk and other riskier real estate classes.

THE ROAD TO MATURITY

The first country to introduce REITs was the US in 1960, and the first REIT, American Realty Trust, was founded shortly thereafter, in 1961. Over the next several decades, 30 plus countries introduced rules and regulations governing the structuring, marketing, listing, and trading of REITs. The first countries to introduce such regulations after the US were the Netherlands, Taiwan, and New Zealand.

Chart 2: Timeline of Countries Introducing REITs

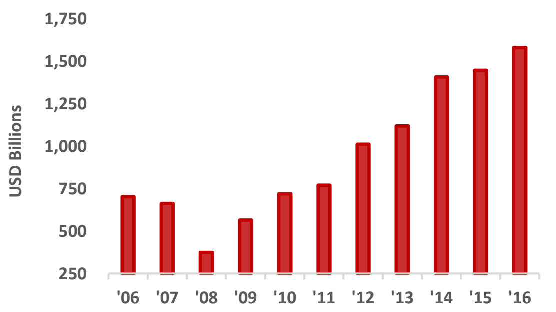


Source: REIT.com

THE TRADER'S MARKET

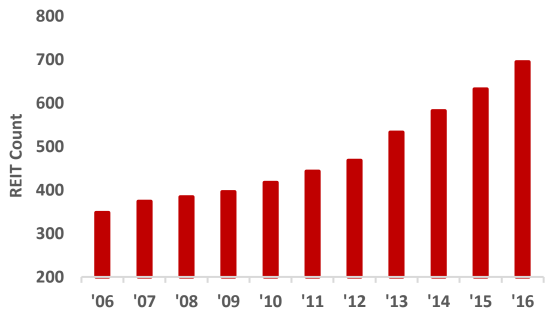
The global REIT market has grown at a remarkable pace. Taking 2006 as a starting point, the global REIT market consisted of 348 active REITs with a market value of USD 702 billion. By the end of 2016, the count increased to 695 with a market value of USD 1,581 billion, doubling in number and increasing by 125% in value.

Chart 3: Market Cap of Global REITs



Source: Bloomberg

Chart 4: Global REIT Count



Source: Bloomberg

North America has maintained its status as the largest REIT market over the years, in terms of both count and market value. In 2006, North America's REIT market accounted for approximately 46% and 58% of the global REIT market in terms of count and market value, respectively. By 2016, the number of active REITs in North America increased from 160 to 288, although global representation dropped to 41%. In terms of market value, the continent's representation increased to 69%.

Excluding North America, Europe witnessed the largest growth of the number of active REITs, while Asia increased the most in terms of value, both based on absolute numbers. Other countries located in Africa, the Middle East, and South and Central America reported the largest year on year growth.

Table 2: Regional REIT Development ***(USD Mkt Cap in billions)***

	2006		2016		Absolute Difference		Annual Growth	
	Count	USD Mkt Cap	Count	USD Mkt Cap	Count	USD Mkt Cap	Count	USD Mkt Cap
North America	160	410	288	1,086	128	676	5.5%	9.3%
Asia	61	57	136	185	75	128	7.6%	11.3%
Europe	93	156	187	180	94	24	6.6%	1.3%
Australia	22	74	47	97	25	23	7.1%	2.5%
Other*	12	5	37	33	25	28	10.8%	18.6%

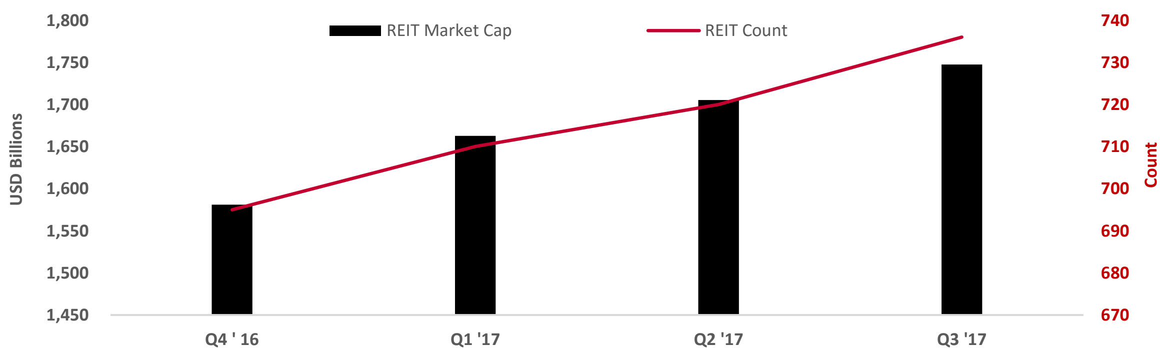
**Others: African countries, Middle Eastern countries, and South & Central American countries*

Source: Bloomberg

In 2006, the average global REIT value stood at approximately USD 2.02 billion. By 2016, the average had increased 12.8% to USD 2.28 billion. Of the five major regions, only Europe and Australia registered negative growth in terms of average REIT values. In Europe, the average dropped from USD 1.67 billion to USD 0.96 billion while in Australia the drop occurred from USD 3.38 billion to USD 2.06 billion.

In 2017, the REIT market continues to grow. Active REITs during the first nine months increased by approximately 6% while market capitalization increased by 11%. At the start of 2017, the average REIT value stood at USD 2.28 billion and has since increased by 4.4% to USD 2.37 billion.

Chart 5: Global REITs in 2017

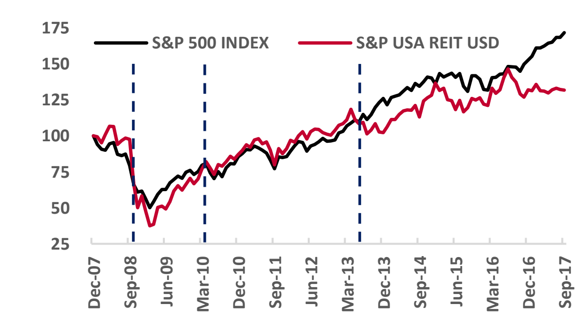


Source: Bloomberg

YIELD IS THE NAME OF THE GAME

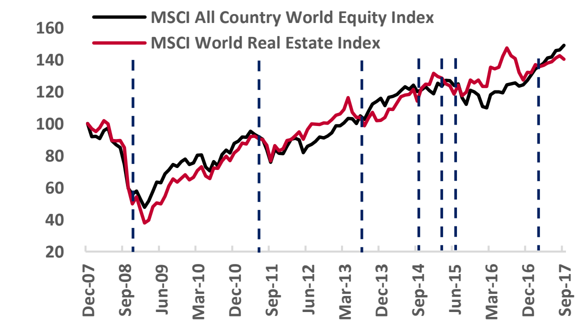
Over a ten-year period ranging from 2007 through Q3 2017, comparative performance between a REIT index and a broad equity market index is inconclusive, with each index either outperforming or underperforming at different points in time. The dashed vertical lines *(charts 6 and 7)* indicate when a switch occurred where one index outperformed the other. The one takeaway however, is that REIT indices move in tandem with the equity markets where listed.

Chart 6: S&P 500 vs S&P USA REIT



Source: Bloomberg

Chart 7: MSCI AC World Equity Index vs MSCI World Real Estate Index

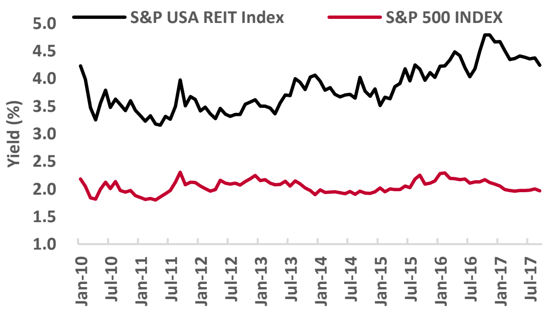


Source: Bloomberg

Despite there not being a clear outperformer between REITs and major equity indices, the reasoning for including REITs in a portfolio is two-fold. The first is to gain exposure to real estate while maintaining liquidity and the second is to generate income. The yield on REITs is clearly greater than that obtained from equities. Focusing on the US market, the yield on the S&P USA REIT is clearly above that of the S&P 500 *(chart 8)*. Even on a global scale, the yield on the MSCI World Real Estate Index is greater than that of the MSCI All Country World Index *(chart 10)*. Since 2010, REIT yields in the US have been increasing while equity yields have remained flat, with the average spread increasing from 162 bps in 2010 to 242 bps in 2017 *(chart 9)*. Globally, although REIT yields continue to be greater than that of equities, they have not been trending upwards. Over the last seven years, both global REIT and equity yields have come down slightly.

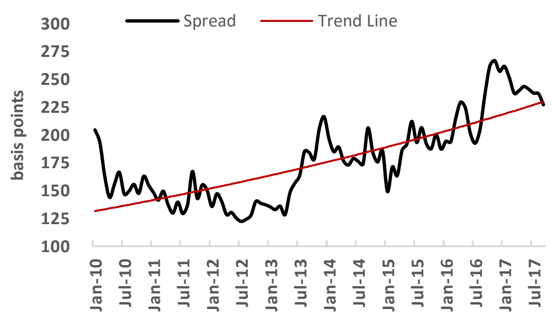
The analysis excludes the period of the global financial crisis between 2008 and 2009. During the crisis asset prices were severely depressed resulting in inflated yields for both REITs and equities.

Chart 8: Yield on S&P USA REIT vs S&P 500



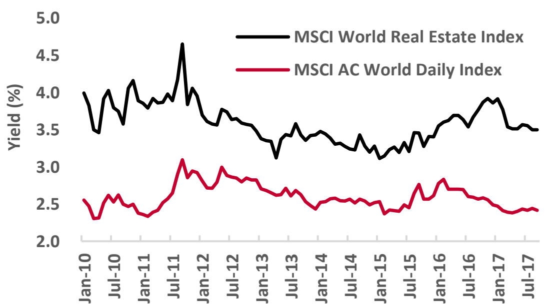
Source: Bloomberg

Chart 9: US REIT & Equity Yield Spread and Trend



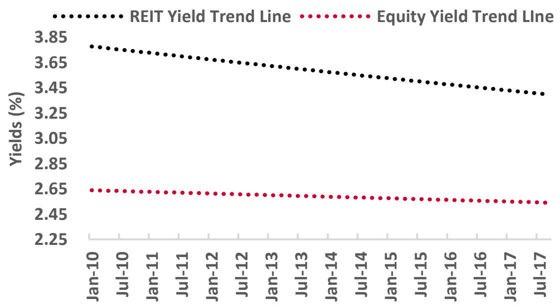
Source: Bloomberg

Chart 10: Global REIT Yield vs Global Equity Yield



Source: Bloomberg

Chart 11: Global Yield Trends



Source: Bloomberg

THE GCC

The first GCC country to introduce a legal framework pertaining to REITs was the UAE, specifically the Emirate of Dubai through the Dubai Financial Services Authority in 2006. As a result, in 2010, the founding of Emirates REIT CEIC Ltd took place and in 2014, it became the first listed REIT. Following Dubai, Abu Dhabi enacted REIT regulations in June 2015 and Saudi Arabia and Bahrain followed suit in October and November 2016, respectively.

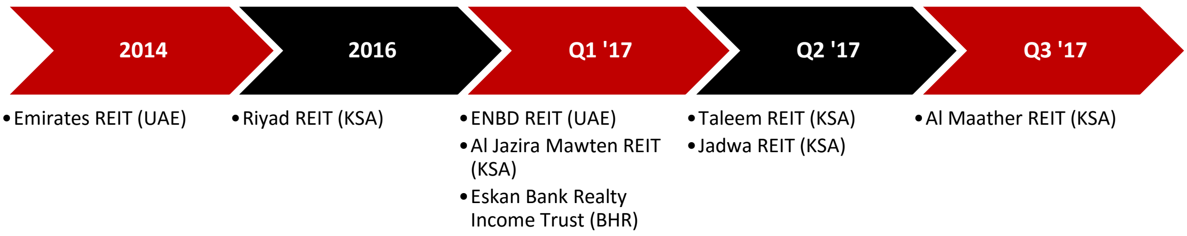
Table 3: Comparison of certain GCC REITs Listing Requirements

Requirement	Dubai	Abu Dhabi	Saudi Arabia	Bahrain
Minimum Distribution	80%	80%	90%	90%
Maximum Leverage	70%	65%	50%	60%
Development Property Limit	30%	30%	25%	20%

Sources: Regulatory Framework for each Jurisdiction

The total listed REIT count for the GCC stands at eight as of Q3 2017 with six of those listing during the first nine months of 2017. In Q4 2017, two additional REITs have listed in Saudi Arabia. The first is Musharaka Real Estate Income Fund and the second is Mulkia Gulf Real Estate REIT. Also, Al Mashaar REIT plans to list in Saudi Arabia before year-end.

Chart 12: Timeline of GCC REITs Listing



Source: Bloomberg

In addition to the above, several more REITs have come to market during Q4 2017. Other than the listed REITs, the region has several private or unlisted REITs.

Table 4: GCC REITs Sector Focus and Size

REIT Name	Country	Sector Focus	Size*
Listed as of Q3 2017:			
Emirates REIT (CEIC) Limited	United Arab Emirates	Mixed	284
Riyad REIT Fund	Saudi Arabia	Mixed	157
ENBD REIT	United Arab Emirates	All except office, residential, retail	254
Al Jazira Mawten REIT	Saudi Arabia	Industrial	68
Eskan Bank Realty Income Trust	Bahrain	Residential	53
Saudi Fransi Capital Real Estate Investment Fund (Taleem)	Saudi Arabia	Education	107
Jadwa REIT Alharamain Fund	Saudi Arabia	Hospitality	209
Al Maather Real Estate Investment Traded Fund	Saudi Arabia	Mixed	192
Listed in Q4 2017 or pending listing:			
Musharaka Real Estate Income Fund	Saudi Arabia	Residential, Industrial, Hospitality	-
Mulkia Gulf Real Estate REIT	Saudi Arabia	Mixed	-
Al Mashaar REIT	Saudi Arabia	Residential, Hospitality	-
Etihad REIT	United Arab Emirates	Mixed	-

Source: NBK Capital Partners and Bloomberg
** Size is as of 30-Sep-17 and in USD millions*

A MATTER OF TIME

REITs in the GCC have been slow to take off. Dubai first introduced a legal framework in 2006 but the global financial crisis put a stop on progress. Investors in the region were uncertain of the future and as one crisis ended and another began, the atmosphere of uncertainty remained. Also, hindering growth is the fact that regional governments do not tax income or dividends, eliminating any added value REITs provide from a taxation perspective.

Today's real estate market, having for the most part recovered, provides sufficient opportunity for the region to move forward in the development of REITs. The real estate market is full of stable and mature residential and commercial assets, including malls, hospitals and warehouses, all of which are prime candidates for inclusion in a REIT. The abundance of assets will promote REIT growth, while the different type of assets will allow for specialization.

Over the past couple of years, certain GCC countries have moved in the right direction by introducing a legal framework regarding REITs, however there is room for improvement. Qatar, Kuwait, and Oman have yet to enact REIT regulations, while Dubai, UAE, Saudi Arabia and Bahrain can adapt a more investor-friendly approach, such as eliminating or reducing restrictions on foreign ownership.

GCC investors have always been attracted to real estate. Many family conglomerates across the region have made their initial fortunes in real estate before diversifying into numerous other businesses. The appetite for real estate is strong and expected to increase further, paving the way for demand of REITs. Institutional and individual investors and real estate developers and owners all stand to benefit as the GCC REIT market expands and matures. Investors will be able to access a variety of real estate at a fraction of the cost while generating yields significantly higher than that available through equities. Developers and owners of real estate assets will have a new source of funding through accessing capital markets. Regional institutions and individual investors will ultimately gain liquidity, a fundamental need in today's geopolitical landscape, while investing in a preferred asset class.

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