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Envisioning

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This book seeks to explain the real estate investment decision making process by which a *real estate investment trust*, or REIT, converts $1 of unitholder capital into $1 of investment real estate. Focusing equally on the people and the process, the contributions of the key participants in the real estate investment decision making process are described and analysed with a particular emphasis on both the overlap between their roles and their interaction.

The process of real estate investment decision making is a fusion of the 'how' and the 'why'. In this book, the *how* is based on the results of new, original academic research, including structured interviews with the managers of a wide range of different types of REITs, as well as the research and publications of others as referenced, together with the author's 25 years experience in REIT management. The *why* is drawn from the real estate theory, capital market theory and finance theory that underpins real estate investment management.

While the real estate investment decision making process draws on a range of tools, such as the Capital Asset Pricing Model, the role of intuition and judgment remains vital. Spreadsheets, sensitivity analysis and scenarios all have an important role to play in real estate investment decision making but need to be balanced with the intuition and judgment that come from years of practical experience.

Real estate investment decision making is presented in this book as comprising three Phases with six Stages and 30 Steps, being an ongoing, cyclical process. The first Phase, the Preparing Phase, comprises the Envisioning Stage and the Planning Stage wherein the REIT articulates where it is going and how it is going to get there, providing unitholders with

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a clear understanding of the risk-return profile to expect from the managers investment of their funds. The second Phase, the Transacting Phase, comprises the Dealing Stage and the Executing Stage, wherein the REIT implements the outcomes of the Preparing Phase through the creation of a tangible real estate portfolio. The third and final Phase, the Observing Phase, comprises the Watching Stage and the Optimising Stage, wherein the REIT ensures that its performance will achieve its goals and so attain its vision, thereby completing the cyclical process of REIT real estate investment decision making.

The six chapters of this book address each of the Stages of the REIT real estate investment decision making process sequentially, introducing and explaining the contribution of the relevant members of the REIT management team to that Stage. For each Stage, the relevant supporting theory, or the *why* for the *how*, is explained in detail and illustrated by application to Super REIT, a $15 billion diversified REIT.

REITs are a continuously evolving real estate investment product. Similar to listed equities investment funds, many REITs started through association with an entrepreneur who was the sole decision maker focusing on specific assets and evolved over time into a team approach focusing on a portfolio of assets. However, whereas the dominance of sophisticated international institutional investors in listed equities investment funds has pressured portfolio managers to adopt more transparent, explicable and repeatable investment decision making processes which are independent of individual decision makers, this has been less evident in REITs where the investment decision making process often appears to be opaque, curious and *ad hoc*.

This book seeks to increase the transparency and explicability of the real estate investment decision making process by REITs, thus contributing to the potential for repeatability, by shifting from a greater emphasis on people to a greater emphasis on process, so contributing to the continued evolution of REITs as a real estate investment product.

Extensive research over the last 25 years has shown that real estate investment is not necessarily different to other forms of investment. While many aspects of real estate investment can be explained by the application of theories and principles developed for other forms of investment, some aspects of real estate investment remain specific to the real estate sector. Similarly, many of the skills required to manage a REIT can be drawn from disciplines other than real estate while some skills remain firmly rooted in the real estate discipline. As the highly successful US real estate investor, Sam Zell, observed:

> *REITs are no longer different from any other industry that is dependent on access to capital markets,*

and

> *The successful REITs are the ones that can be characterised as operating companies versus a collection of properties.* (Garrigan and Parsons, 1997)

This is a view echoed by Geltner et al. (2007):

> *Shares of the major REITs are publicly traded in the stock exchange. Viewed by Wall Street as operational firms, that is, actively managed corporations, they are valued as such (i.e. not as passive portfolios of properties). Thus, REITs are valued in essentially the same way other publicly traded firms are valued …* (Geltner et al., 2007)

This book seeks to view the REIT holistically as a major business enterprise which combines roles and skills common to all major business enterprises with roles and skills specific to the real estate sector. Similar to mining enterprises having CEOs as well as geologists or airline enterprises have CFOs as well as pilots, a REIT may be considered as just another type of business enterprise where the CEO and CFO work in a business team with dealers and developers. This reflects the increasing trend around the world for the CEO and various members of a REIT senior management team to increasingly be experts in a discipline other than real estate and for those with expertise in the real estate discipline to decreasingly occupy positions inside the C-suite.

With a REIT sector now forming part of the stock market of the US, Australia, numerous Asian countries and an increasing number of European countries, this book seeks to provide principles of real estate investment decision making that are capable of application in all countries (subject to local laws, regulations and rules) rather than focusing on decision making within the context of a specific country's laws, regulations and rules.

For clarity, this book adopts the hierarchy whereby a REIT may comprise a group of funds and each fund may comprise a group of portfolios and each portfolio may comprise a group of properties. Also, the term '*appraisal*' is used instead of '*valuation*' though it is acknowledged that *valuation* is commonly used in Commonwealth countries.

Further, this book focuses the application of the REIT real estate investment decision making process on the acquisition of a property, though it is acknowledged that the process is equally applicable to the disposal of a property or other major transaction such as a large lease renewal or the letting of a substantial area of vacant accommodation.

Finally, where individual authors have contributed ideas specifically referred to in a chapter such authors are acknowledged individually in the text, with those authors contributing ideas generally referred to in a chapter being acknowledged in the references at the end of that chapter to which the reader is referred for greater detail.

This chapter seeks to outline REITs in principle with an overview of the REIT real estate investment decision making process and the key participants. Accordingly, by the end of this chapter, the reader should understand:

- the relevance of **commercial** and **legal principles** underlying a REIT and its characteristics;
- the importance of the **structure** and **composition** of a REIT management team for effective control of a large and often international business; and
- the significance of the **Phases, Stages** and **Steps** comprising the REIT real estate investment decision making process.

1.1 People and process

As the title *Global Real Estate Investment Trusts: People, Process and Management* indicates, this book focuses on both the people and the process involved in real estate investment decision making with the consideration of people intentionally coming first. This reflects the current emphasis on people relative to process in REIT real estate investment decision making which, as referred to above, is expected to reverse as REITs continue their evolution to a greater emphasis on process.

1.1.1 People

Over the last 40 years, the global REIT sector has developed from a small adjunct to the stock markets of several countries to a significant sector of the global equities market. REITs themselves have grown from small businesses collecting rents from a handful of buildings to massive multinational conglomerates undertaking a wide range of activities related to real estate.

The evolution from being small, localised entities into being large, international entities has been accompanied by an evolution in both people and real estate investment decision making processes. Accordingly, REITs today are major business enterprises, with management structures that mirror other major business enterprises, but happen to have a principal business undertaking a wide range of activities related to real estate.

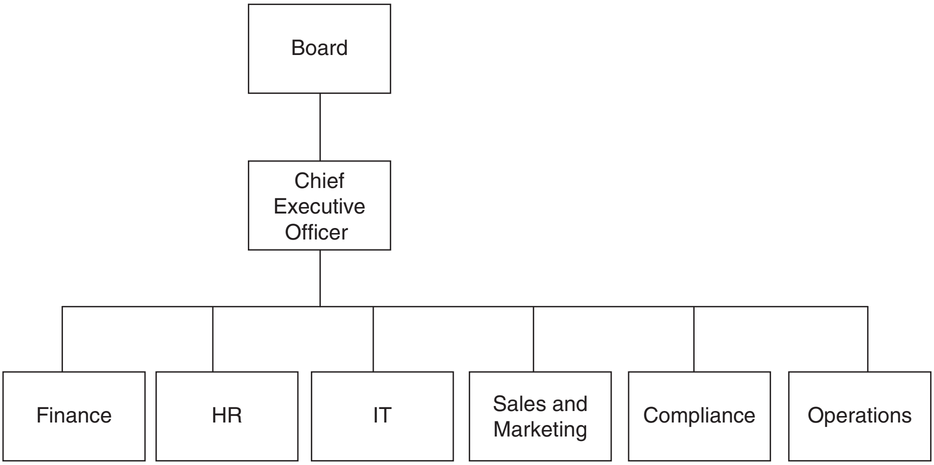

Figure 1.1 Typical management structure of an international enterprise.

As small, localised entities, REITs were often lead by an individual and managed by a small team who, between them, fulfilled all the roles necessary for the REIT to function. As is common in small business, the respective roles may not have been defined and may have overlapped.

As large, international entities, REITs have evolved to adopt that management structure common to many international enterprises as illustrated in Figure 1.1. Though such line management functions as Finance, HR and IT are common to both REITs and major enterprises in other sectors such as banking, retail and so forth, REITs may be considered to have evolved the sales and marketing and operational line management functions to reflect the nature of the REIT business.

The sales and marketing line management function has evolved to comprise an investor interface function including marketing, sales and investor relations. For a business that specialises in real estate, the operational line management functions have evolved most specifically in REITs and so exhibit the greatest difference, as may be expected, to line management functions in other enterprises.

The operations line management functions for a large REIT reflect the various line management layers involved in the fund level, portfolio level, asset level, property level and facility level management of a REIT as illustrated in Figure 1.2. Those people comprising each of the management functions illustrated in Figure 1.2 contribute to the real estate investment decision making process within a REIT and are considered in the chapter outlining that part of the real estate investment decision making process with which they are most closely associated. Accordingly, the Portfolio Management, Strategy and Research Teams are

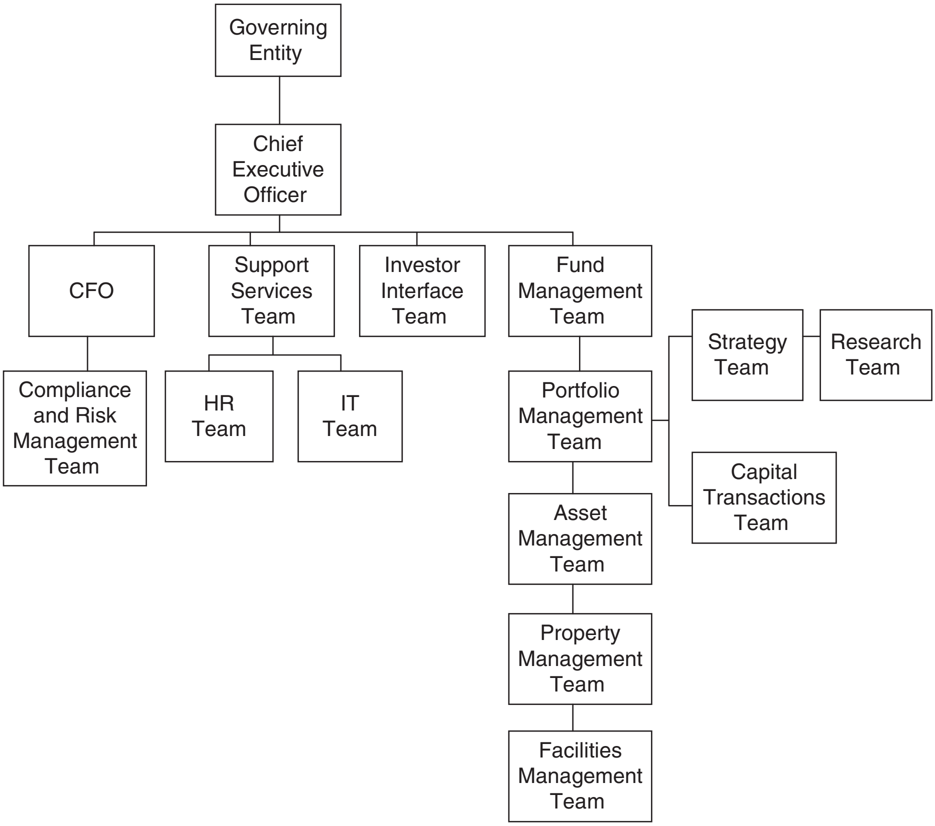

Figure 1.2 Typical management structure of an international REIT.

considered in Chapter 2 (Planning Stage), the Capital Transaction Team is considered in Chapter 3 (Dealing Stage), the Investor Interface Team is considered in Chapter 4 (Executing Stage), the Compliance and Risk Management Team is considered in Chapter 5 (Watching Stage), the Asset Management, Property Management and Facilities Management Teams are considered in Chapter 6 (Optimising Stage) with the Governing Entity, CEO, CFO, Support Teams and Fund Management Team considered in this chapter (Envisioning Stage).

While generic names have been adopted for the various management roles, it is accepted that names may vary in different countries and for different REIT models. It is also accepted that only the largest international REITs may separate all of the various roles considered, with smaller REITs and domestic REITs combining roles to suit operational requirements.

1.1.2 Process

The real estate investment decision making process outlined in this book is based on new, original academic research, including structured interviews with the managers of a wide range of different types of REITs and the research and publications of others as referenced, as well as drawing on the author's 25 years experience in REIT management.

While this book focuses on the steps involved in real estate investment decision making in the context of a large sectorally and geographically diversified REIT, the principles of the steps may be equally applied to small REITs and to sectorally or geographically focused REITs.

However, rather than the size or nature of the REIT, a potentially greater challenge to the effective implementation of the steps in the real estate investment decision making process comprises the willingness of REIT management teams to evolve their approach to decision making which may be succinctly summarised as:

> *To some degree, the quest to upgrade* the *quality of real estate decisions is perhaps a classic exposition of the aphorism: "You can lead a horse to water, but you can't make him drink".'* (Roulac in Pagliari, 1995)

Real estate investment decision making is the synthesis of theory, history, content, context, process and methodology (Roulac, 2001). This book breaks the REIT real estate investment decision making process down into three phases comprising six stages with 30 sequential steps as summarised in Table 1.1.

The Preparing Phase comprises the:

- **Envisioning Stage** – in which the REIT clearly articulates its destination together with a high order route map by which to get to the destination and some measurable outcomes to determine whether or not the REIT has arrived at the destination (considered in detail in this chapter); and the
- **Planning Stage** – in which the REIT converts its destination into the identification of a target list of specific real estate assets for potential acquisition that meet the stock selection criteria and may be mis-priced (considered in detail in Chapter 2).

Accordingly, on completion of the Preparing Phase, the REIT has articulated where it is going and how it is going to get there, providing unitholders with a clear understanding of the risk-return profile to expect from the managers investment of their funds and is positioned to undertake the Transacting Phase.

Table 1.1 Phases, Stages and Steps in the REIT real estate investment decision making process.

Phase	Stage	Steps	Steps	Steps	Steps	Steps
Preparing	Envisioning	Vision	Style	Goals	Strategic Plan	Objectives
	Planning	Property P'folio Strategy	Strat. Asset Allocation	Tactical Asset Allocation	Stock Selection	Asset Identification
Transacting	Dealing	Preliminary Negotiation	Preliminary Analysis	Structuring	Adv. Fin Analysis	P'flio Impact Assessment
	Executing	Governance Decision	Transaction Closure	Documentation	Due Diligence	Independent Appraisal
Observing	Watching	Settlement	Post Audit	Performance Monitoring	Performance Measurement	Portfolio Analysis
	Optimising	Asset Managem't	Prop. & Fac. Management	Transformation	Portfolio Rebalancing	Disposal

The Transacting Phase comprises the:

- **Dealing Stage** – in which the REIT converts the target list of specific assets for potential acquisition into an in-principle transaction for the acquisition of a nominated asset (considered in detail in Chapter 3); and the
- **Executing Stage** – in which the REIT verifies all information relied upon and assumptions made in the pricing process and reflects this in the documentation necessary to protect the interests of unitholders at settlement (considered in detail in Chapter 4).

Accordingly, on completion of the Transacting Phase, the REIT has implemented the outcomes of the Preparing Phase through the creation of a tangible real estate portfolio and is positioned to undertake the Observing Phase.

The Observing Phase comprises the:

- **Watching Stage** – in which the REIT monitors the portfolio to determine whether or not the objectives, goals and hence the vision for the REIT will be achieved (considered in detail in Chapter 5); and the
- **Optimising Stage** – in which the REIT takes such action as may be necessary to ensure the objectives, goals and hence the vision for the REIT will be achieved (considered in detail in Chapter 6).

Accordingly, on completion of the Observing Phase, the REIT has ensured that its performance will achieve its goals and so attain its vision, thereby completing the cyclical process of REIT real estate investment decision making.

While the complete cyclical process of REIT real estate investment decision making is only likely to be undertaken sequentially by a newly formed REIT at inception or by an existing REIT facing transformational change or restructure, respective stages or individual steps may be undertaken by existing, operational REITs on an ongoing basis or as required. For example, while an existing operational REIT may be expected to undertake the Watching Stage on an ongoing basis, it may only be expected to undertake the Dealing Stage when required for the acquisition or disposal of a property or other major transaction within the portfolio.

Reflecting the fiduciary nature of REIT management, individual steps within a given stage should be completed sequentially in order to avoid a significant omission. For example, an existing, operational REIT undertaking the Dealing Stage when required should complete the five steps of the Dealing Stage sequentially and not omit a step, such as the Portfolio Impact Step, as this will result in important data then being missing from the real estate investment decision making process and a potentially suboptimal decision then resulting which may not be in unitholders' best interests.

To illustrate the REIT real estate investment decision making process, a fictitious existing and operational REIT, named Super REIT for convenience, is used by way of example for each Phase, Stage and Step. Super REIT is a $15 billion diversified REIT which implements the real estate investment decision making process to invest in Superman Tower in the fictitious city of Metropolis.

The approach to REIT real estate investment decision making described in this book is premised on a normative approach of sequential Steps undertaken by rational participants in a methodical manner with access to all the information, data and tools that may be required to make logical, optimal decisions in an unproblematic environment. Significantly, while the approach is described as normative, being how an investor should behave, it is based on and supported by new, original academic research (including structured interviews with the managers of a wide range of different types of REITs, as well as the research and publications of others as referenced) providing a descriptive approach, being how an investor actually behaves.

Interesting research is currently underway around the world, drawing from the disciplines of cognitive psychology and behavioural finance, that fundamentally challenges the premis of such a normative approach, arguing that real estate investment decision making is neither sequential, rational, methodical, informed, logical nor optimal and often undertaken in a problematic environment, being:

> '*undertaken by imperfect players in imperfect markets using imperfect information*' (Roberts and Henneberry, 2007).

Ongoing research suggests that the real estate investment decision making process may be influenced by the individual decision maker, their decision making environment (which may be complex, dynamic and chaotic) and the extent of information available, with a propensity for the decision maker to '*collapse down*' the decision making process and take short cuts, potentially leaving the decision making process open to the influence of multiple biases, perceptions, beliefs, preferences, judgment and sentiment (MacCowan and Orr, 2008; French and French, 1997; French, 2001; Gallimore et al., 2000; Gallimore et al., 2000a; Gallimore and Gray, 2002; Roberts and Henneberry, 2007).

Such research is consistent with the long accepted view that real estate investment decision making is more than an explicit process, including '*… the implicit decision-making apparatus of judgment, hunch, instinct, intuition, faith, and gut feel.*' (Pyhrr et al., 1989), so underlining the vital connection between people and process.

1.1.3 People and process

This book seeks to explain the real estate investment decision making process by which a real estate investment trust, or REIT, converts $1 of unitholder capital into $1 of investment real estate.

While focusing equally on the people and the process, as the book title indicates, the REIT real estate investment decision making process is dependent upon the combination of and interaction between people and process, being incapable of effective operation in the absence of either and sub-optimal in the event that either is compromised.

1.2 REITs: an introduction

The original role of a REIT, which remains the core role of many REITs today, was to unitise and securitise otherwise illiquid investment real estate. As individual buildings increased in value and became denominated in billions of dollars rather than just in millions, the ability of and wisdom for investors to own such a building in its entirety came into focus.

By acquiring a billion dollar building and offering a billion one dollar units tradeable on a stock exchange, the REIT provides an intermediation role allowing a building for which there may otherwise be a limited market of possible purchasers to be owned indirectly by investors who would otherwise be unable to own such real estate.

The same intermediation principle is applicable to buildings in different real estate sectors, different states and different countries. In each case, the REIT offers the opportunity for bricks and mortar investment real estate to be broken down into small paper units tradeable on a stock exchange.

Further, the same intermediation principle is applicable to either individual buildings or to a very large number of buildings. As the number of buildings owned by a REIT grows or as the REIT expands into different sectors, states or countries, the REIT may group the buildings, sectors, states or countries through the creation of funds and portfolios based on such characteristics or upon other characteristics such as income, capital growth and so forth.

The evolution of REITS varies between countries with, for example, US REITs based in specific enabling legislation, Australian REITs based in trust law and other countries adopting varying combinations of both. While the details of governing documents may vary between countries, a common feature of REITs worldwide is that they enjoy some form of beneficial tax treatment in their local jurisdiction requiring very close adherence to local laws, regulations and rules in order to qualify for and maintain the tax benefit.

In the US, REITs were shaped through successive legislation including the Real Estate Investment Trust Act (1960), the Tax Reform Act (1986) and the REIT Modernisation Act (1999). US REITs have to fulfil a variety of criteria including a specified proportion of assets invested in real estate, mortgage loans, shares in other REITs, cash or government securities and deriving a specified proportion of gross income from rents, mortgage interest or gains from the sale of real estate (Block, 2002; Chan et al., 2003). From a taxation viewpoint, US REITs pay no corporate taxes provided that they distribute at least 90% of taxable income to unitholders who then pay tax at their individual tax rate (Block, 2002; Chan et al., 2003).

Comparatively, in Australia, REITs were initially shaped by the equitable principles of trust law generally and latterly by corporations and taxation legislation specifically. Australian REITs have comparatively few criteria to fulfil, with the nature of investment determined by those investments authorised under a financial services licence (Booth, 2006). From a taxation viewpoint, Australian REITs pay no corporate taxes provided that they distribute all relevant income to unitholders who then pay tax at their individual tax rate (Booth, 2006).

With REITs now existing not only in the US and Australia but also growing across Asia and emerging in Europe, the range of differing laws, regulations and rules for the REIT sector in the respective countries is vast and beyond the scope of this book to address. Readers seeking further detail of REIT laws, regulations and rules in those countries with an active REIT sector are referred to the comprehensive overview provided by Rachel Booth in *Real Estate Investment Trusts: A Global Analysis* (2006).

In addition to the common feature of some form of beneficial tax treatment, REITs across the world are also gradually converging on more transparent governance while gradually diverging on the nature of REIT models developed.

1.2.1 Transparency in governance

While there is a trend to greater transparency in the governance of entities listed on stock exchanges around the world, the details of acceptable levels of transparency vary significantly between countries.

For the purposes of this book, a high level of transparency in governance is assumed though it is acknowledged that this may be in excess of the level required in certain jurisdictions. In this sense, the level of openness and explicitness in the principles of real estate investment decision making outlined in this book may be considered aspirational targets rather than a required threshold in some countries.

1.2.2 REIT models

The variety of REIT models developed is only limited by investment banker creativity, investor demand and local jurisdictional laws, regulations and rules. REIT models have evolved around the world to provide a wide range of combinations of focus, sector and geography.

REITs may focus on being real estate owners and/or real estate developers and/or real estate fund managers and may be internally managed or externally managed. Similarly, REITs may be sector specific and provide real estate investment opportunities in established sectors such as office, retail and industrial real estate as well as emerging sectors such as healthcare, self-storage and prison real estate. Further, REITs may be city specific, state specific, country specific or international real estate investors. Conversely, REITs may be diversified and provide real estate investment opportunities in more than one sector and/or more than one geography.

For the purposes of this book, it is not proposed to consider a specific REIT focus, sector or geography but to outline the principles of the real estate investment decision making process that may be capable of application by any REIT focus, sector or geography.

1.2.3 REITs: summary

The REIT sectors in the US, Australia, Asia and Europe are continuously evolving at such a pace that a fully up to date understanding may only be maintained through daily monitoring of the financial media and the reports of global investment banking houses such as UBS and Morgan Stanley.

The exponential development of REIT sectors around the world over the last half century has resulted in a level of variety of REITs globally that is beyond consideration in this book. Accordingly, therefore, this book seeks to focus on the principles of REIT real estate investment decision making that may be capable of application by any variety of REIT.

1.3 Preparing Phase

The Preparing Phase comprises the:

- **Envisioning Stage** – in which the REIT clearly articulates its destination together with a high order route map by which to get to the destination and some measurable outcomes to determine whether or not the REIT has arrived at the destination (considered in detail in this chapter); and the
- **Planning Stage** – in which the REIT converts its destination into the identification of a target list of specific real estate assets for potential

acquisition that meet the stock selection criteria and may be mis-priced (considered in detail in Chapter 2).

Accordingly, on completion of the Preparing Phase, the REIT has articulated where it is going and how it is going to get there, providing unitholders with a clear understanding of the risk-return profile to expect from the managers investment of their funds. The REIT is then positioned to undertake the second Phase of the REIT real estate investment decision making process, the Transacting Phase, which then leads to the third and final Phase, the Observing Phase, of the real estate investment decision making process.

1.4 Envisioning Stage

This chapter outlines the Envisioning Stage of the REIT real estate investment decision making process comprising the Steps of development of a Vision, Goals, Style, Strategic Plan and Objectives for the REIT.

The Envisioning Stage may be conceptualised through the conversation between Alice and the Cheshire Cat:

> *'Would you tell me, please, which way I ought to go from here?'*
> *'That depends a good deal on where you want to get to,' said the Cat.*
> *'I don't much care where-' said Alice.*
> *'Then it doesn't matter which way you go,' said the Cat.*
> *'-so long as I get* somewhere,*' Alice added as an explanation.*
> *'Oh, you're sure to do that,' said the Cat, 'if you only walk enough.'*
>
> (Carroll, 1999)

In the context of REITs, Garrigan and Parsons (1997) succinctly note:

> *'The management of a modern real estate operating company creates an entirely different dynamic than that of a passively managed group of properties.'*

Such differences may be manifest in two essential features of REITs that distinguish them from unlisted real estate portfolios or directly held real estate assets:

- the REIT is a **corporate and/or trust entity** which is more than a portfolio of properties or an individual property. The REIT brings together not only the real estate portfolio but also specialist management skills, capital budgeting expertise and a range of other corporate activities into an operating business. Accordingly, the REIT as a business should be capable of generating synergistic value in excess of that of the carried assets, recognised by the market through the REIT trading at a premium to the net value of its real estate portfolio; and
- as a **listed entity**, the REIT has a standard of transparency and accountability comparable to other listed entities and potentially considerably greater than that for unlisted entities. Further, unlike unlisted entities or individual properties where unit pricing might be monthly, quarterly or annually, a REIT is priced by the minute through the stock market as an indicator of the success or otherwise of the operating business.

By undertaking the Envisioning Stage, the REIT is able to focus resources on activities that will contribute to attaining its Vision, operating as an effective business and providing investors with confidence through defined direction and demonstrably measurable Goals which should be positive for the REIT's unit price. As Goleman (1999) observes:

> '*An organisational mission statement serves an emotional function: articulating the shared sense of goodness that allows us to feel what we do together is worthwhile.*'

and

> '*Clarity about an organisation's values, spirit, and mission leads to a decisive self-confidence in corporate decision making.*'

though care is required to avoid 'decisive self-confidence' being undermined by behavioural influences such as biases and irrational preferences, or by being unable to deal with complexity where more than three or four variables require simultaneous consideration (Pyhrr et al., 1989).

However, by undertaking the Envisioning Stage explicitly, the REIT faces a conundrum. On the one hand, if every REIT is explicit about its Vision, Goals and Strategic Plan, competitive advantage may be at risk. On the other hand, relative to the stock market as a whole, the REIT sector is small and individual REITs may benefit from homogeneity and only a minor point of difference (Geltner et al., 2007).

Also, knowing where other REITs are planning to go provides boundaries for the development of Goals and minimises the business risk of sub-optimal decisions (Baum, 2002), with the repeated statement of Vision and Goals by all REITs providing each with an incentive to achieve as failure is public (Hudson-Wilson and Wurtzebach, 1994).

On completion of the Envisioning Stage, the REIT should have a clearly articulated destination together with a high order route map by which to get to the destination and some measurable outcomes to determine whether or not the REIT has arrived at the destination.

Having completed the Envisioning Stage, the REIT then moves into the Planning Stage of the REIT real estate investment decision making process comprising the Steps of development of the Property Portfolio Strategy, Strategic Asset Allocation, Tactical Asset Allocation, Stock Selection and Asset Identification, considered in Chapter 2.

Completion of the Envisioning Stage and the Planning Stage mark the completion of the first of the three Phases, the Preparing Phase, wherein the REIT articulates where it is going and how it is going to get there, providing unitholders with a clear understanding of the risk-return profile to expect from the managers investment of their funds.

Accordingly, by end of this chapter, reader should understand:

- the **interdependency** between a REIT's Vision and investment management Style;
- the **interpretative process** by which a REIT's Vision is converted into action through Goals and the Strategic Plan; and
- the key role of Objectives in **aligning employee motivation and performance** with the attainment of the REIT's Vision.

1.5 People

The Envisioning Stage is principally undertaken by the REIT Governing Entity, the CEO, CFO and the Fund Management Team. As with any major business enterprise, the Support Teams of HR and IT underpin all aspects of the business and so are also considered in this chapter.

In common with other major business enterprises, some REIT models and sizes may suit certain roles being outsourced where the laws, regulation and rules in that jurisdiction permit. The decision to use outsourced service providers or in-house staff is usually based on a broad range of considerations including:

- **cost** – outsourced service provider costs may be substantial in terms of fees, some of which may be recoverable from tenants and other parties. However, the remuneration and on-costs for in-house staff in terms of HR, IT, workspace and so forth together with costs associated with staff turnover may also be substantial;

- **control** – the use of outsourced service providers may result in an actual or perceived loss of control by a REIT compared to the use of in-house staff;
- **management** – the management and motivation of outsourced service providers may be challenging to achieve due to the extent of intermediaries relative to an employer/employee relationship;
- **communication** – balancing the amount, quality and timeliness of information provision to decision makers within the REIT by an outsourced service provider relative to in-house staff;
- **expertise** – considering the nature of skills required and the extent to which such skills are required on an ongoing basis may favour use of an outsourced service provider or in-house staff;
- **flexibility** – the cost and time taken to address underperformance and to replace non-performers may vary between outsourced service providers and in-house staff; and
- **conflict of interest** – the use of outsourced service providers may result in an actual or perceived conflict of interest by a REIT compared to the use of in-house staff.

As individual situations differ, there is no simple guide to the decision whether to use outsourced service providers or in-house staff. Generally, a REIT may be expected to use a combination of outsourced service providers and in-house staff with the proportion varying over time as the REIT grows in size and/or complexity.

1.5.1 Governing Entity

The term Governing Entity has been adopted for the purposes of this book to acknowledge that, despite the wide diversity of governance structures adopted by REITs in different jurisdictions around the world, each has a person or a group that, ultimately, provides governance to the REIT concerning the real estate investment decision making process.

In the US, a Governing Entity may be the Trustee(s) or Director(s) whereas, in Australia, a Governing Entity may be the Manager or Responsible Entity (Booth, 2006). While specific requirements for and obligations of a Governing Entity will vary depending on local law, regulations and rules, there are some generic requirements for and obligations of a Governing Entity which may be commonly applicable in most jurisdictions and which are considered in this chapter. Further, the Governing Entity will be assumed to be a body of people (such as a board or committee) rather than an individual person, though the principles considered may be applicable to both.

For the purposes of this book, a high level of transparency in governance is assumed though it is acknowledged that this may be in excess of that level required in certain jurisdictions. In this sense, the level of openness and explicitness in the principles of real estate investment decision making outlined in this book may be considered aspirational targets rather than a required threshold in some countries.

The role of the REIT Governing Entity is to represent the interests of unitholders, with the principal purpose of the role being to focus on the future while overseeing the present and the scope of the role comprising the entire business, including all funds and portfolios.

The REIT Governing Entity usually reports to the unitholders in the REIT, with the direct report comprising the CEO. The principal contribution of the REIT Governing Entity is stewardship, with the functions of the role including:

- **effective corporate governance** – ensuring the maintenance of high standards of accountability, transparency, independence and effectiveness through an appropriately sized governance group with skills, age and gender diversity and complementarity and an appropriate mix of independent, non-executive and executive members. The Governing Entity should not replicate the real estate skills or other skills of management and should contribute skills in governance, business, strategy, finance and law to ensure a range of perspectives, representation of REIT constituencies and representation of the interests of unitholders. The Governing Entity also appoints, works with, retains, motivates and removes the CEO, with an obligation to ensure qualified management and a management succession plan;
- **focus on the future** – the Governing Entity evolves the Vision for the future direction of the REIT, from which the Goals, Strategic Plan and Objectives are developed. Consistent with a focus on the future, the Governing Entity works closely with the CEO on corporate activity, including mergers, acquisitions, making bids and responding to bids;
- **oversight of the present** – with a particular emphasis on risk management, the Governing Entity supervises operations through management reporting and the appointment of Committees to identify risk areas, require policy development for approval, implementation and monitoring in order to ensure compliance with relevant laws, regulations and rules for areas such as occupational health and safety and environmental issues. Consistent with a focus on the future, the Governing Entity also monitors government policy and real estate industry trends for emerging risk management issues such as green building regulation or carbon pricing law;
- **monitor solvency** – monitoring of monthly management accounts and cash flow together with consideration and approval of annual statutory accounts and appointment of and receipt of the report of the external auditor. The Governing Entity is generally responsible for the statement of fair value of assets in the accounts of the REIT under International

Financial Reporting Standards and so should be closely involved with the appraisal policy for all investment real estate assets including the basis and frequency of appraisal and independence of the appraiser;

- **continuous disclosure** – the Governing Entity should ensure full disclosure of information to relevant stakeholders, including the approval of the annual report and the conduct of the annual general meeting. With the increasing concentration of unitholder power in institutional investors and growing activism of small unitholders worldwide, the annual general meeting, media releases and continuous communication are ideal opportunities to engage with and enfranchise unitholders; and
- **setting values and shaping culture** – the Governing Entity sets the values of the REIT and determines acceptable levels for ethical conduct in areas such as honesty, fiduciary responsibility, prudence, care and diligence, acting in the best interests of unitholders, conflict of interest, related party transactions, alignment of the interests of management and unitholders, openness and transparency, insider trading, giving and receiving gifts, government relations and so forth, usually through the development and communication of a code of ethics, values statement or similar clear, written commitment (Garrigan and Parsons, 1997; Jarchow, 1988).

Tricker (1994) conceptualises the complex interactions involved in effective REIT governance as requiring the balancing of outward and inward roles (such as the outward provision of accountability role, as well as the inward monitoring and supervising role) with backwards/compliance and forwards/performance roles (such as the backward/compliance role of monitoring and supervising, the forward/performance role of policy making), with the central interaction for effective REIT governance being a positive working relationship between the Governing Entity and the CEO, as illustrated in Figure 1.3.

While there is no simple formula to ensure such a positive working relationship, which is heavily dependent on the personalities of the participants, the prospects for a positive working relationship are enhanced where there is a clear understanding of the respective roles and responsibilities, mutual respect, sharing of knowledge and expertise and open and honest communication between the participants.

1.5.2 Chief Executive Officer (CEO)

The role of the REIT Chief Executive Officer is to manage the REIT as a business, with the principal purpose of the role being to optimise unitholder returns and the scope of the role comprising the entire business, including all funds and portfolios.

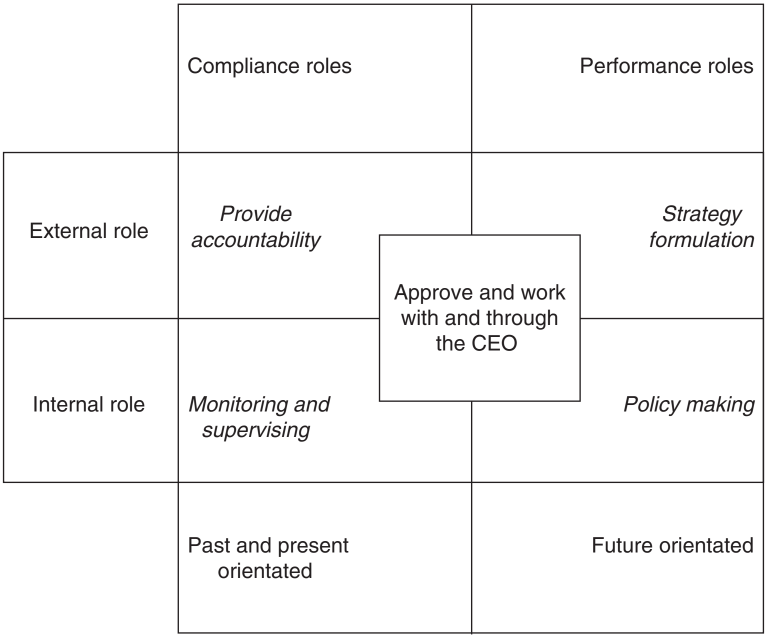

Figure 1.3 Interactions involved in effective governance. From Tricker (1994). *International Corporate Governance: Text, Readings and Cases* (Figure 4.1, p.149). © 1994 Prentice Hall Asia, a Pearson company. Reproduced by permission.

The CEO usually reports to the Governing Entity, with direct reports including the CFO and each of the Support Team, Investor Interface Team and Fund Management Team.

The principal contribution of the CEO is the development of the Vision for the REIT as a whole, in consultation with the Governing Entity, with the functions of the role including:

- being the **public face** of the REIT comprising the management of the interface with unitholders, the financial markets and the capital markets (with a focus on equity capital management), both through management of the Investor Interface Team and through direct involvement including media activities and unitholder, banker and regulator presentations;
- leadership of the business and regular communication with all REIT staff to imbue a **common sense of purpose** and develop a REIT-wide commitment to deliver the Vision, Goals, Strategic Plan and Objectives;
- management of the finance, fund management, HR and IT aspects of the business through the **management of the CFO, Support Teams and Fund Management Team** direct reports;
- monitoring of all aspects of **risk management and compliance** through membership of the relevant compliance and investment committees;

- making **recommendations to the Governing Entity** on REIT acquisitions, disposals, large transactions and major capital expenditure consistent with achieving the REIT's Goals and thus attaining its Vision; and
- periodic **management reporting** at the REIT level to the Governing Entity.

Reflecting the evolution of REITs, the nature of the REIT CEO role tends to be clearest at the extreme. Where a REIT is associated with an entrepreneur who is the sole decision maker as CEO at one extreme and where a major international REIT with a CEO who controls a massive global management structure is at the other extreme, the role of the CEO is clear. However, for those REITs in transition from an entrepreneur structure to a corporate structure, for those REITs growing or contracting rapidly or for those REITs facing some form of major change or transformation, the nature of the CEO role may fall between the two extremes and so be far less clear.

1.5.3 Chief Financial Officer (CFO)

The role of the REIT Chief Financial Officer is to manage the financial affairs of the REIT, with the principal purpose of the role being to maintain solvency and the scope of the role comprising the entire business, including all funds and portfolios.

The CFO usually reports to the CEO, with direct reports including the Compliance and Risk Management Team together with accounting, internal audit, finance, treasury and tax managers as well as being the point of contact for the REIT's external, independent auditors.

The principal contribution of the CFO is the provision of financial transparency, with the functions of the role including:

- management of **accounting for all purposes** including management accounts, statutory accounts, taxation and payroll at the REIT, fund, portfolio and property levels and budgeting, forecasting, performance measurement and analysis at the REIT level;
- management of **reporting** at the REIT, fund, portfolio and property levels;
- **capital management** with a focus on debt management (but including equity management), distribution management, capital budgeting and capital raising together with relationship management with major lenders and institutional investors;
- **cash management, currency management** and **derivatives management** for foreign exchange and interest rate management;
- **risk management** and **compliance** management including supervision of internal auditors and external, independent auditors and insurance together with management of the Compliance and Risk Management Team; and

- **corporate real estate management** including the REIT's own offices, data centres and so forth.

Given the REIT-wide view of the business held, the CFO is often the second highest ranking executive in the REIT management team after the CEO and so may also be the Deputy CEO or Acting CEO in the CEO's absence.

1.5.4 Support Teams

The role of the REIT Support Teams is to provide the infrastructure necessary for the REIT to operate as a business, with the principal purpose of the roles being to provide human resources (HR) and information technology (IT) services to the business and the scope of the roles comprising the entire business, including all funds and portfolios.

The HR Team usually reports to the CEO without any direct reports but with responsibility for managing a range of external service providers including recruitment consultants, remuneration consultants, training providers and so forth.

The principal contribution of the HR Team is the administration of people within the business, with the functions of the role including:

- **recruitment, development, promotion** and **termination** of employees;
- design and administration of the REIT **remuneration policy** including base salary levels, short and long term incentive packages, stock ownership incentive packages and perquisites, to align the Objectives of employees with the Goals of the REIT and the motivations of the differing personality types of employees in the various Teams;
- maintenance of **employee records** including development and maintenance of position descriptions to clearly define roles, responsibilities and expectations;
- co-ordinating a periodic cycle of individual employee **performance plans** and performance reviews, to align the Objectives of employees, the Goals of the REIT and the REIT remuneration policy and to promote employee productivity, satisfaction and retention;
- design and management of employee **development programmes**, including continuing professional development for role specific learning, training programmes for generic skills development, graduate rotation programmes, career track enhancement initiatives and so forth; and
- design and administration of all relevant **HR policies** including occupational health and safety, equity and so forth.

The IT Team usually reports to the CEO without any direct reports but with responsibility for managing a range of external service providers including software developers, hardware providers, recovery specialists and so forth.

The principal contribution of the IT Team is the administration of technology within the business, with the functions of the role including provision and maintenance of:

- **hardware** infrastructure for the business locally, nationally and internationally on an interconnected, current time basis;
- **software** infrastructure for the business including generic packages for word processing, spreadsheeting, email and so forth for all employees as well as specific packages such as SAP™ for the CFO's team, Peoplesoft™ for the HR Team, DYNA™ for the Portfolio Management Team etc.;
- **databases** for the business to suit specific requirements, including CRM packages for the Investor Interface Team, research databases for the Research Team and so forth;
- **security** for the IT system including the management of periodic back-up and offsite data centres;
- the REIT **website**, which is increasingly becoming the first point of contact with a REIT for many stakeholders as well as being a repository of vast amounts of REIT specific information for both external and internal users; and
- **telephony**, video conferencing and related technology applications.

In common with many major business enterprises, the contribution of Support Teams is often both invisible and undervalued, with greater attention paid to a Support Team when something occasionally goes wrong rather than when most things usually go right.

1.5.5 Fund Management Team

The role of the Fund Management Team is to manage the respective funds comprising the REIT, with the principal purpose of the role being to optimise the risk-return balance at the fund level and the scope of the role usually comprising either one or a small number of funds per fund manager.

The Fund Management Team usually reports to the CEO, with direct reports including the Portfolio Management Teams for the respective portfolios within the funds comprising the REIT.

The principal contribution of the Fund Management Team is the selection of investment management Style and development of the Goals and Strategic Plan, in consultation with the CEO and CFO, for each of the respective funds comprising the REIT, with the functions of the role including:

- business **planning** for each of the respective funds comprising the REIT;
- **budgeting and forecasting** at the fund level;

- **performance measurement** and analysis at the fund level;
- **capital management** at the fund level including equity, debt and cash management and capital expenditure management;
- **foreign exchange management** at the fund level, where relevant;
- **distribution management** at the fund level;
- periodic **management reporting** at the fund level to the CEO and Governing Entity; and
- **relationship management** with joint venture partners and co-owners, where necessary.

For a REIT comprising a number of funds, the position of the Fund Management Team is particularly challenging, requiring not only regard to the performance of individual funds but also regard to the performance of all other funds and the potential cumulative impact on the performance of the REIT as a whole.

1.5.6 People

Each of the Governing Entity, CEO, CFO, Support Teams and Fund Management Team are closely associated with the holistic process of the Envisioning Stage. The Governing Entity and the CEO determine the Vision for the REIT which then cascades down to the CEO, CFO and Fund Management Team to develop the Goals and Strategic Plan which, if achieved, will attain the Vision. Achievement of the Goals is then facilitated through achievement of the Objectives of each employee in the REIT facilitated by the requisite people and technology infrastructure provided by the Support Teams.

1.6 Vision

The first Step of the Envisioning Stage comprises the development of the Vision which is a public statement by the REIT, considered interdependently with Style, from which the Goals, Strategic Plan and Objectives of the REIT may then be developed. The Vision should be reviewed regularly but, in recognition of its long term nature, such review should not be more frequent than five yearly. The Vision for a REIT is developed by the Governing Entity with support from the CEO.

The Vision is a clear statement of where the REIT is going; usually being a qualitative statement of how the REIT intends to create value for unitholders, with both financial and non-financial emphases. The nature of a REIT as a real estate business usually results in a greater emphasis on the financial aspects rather than the non-financial aspects with some variation on wealth maximisation common.

An emphasis on wealth maximisation is consistent with the later Stages and Steps of the REIT real estate investment decision making process which focus on earning abnormal returns and the use of decision rules which lead to wealth maximisation. Wealth maximisation may be expressed in a variety of ways but usually focuses on an income return emphasis, a capital return emphasis or a total return emphasis pre-tax as, in most jurisdictions, post-tax wealth maximisation is then a matter for the unitholder rather than the REIT. Similarly, wealth maximisation may be expressed as an absolute concept or relative to something such as a benchmark or index.

Non-financial emphases in a REIT Vision may include intangible or psychological benefits such as the sense of security or self-esteem engendered by a REIT with a Vision to invest only in absolutely prime locations or in buildings only leased to tenants with the highest possible credit rating.

There should be a stated time horizon for the Vision which may be explicit ('*within ten years*') or implicit ('*eventually*' or '*ultimately*' or expressed through the identified Goals). A stated time horizon is particularly important in the context of the stated risk-return relationship with a Vision emphasising short term, high risk, high return characterising a REIT very differently from a Vision emphasising long term, low risk, low return.

Reflecting the interdependence with Style, the Vision requires a risk framework. The Governing Entity, with support from the CEO, thoroughly considers the nature or types of risk and the level of risk that are acceptable to the REIT and develops a stated risk tolerance to underlie the Vision and which must be consistent with the nature of activities of the REIT.

Consistency is essential between the Vision and:

- **governance** – with the composition of the Governing Entity being consistent with the Vision. For example, a REIT with a Vision for steady returns from low risk investment may be consistent with a Governing Entity comprising older, reflective, low risk tolerance individuals whereas a REIT with a Vision for speculative returns from high risk development may be consistent with a Governing Entity comprising younger, more aggressive, high risk tolerance individuals;
- **values and culture** – with the Vision being consistent with the stated values and culture of the REIT. For example, a Vision to be a lean organisation may be inconsistent with stated values such as employee retention and a culture of employee participation; and
- **brand and image** – with the Vision being consistent with the brand and image of the REIT. For example, a brand or image that emphasised long term security may be inconsistent with a Vision focused on short term profit.

For a new REIT, the Vision may be developed without the constraints of an existing real estate portfolio or REIT management structure. However, where the REIT is operational, the Vision needs to be developed within the constraints of the existing real estate portfolio and REIT management structure.

Accordingly, the development of the Vision provides the REIT Governing Entity and CEO with another conundrum – the Vision should be aspirational whilst also being attainable with regard to the constraints of the existing real estate portfolio and REIT management structure. The REIT Governing Entity and CEO need to balance the expectations of unitholders and anticipated trends and changes that may affect the REIT's environment with the challenge of implementation through the capacity of the existing real estate portfolio and REIT management structure to deliver and their capacity for change management.

Bringing independent thinking and an objective mindset to the process, the REIT Governing Entity is able to have a dialogue with the CEO, listening and questioning, being cognisant of the REIT's competitive advantages and any parenting advantages that it may enjoy, before stepping back and forming an often relatively simply stated overview of the current environment in the context of which the Vision may be developed:

> *Confronting knowledgeable, experienced and committed organisational people with challenging questions in a receptive environment can be the conduit to (these) new strategic perspectives.*

and

> *'This needs to be coupled with new perspectives that prise open invisible but restricting assumptions that limit the organisation's growth, capability and field of vision'* (Management Today, March 2010).

Accordingly, the REIT's Vision provides a clear statement of where the REIT is going over a stated future period from which the Goals, Strategic Plan and Objectives can then be developed to transform the Vision into action and outcomes.

1.7 Style

Style is a public statement by the REIT, considered interdependently with the Vision, from which the Goals, Strategic Plan and Objectives of the REIT may be developed. Consistent with the Vision, Style should be reviewed regularly but not more frequently than five yearly. The Style adopted by a REIT is developed by the Fund Management Team with the support of the CEO and Governing Entity.

Style is a clear statement of the approach to real estate investment management to be adopted by the REIT reflecting the stated risk tolerance underlying the Vision. Style is usually expressed as a combination of generic Style (active or passive, top down or bottom up, value or growth) and specific Style (core, value added or opportunistic) often with little explanation of how the REIT interprets such generic and specific Style in the context of its own real estate investment management. Reflecting the interdependence of the Vision and Style, the stated time horizon for the Vision will generally also be applicable to Style.

1.7.1 Active vs. *passive*

An active Style of real estate investment management or a passive Style of real estate investment management is an expression of generic Style. A passive Style is an investment management style where a manager seeks to replicate or follow a benchmark or index and so approximate the risk-return of the benchmark or index. An active Style is an investment management style where the manager seeks to actively manage an individual investment or portfolio in order to add value and enhance returns above those achieved by a benchmark or index within a stated risk tolerance.

REIT real estate investment management is generally an active Style reflecting:

- the relative **informational inefficiency** of the real estate market and the ability to identify assets that offer the opportunity to earn abnormal returns; and
- the **heterogeneity** of the real estate market which limits the ability of a manager to construct a real estate portfolio that replicates a benchmark or index.

The key issue for attention then becomes the specific Style adopted by a REIT within a generic active Style, being either core, value added or opportunistic, which is considered further below.

The Style of REIT management as a form of investment management at the portfolio level should be distinguished from the Style of property asset management which may also be active or passive. In terms of property asset management, certain types of real estate investment suit a low-involvement or passive approach to property asset management by the investor, such as early and mid term ground leases or UK properties leased on 25-year full repairing and insuring leases. Conversely, certain types of real estate investment suit a high involvement or active approach to property asset management such as the implementation of transformational initiatives to enhance returns including refurbishment or partial redevelopment of a real estate investment.

1.7.2 *Top down* vs. *bottom up*

A top down Style of real estate investment management or a bottom up Style of real estate investment management is an expression of generic Style. A top down Style is an investment management Style where a manger sequentially considers the global economy, national economy, regional economies and local economies and then considers the global real estate market, national real estate market, regional real estate markets and local real estate markets to identify optimal geographic areas and/or real estate sectors for investment, then seeking assets within such areas and sectors for acquisition. A bottom up Style is an investment management Style where the manager seeks to specifically consider the investment attributes of a nominated individual asset and their acceptability as the basis for acquisition, potentially disregarding other than local economic and real estate market conditions.

REIT real estate investment management is generally a top down Style reflecting the portfolio focus of REIT real estate investment management. The distinction between a top down Style and a bottom up Style is central to the distinction between the management of the REIT as a portfolio of properties rather than as an amalgamation of individual property assets. Historically, REITs often evolved out of the real estate holdings of an individual or an entity which had generally been acquired with a greater emphasis on the individual property in a transactional approach (the '*art of the deal*'; Wurtzebach et al., 1994) rather than upon the portfolio impact, reflecting a bottom up Style. REITs have now evolved to focus primarily on the portfolio role of individual property assets with the top down Style permeating the entire REIT real estate investment decision making process through the Steps of Strategic Asset Allocation (wherein the entire real estate market is analysed through a range of risk-return lenses to identify target sectoral and geographic weightings), Tactical Asset Allocation (wherein target markets offering significant potential outperformace are identified) and Stock Selection (being the process of identifying portfolio asset criteria).

The key issue for attention then becomes the specific Style adopted by a REIT within a generic top down Style, being either core, value added or opportunistic, which is considered further below. It should be noted that an opportunistic Style may incorporate aspects of a bottom up Style, as an opportunistic Style places a greater emphasis on individual property opportunities within the framework of the REIT real estate investment decision making process.

1.7.3 *Value* vs. *growth*

A value Style of real estate investment management or a growth Style of real estate investment management is an expression of generic Style. A value Style is an investment management Style where the manger consistently

Table 1.2 Principal characteristics of specific Styles.

Features/Style	Core	Value added	Opportunistic
Property type	Traditional	Mix between non-traditional and traditional	Mix between non-traditional and traditional
Asset size/ quality	Predominantly large, high quality	Mix between large and small and impaired assets	Mix between large, but predominantly small and impaired assets
Markets	Primary markets	Primary/secondary markets	Domestic and international markets
Diversity	Fully diversified	Limited diversification	Diversification is not a consideration
Leverage	None to low (0–30%)	Moderate – high (50–70%)	High – very high (70%+)
Income/capital component	Relatively high income component	Balance between income and capital	Relatively high capital component
Holding period	Multiple market cycles (at least one)	Generally limited to period for active management strategies to be implemented	Generally limited to period for active management strategies to be implemented

Source: de Francesco (2010). Reproduced by permission of IPD.

focuses on seeking assets that are significantly mis-priced and offer the potential for abnormal income, capital and/or total returns over a defined future timeframe. A growth Style is an investment management Style where the manager consistently focuses on constructing a portfolio comprising assets that offer the potential for growing income, capital and/or total returns over an undefined but usually longer future timeframe.

REIT real estate investment management is generally a growth Style reflecting the focus on the portfolio, though Tactical Asset Allocation may include elements of a value Style. The key issue for attention then becomes the specific Style adopted by a REIT within a generic growth Style, being either core, value added or opportunistic, which is considered further below.

1.7.4 Core, value added and opportunistic

Core, value added and opportunistic Styles of real estate investment management are expressions of specific Style. Reflecting the relatively recent adoption of terms for specific Style in real estate investment management, the definitions of core, value added and opportunistic vary with one interpretation of the principal characteristics provided in Table 1.2.

Core Style

A core Style seeks to provide a risk adjusted return that is approximately equal to the market but through the holding of only a small portfolio of high quality properties with limited leverage. Outperformance may be generated within a core Style through the acquisition of individual assets with high risk adjusted returns but low correlation with other assets in the portfolio (Pagliari, 1995).

Value added Style

Sometimes also referred to as the *core plus Style*, the value added Style seeks to achieve outperformance by identifying opportunities to add value using mixed quality real estate assets and moderate leverage. This may include selecting markets where development to address undersupply may generate outperformance or individual assets where transformation refurbishment, remodelling or focused, active asset management may generate outperformance (Pagliari, 1995).

Opportunistic Style

The opportunistic Style to generating outperformance includes a wide spectrum of multiplicative risk approaches including higher risk real estate assets and greater leverage. These may range from identifying opportunities arising from the prospect of reletting partial vacancy in a building to a contrarian approach of acquiring empty buildings in temporarily over-supplied markets where confident of long term economic growth (Pagliari, 1995).

1.7.5 Style

Having developed the Vision to provide a clear statement of where the REIT is going over a stated future period and adopted an interdependent Style reflecting the stated risk tolerance underlying the Vision, the REIT is now in a position to develop the Goals, Strategic Plan and Objectives that will transform the Vision through the Style into action and outcomes.

1.8 Goals

Goals are a public statement by the REIT, consistent with the Vision and the Style, from which the Strategic Plan and Objectives of the REIT may be developed. Goals should be reviewed regularly during the life of the Vision to ensure continued relevance with review every two to three years optimal. Goals for a REIT are developed by the CEO and the Fund Management Team.

Goals are stated measures or steps of significance to which management efforts are directed and which, if achieved, will attain the Vision. The Goals are usually a quantitative statement of the Vision and so mirror the contents of the Vision. Accordingly, if the Vision has a financial emphasis, the Goals will be quantitative financial measures such as a target level of return, target relative to a benchmark or index or a specified risk tolerance, such as a target for volatility of returns. If the Vision has a non-financial emphasis, the Goals will be quantitative non-financial measures such as the proportion of portfolio revenue from highest credit rating tenants.

To be effective, Goals should be:

- **relevant** – demonstrating a clear alignment with the Vision so that the achievement of Goals can clearly be seen to contribute to the attainment of the Vision;
- **few** – being up to around six Goals, facilitating clear focus on those matters which are critical for achievement if the REIT is to attain its Vision;
- **independent** – being capable of individual achievement without one Goal being dependent on another and with care required to avoid conflict between Goals;
- **clear** – unequivocal, simple, succinct statements that are not open to misinterpretation;
- **measurable** – capable of easy and indisputable quantification;
- **attributable** – providing clarity as to whom within the REIT management team will be responsible for achievement;
- **timely** – having a specified time horizon within which achievement is required, acknowledging that all years are not going to be the same, that specific risk exists through the properties comprising the portfolio and that appraisal timing has an impact on performance;
- **marketable** – being framed to provide confidence to investors and the market;
- **achievable** – while providing a challenge to management to achieve, Goals should not be manifestly unachievable or they will be disregarded by management and become counter-productive; and
- **manageable** – being capable of dissection by management and interpretation as Objectives which, if achieved, will achieve the Goal (Baum, 2002).

Given the relative longevity of Goals, care is required to avoid deviation from stated Goals in the development and implementation of the Strategic Plan and Objectives. An apparent need to reshape the Strategic Plan or Objectives to achieve something other than specified Goals is usually indicative of a change in the REIT environment, warranting a review of the continued relevance of the achievement of the stated Goals to the attainment of the Vision.

In the event that the Goals include financial measures such as a target level of return relative to a benchmark or index, clarity is required in the choice of benchmark or index to ensure relevance in composition and the time period over which measurement is to occur having regard to the status of the REIT relative to those other REITs comprising the benchmark or index. Further, consideration should be given to the choice of a specific numeric Goal (such as a return of 100 basis points above a nominated index) or a Goal specified as a relative measure (such as a return within the top quartile of a nominated index). In each case, a Goal concerning a clear statement of risk tolerance is also required for effective risk-return management.

Having developed a clear Vision and a small number of specified Goals, the REIT is now in a position to develop a Strategic Plan and Objectives to achieve the Goals and so attain the Vision.

> A survey of 215 commercial real estate investment groups in Sweden found their top three ranking goals to be long term return on equity, value appreciation and regular return on equity. (Brzeski et al., 1993)

1.9 Strategic Plan

The Strategic Plan is a public statement by the REIT, consistent with and outlining the pathway to the Goals, through the Style to the Vision. The Strategic Plan, developed by the Fund Management Team, should be reviewed regularly, consistent with the Goals which it seeks to achieve, with review every two to three years optimal.

The Strategic Plan provides a route map to the achievement of Goals by the REIT, being based on the rational analysis of alternative routes in the context of the REIT's current and expected environments. Reflecting the evolution of the REIT sector, several strategic models have developed which may provide a template for the REIT Strategic Plan, such that a REIT may need to undertake part or all of the strategic planning process.

1.9.1 Strategic models

With REITs having now operated in various countries around the world for over 40 years, a series of strategic models have evolved as summarised by Geltner et al. (2007):

- **financial strategic model** – by seeking capital more often from the market in order to grow, being a strategic model that suits a capital intensive industry such as real estate;
- **specialisation strategic model** – being the choice between sector or geographic specialisation and diversification;

- **vertical integration strategic model** – also known as the development strategy and the funds management strategy, whereby the REIT seeks to control and derive returns from all stages of the real estate lifecycle including land acquisition, real estate development, part or whole transaction into a related fund, ongoing management, leasing and so forth within either the REIT or a related fund;
- **economy of scale strategic model** – where a REIT seeks to grow larger to benefit from lower operating costs and lower costs of capital, being particularly effective for sector specialised REITs;
- **branding strategic model** – building a brand name recognition and reputation among the REIT's space using customers, also being particularly effective for sector specialised REITs; and
- **power in the space market strategic model** – where a REIT uses its size and access to capital to corner a market by concentrating its space ownership within a geographically confined space market and so has market power as the dominant space owner.

Depending on the environment surrounding a REIT at a given point in time, one of the above strategic models may provide a template for the REIT Strategic Plan.

1.9.2 Strategic planning process

The Strategic Plan provides a route map to the achievement of Goals by the REIT, being based on the rational analysis of alternative routes in the context of the REIT's current and expected environments.

Strategic environment

A comprehensive and detailed analysis of the strategic environment will determine exactly where the REIT is now, providing an assessment of current and potential issues facing the REIT in a wide range of different dimensions, for comparison to where the REIT wants to be to achieve its Goals and so attain its Vision.

A variety of popular management tools are commonly used to analyse the strategic environment including a SWOT analysis (identifying the REITs strengths, weaknesses, opportunities and threats), consideration of Porter's five forces (being competitive rivalry, barriers to entry, threat of substitutes, customer power and supplier power; Porter, 1994), together with other tools such as balanced scorecard, core competence agenda, value chain analysis and moral purpose framework. The use of external consultants with strategic planning expertise may facilitate discussion and self-examination in the strategic planning process, leading to a more objective view and encourage '*out of left field thinking*' by management which should be rewarded where productive.

Such analysis should provide a clear understanding of the current internal and external environment of the REIT together with the potential future internal and external environment facing the REIT. The REIT's current internal environment, being issues such as employee skill levels or availability of capital, may impact the REIT's strategic planning with critical self-assessment by the REIT, particularly around issues of culture and values, being an essential foundation for strategic planning.

Similarly, the current external environment, being issues such as the state of the economy or the real estate market for a particular sector, may also impact the REIT's strategic planning. By then analysing the potential future internal and external environments, the REIT may also identify a range of factors in the short to medium term future that may have an impact on the strategic planning process such as the potential availability of certain types of investment real estate for acquisition or the potential for legislative change impacting the REIT.

Strategic alternatives

Having clearly established the current environment, being where the REIT is now and the Vision, being where the REIT wants to go, the REIT management team has a starting point and end point for the journey and now needs to determine the optimal route, being usually one route from a range of possible routes which each offer differing advantages and disadvantages.

For an existing REIT portfolio, the identification of the optimal route for strategic planning needs to accommodate individual projects already underway and current or anticipated property specific issues. For example, if a redevelopment project is partially complete or a whole building lease to a major tenant is due for renewal in six months' time, these issues cannot be disregarded in the strategic planning process and must be accommodated in the identification of the optimal route. Similarly, the choice of the optimal route may be influenced by medium term expectations such as upcoming major capital expenditure for plant replacement or the impact of a competing development.

In order to determine the optimal route, the use of scenario analysis is common whereby a range of distinctly different but plausible potential routes or strategic alternatives are identified as scenarios for individual assessment. Each scenario may be initially assessed by testing against the following five criteria:

- **comprehensibility** – being whether the strategic alternative can be clearly understood;
- **appropriateness** – being the extent of fit with the Goals and Vision;
- **sustainability** – including economic, environmental and social responsibility;

- **feasibility** – being the readiness and ability of the REIT to implement the strategic alternative; and
- **accountability** – being the ability for quantitative and qualitative reporting and accountability mechanisms to be developed for the strategic alternative.

Such initial testing may result in the range of strategic alternatives being narrowed to, ideally, two or three for detailed analysis through cash flow modelling at the REIT level. By testing the impact on earnings, distributions, debt covenants and so forth, each remaining strategic alternative may be analysed and the optimal strategic alternative derived.

Before adoption, the optimal strategic alternative should be further analysed through sensitivity analysis, whereby key inputs are varied and the sensitivity of earnings, distributions, debt covenants and so forth, monitored. Such sensitivity analysis is commonly based on three possible states for the REIT, being the most likely, optimistic and pessimistic, with attached probabilities.

Accordingly, in developing the Strategic Plan at the REIT level through the selection of the optimal strategic alternative, the strategic planning process considers the return outcomes of each strategic alternative in the context of the risk profile resulting and the extent to which each may be consistent with and likely to achieve the REITs Goals and so attain the REIT's Vision.

1.9.3 Strategic Plan

Having considered the applicability of strategic models and undertaken the strategic planning process, the REIT has developed a Strategic Plan which provides a route map to the achievement of Goals by the REIT.

With a clear Vision and a small number of specified Goals capable of being achieved through the Strategic Plan, the REIT is now in a position to develop Objectives with which to align REIT management executive motivations with fulfilment of the Strategic Plan.

1.10 Objectives

Unlike the Vision, Style, Goals and Strategic Plan which are public statements, Objectives are a non-public or internal statement by the REIT. Objectives should be reviewed annually or bi-annually in line with the performance plans of those REIT executives tasked with the achievement of the Objective in order to ensure alignment. Objectives are developed by the respective line managers and then discussed and agreed with each relevant REIT management executive as part of the periodic performance planning process administered by the HR Team.

With the Strategic Plan conceptualised as the route map to the achievement of Goals by the REIT, Objectives comprise the checkpoints along the route adopted. Unlike Goals, Objectives may be many but otherwise meet the same criteria for effectiveness including relevance, independence, clarity and so forth.

Objectives may be likely to be smaller, discrete items for achievement which, when fulfilled in aggregate across the REIT, achieve the stated Goals and which are capable of reward for achievement at the individual REIT management executive level. Accordingly, an individual REIT management executive may have a series of Objectives for which achievement results in satisfactory performance of the role and exceeding results in some form of remuneration linked incentive such as the payment of a bonus, as well as contributing to the achievement of a Goal at the REIT level.

In summary, therefore, achievement of Objectives by individual REIT management executives contributes to the fulfilment of the Strategic Plan which, in turn, results in the achievement of the stated Goals which, in turn, results in the attainment of the Vision. Thus, through the careful implementation of each Step in the Envisioning Stage, a REIT may align the motivations and actions of all employees with the attainment of its Vision.

1.11 Super REIT

The implementation of the Envisioning Stage may be illustrated by application to Super REIT, a $15 billion diversified REIT. As a large REIT, Super REIT considers itself to be a sector leader and reflects this in the development of its Vision:

> '*Super REIT's vision is to be the premier diversified REIT on the stock exchange.*'

As such, Super REIT's Vision is both aspirational and a qualitative statement, with '*premier*' being undefined and lacking either a financial or non-financial emphasis. Consistent with its risk tolerance and interdependent with its Vision, Super REIT's adopted generic Styles are active, top down and growth with its adopted specific Style being value added or core plus, reflecting its relatively large portfolio of good quality assets and moderate leverage of 40%.

Having adopted its Vision, Super REIT identifies four Goals to indicate how it intends to attain its Vision, having financial and non-financial emphases:

Goal 1 to be within the top quartile **return** performance of the stock exchange REIT index every year;
Goal 2 to be within the lowest **tracking error** quartile of REITs in the stock exchange index every year;
Goal 3 to be an **employer of choice** with five appropriate candidates for each career opportunity offered within two years; and
Goal 4 to be a **green real estate investor** with 25% of buildings in the portfolio green star rated within five years.

The principal Goal of top quartile return performance of the stock exchange REIT index every year is consistent with wealth maximisation which, when combined with Goal 2 concerning risk and the adopted Style, provides a stated time horizon and defines '*premier*' in the Vision in a financial context. Similarly, Goal 3 and Goal 4 define '*premier*' in a non-financial context. Accordingly, Super REIT may contend that the achievement of each of its stated Goals would result in the attainment of its Vision to be the premier diversified REIT on the stock exchange.

Having regard to its current portfolio, its current internal and external environment and its expectations about its future internal and external environment, Super REIT adopts an economy of scale strategic model and undertakes scenario analysis and sensitivity analysis to develop a Strategic Plan. Focusing on return optimisation at the REIT, portfolio and property level, measures for effective risk management at each level, steps to significantly improve the appeal of the REIT as an employer and a commitment to substantial capital expenditure to improve the environmental friendliness of several identified properties within the portfolio, the Strategic Plan includes a detailed strategy for each Goal committed to writing and supported by a large number of specified Objectives encompassing all REIT management executives in the respective Teams.

By way of example, the Objectives for the return optimisation aspects of the Strategic Plan include:

- budget debt interest cost reduction Objectives for members of the Fund Management Team;
- budget capital expenditure Objectives for members of the Portfolio Management Team;
- budget major rent review income Objectives for members of the Asset Management Team;
- budget net income Objectives for members of the Property Management Team; and
- energy cost reduction Objectives for members of the Facilities Management Team.

Each of which are linked to achievement in the performance planning process for the respective REIT management executives with exceeding achievement tied to a remuneration incentive.

Accordingly, if the members of the Property Management Team achieve their Objectives for budget net income this will help achieve the REIT Goal of being within the top quartile return performance of the stock exchange REIT index every year which, in turn, will help attain the Vision to be the premier diversified REIT on the stock exchange.

By replicating such a cascading approach from the Vision through the Goals, Strategic Plan and Objectives, Super REIT may effectively align the motivations and actions of all REIT management executives with the attainment of its Vision.

Having completed the Envisioning Stage, Super REIT has a clearly articulated destination together with a high order route map by which to get to the destination and some measurable outcomes to determine whether or not it has arrived at the destination. In order to convert its Vision into an identified target list of specific real estate assets for potential acquisition that meet the stock selection criteria and may be mis-priced, Super REIT must now embark on the Planning Stage of the REIT real estate investment decision making process.

1.12 Summary

While REITs may have an unusual legal or commercial structure to preserve their tax status and facilitate their tax effectiveness, they otherwise have much in common with other large business enterprises. The management structure of a large REIT resembles that of any other large business, with the exception of the sales and marketing and operational roles that have evolved into an investor interface role and the various line management roles involved in the fund level, portfolio level, asset level, property level and facility level management of the REIT portfolio.

The REIT real estate investment decision making process, whereby \$1 of unitholder capital is converted into \$1 of investment real estate, comprises three Phases, six Stages and 30 Steps. The first Phase is the Preparing Phase, comprising the Envisioning Stage (considered in this chapter) and the Planning Stage (considered in Chapter 2), with the second and third Phases comprising the Transacting Phase and the Observing Phase, respectively.

The Envisioning Stage comprises five sequential Steps, being Vision, Style, Goals, Strategic Planning and Objectives, whereby the REIT determines where it is going, how it is going to get there and how it will know when it has arrived at its destination. The Vision comprises an aspirational statement of a future state for the REIT, which is interdependent with the risk tolerance of the REIT expressed through the investment management

Style adopted. Key aspects of the Vision are translated into measurable outcomes through the identification of Goals to which management efforts may then be directed for achievement. Strategic Planning provides the link between the Vision and action through the identification of a range of activities which, when undertaken, will result in achievement of the Goals. Objectives then connect each REIT management executive with Goals through the Strategic Plan with defined responsibilities for achievement which are then recognised by remunerative reward.

Through undertaking the Envisioning Stage, the REIT creates a sequence of effective action whereby achievement of Objectives by individual REIT management executives contributes to fulfilment of the Strategic Plan which, in turn, achieves the Goals which then results in the Vision being attained for the REIT. Having completed the Envisioning Stage, the REIT has a clearly articulated destination together with a high order route map by which to get to the destination and some measurable outcomes to determine whether or not the REIT has arrived at the destination.

Completion of the Envisioning Stage positions the REIT to undertake the Planning Stage, wherein the REIT's Vision is converted into an identified target list of specific real estate assets for potential acquisition that meet the stock selection criteria and may be mis-priced.

Completion of the Envisioning Stage and the Planning Stage mark completion of the first of the three phases, the Preparing Phase, wherein the REIT articulates where it is going and how it is going to get there, providing unitholders with a clear understanding of the risk-return profile to expect from the manager's investment of their funds. This leads to the second phase of the REIT real estate investment decision making process, the Transacting Phase, completion of which then leads to the third and final phase, the Observing Phase, of the real estate investment decision making process.

1.13 Key points

- REITs are major **business enterprises** where the increasing dominance of institutional investors may be expected to pressure REIT managers to adopt more transparent, explicable and repeatable real estate investment decision making processes.
- REITs provide an **intermediation role** to unitise otherwise illiquid investment real estate, having unusual legal and commercial structures generally associated with the maintenance of their beneficial tax status.
- The **management structure** of REITs mirrors that of other major business enterprises but with operational line management functions reflecting the real estate investment management nature of the REIT business.

- The REIT real estate investment decision making process converts $1 of unitholder capital into $1 of investment real estate, comprising **three Phases, six Stages** and **30 Steps**.
- The first Phase of the REIT investment decision making process is the **Preparing Phase**, comprising the Envisioning Stage and the Planning Stage, followed by the Transacting Phase and the Observing Phase.
- The **Envisioning Stage** is a sequential process comprising the Steps of development of a Vision, adoption of an investment Style, identification of Goals and development of a Strategic Plan together with the specification of Objectives.
- Principal participants in the Envisioning Stage are the **Governing Entity**, **CEO**, **CFO**, **Support Teams** and the **Fund Management Team**, each contributing to the development of the REIT-wide Vision, Style, Goals and Strategic Plan.
- The **Vision** provides the foundation for all REIT activities and serves as the basis for development of strategic direction, being an aspirational statement for stakeholders and the market of where the REIT is going and how it intends to create value for unitholders.
- The investment management **Style** comprises the statement of risk tolerance for the REIT interdependent with and underlying the Vision, comprising a combination of generic and specific styles.
- **Goals** are stated measures or steps of significance to which the REIT management team efforts are directed and which, if achieved, will attain the Vision.
- The **Strategic Plan** is the route map to the achievement of Goals by the REIT.
- The **Objectives** are the checkpoints along the route map comprising the Strategic Plan, being linked to individual employee responsibility and remuneration.
- Achievement of Objectives will contribute to fulfilment of the Strategic Plan which, in turn, will achieve the Goals which will then result in **attaining the Vision** for the REIT.
- Completion of the Envisioning Stage may result in the REIT having a clearly articulated **destination** together with a **high order route map** by which to get to the destination and some measurable outcomes to determine whether or not the REIT has arrived at the destination.
- The Envisioning Stage is followed by the **Planning Stage**, where the REIT Vision is converted into an identified target list of specific real estate assets for potential acquisition that meet the stock selection criteria and may be mis-priced, with completion of the Envisioning Stage and the Planning Stage completing the first Phase, the Preparing Phase, so positioning the REIT to then enter the second Phase, the Transacting Phase.

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