DOI: 10.54254/2754-1169/109/2024BJ0173

How Does Corporate Governance Influence Real Estate Investment Trusts (REITs) Performance?

Yifei Su[1,a,*]

[1]*Business School, Durham University, Durham, United Kingdom*
a. wzkr35@durham.ac.uk
**corresponding author*

Abstract: This paper aims to study how corporate governance could influence the performance of Real Estate Investment Trusts (REITs). This paper uses literature reviews to analyze REITs' special features, such as the advisory pattern and mandatory dividends. In addition, as the birthplace of REITs, the United States has a highly sophisticated system. In this paper, U.S. REITs, such as S&P 500 REITs, are taken as the primary research object, and the compensation of CEOs of some REIT companies is also studied. Based on the research and analysis, it is concluded that REIT companies are highly susceptible to the influence of their multi-party shareholder ratios when faced with decision-making opportunities. Additionally, the responsibilities of each department within the company's management also affect the performance of REITs. Furthermore, the paper spares no effort to create a future academic research room and provides clear guidance for investors to have an initial understanding of REITs.

Keywords: REITs. Corporate governance. U.S. stock market.

1. Introduction

1.1. The Emergence of REITs

With the advances in financial technologies, the concept of Real Estate Investment Trusts (REITs) is now gaining more and more popularity and attention among investors globally. Based on Omokhomion et al.'s statement, a Real Estate Investment Trust is a corporation that owns income-generating real estate assets and allows investors to invest in the real estate industry and enjoy the diversification benefits brought [1]. The showing up of REITs does not just mean providing excellent opportunities for investors to put their wealth into real estate investments but also discovering a new financing source for real estate developers.

1.2. Research Implications

Similar to any other kind of investment, the performance of REITs could be affected by many factors. REITs are a newly developing financial derivative product, and research on the influence of corporate governance on REITs' performance is relatively limited. There is also little systematic theoretical framework at present.

By citing and analyzing literature, this paper aims to clearly understand how corporate governance varies with the traditional operating patterns in other corporations due to special legal requirements. Meanwhile, the paper could help investors gain better insight into how corporation governance influences the performance of REITs. In this paper, the REITs market in the U.S. acts as the main research object. The performance of U.S. REITs is evaluated after the discussion about how corporate governance varies with the traditional pattern. At the same time, based on the abovementioned discussion, the paper spares no effort to provide further research rooms on this and related topics.

2. Features and Implications

2.1. Definition of Corporate Governance

Due to the principal agency problem, conflicts among shareholders and the management team can harm a corporation's performance in various aspects, not just the financial one but also the corporation's reputation. Communicating methods have always been a debatable topic as they are a key component of maintaining investor relations.

Many successful companies need to put more effort into improving their corporate governance system. Corporate governance is a system of rules designed to alleviate the tense relationship between management and shareholders. All discussions about corporate governance share the common task of balancing the interests of a corporation’s stakeholders. Good corporate governance creates a transparent channel to align the interests of shareholders and management teams through rules, controls, and guides.

2.2. Definition of REITs

The concept of Real Estate Investment Trusts was introduced in the year 1960 by the U.S. It refers to the standardized financial products that are financed publicly by issuing income certificates to public investors through legal processes, holding real estate assets through special purpose carriers, for example, the assets owing company could set up a particular purpose vehicle company to manage the assets with risk isolation mechanisms, to be actively managed and operated by managers.

Looking back, many economies introduced the idea of REITs during economic downturns. For example, China introduced the concept of REITs under the condition of the superimposed influence of the pricing war with the USA and COVID-19. Japan authorities brought the J-REITs to the general public with proper adjustments in related industry regulatory framework under the pressure of a 20-year-lasting real estate depression.

All these cases suggested that REITs are a good tool for economic recovery as they have profound multifaceted macroeconomic meaning. With tax incentives, finite levers, and mandatory dividends, REITs positioned themselves beside debt and equity. The mandatory dividend made REITs a good investment option with both returns and risks in the gap between debt and equity.

Also, its unique characteristics of involving real estate assets made it a critical starting point for supply-side reform. REITs can significantly lower the cost for investors to invest in real estate projects. Without REITs, investors willing to invest in real estate must purchase the whole asset and wait patiently until arbitrage opportunities appear. REITs, acting as a bridge between the stock exchange market and real estate, undeniably enrich the investment sources for the general public.

The importance of REITs in the financial markets in developed or developing economies is undeniably profound. According to The European Public Real Estate’s REITs survey, it has unified statistics about the current development status of REITs in different countries. In the official report, the United States ranked first regarding the number of REITs listed, with 173 REITs. In Europe, Spain has the most significant number of REITs listed in the market, followed by the United Kingdom with 49 REITs. Thailand won first place in Asia with 61 REITs listed in the market, only one more than

DOI: 10.54254/2754-1169/109/2024BJ0173

Japan. Besides, it is worth noticing that Brazil has the second-largest number of REITs in the world. In the meantime, China was at the very initial stage, only having 8 in the market [2].

2.3. Corporate Governance in REITs

Real Estate Investment Trust's governance system varies from ordinary corporations due to a few legal restrictions. According to Ramachandran et al., as most REITs are still at the initial stage and are yet to break even, the solid corporate governance mechanism and strict monitoring of corporate governance performance could be beneficial to some extent to reduce the magnitude of losses for loss-making REITs and stimulates them to spend more effort to achieve a positive level performance [3]. This indicates that a unique corporate governance mechanism must be designed according to REITs' features. The following section will describe how REITs' legal restrictions forced the mechanism to be adjusted.

2.3.1. Mandatory Dividends

First, payout requirements vary to qualify for a REIT in different regions. For example, in Asia, China required REITs to distribute at least 90% of their consolidated distributable income to investors. According to Jensen, M. and Meckling, W.'s idea, they pointed out that the payout requirements tend to mitigate the principal-agency problems as the managements have less access to retained profits and, therefore, they are exposed to fewer opportunities to influence the way using the left disposable income [4]. Meanwhile, the payout requirement pressured the management teams to meet the dividend policies. Considering these challenges, the management team is forced to be more careful with their decisions. If the REIT company fails to meet the payout requirements, the stock market will punish the REIT through the price performance. Corporations are, therefore, compelled to raise capital elsewhere, probably through debts or equity, to meet the promised dividend.

2.3.2. Internal Advisory v.s. External Advisory

Secondly, another feature that differs from the corporate governance in REITs is the management structure the corporation chooses to be. The corporation could hire specific purpose business entities for its management to form external advisory REITs (advisory REITs). Such specific purpose business entities could provide services not just by giving suggestions on decision-making and purchasing certain assets, determining price inquiry range, numbers of shares issued, and declaring the dividend ratio.

Normally, these advisory companies could come up with stronger rational suggestions for managing the corporation. As the listing processes of REITs involve many complicated legal requirements, which can cause companies a lot of trouble, hiring advisors might help mitigate the surfer. Advisors often have a deeper understanding of the process, whether in terms of investment or law. Besides, with their undeniable strong expertise and insight into the market, they could adjust beforehand to avoid a considerable potential loss for the corporation.

However, this does not suggest that the external advisory does no harm to the REITs company's performance. Sagalyn pointed out that the potential conflicts in advisor REITs are more significant than self-administrated [5]. As the wage arrangement stated, the wage is determined based on the assets under external management. This particular wage rate could trigger the management team to manipulate the capital structure to purchase more assets to achieve their personal goal.

As the high mandatory payout forced the REITs to return capital to investors frequently, the investment opportunities are limited and left to the managers if they pursue growth in the corporation's value. This has created challenges for managers to be more cautious when raising capital. Hartzell et al. 's data analysis concluded that when management ownership is high, they make investment

DOI: 10.54254/2754-1169/109/2024BJ0173

decisions and change their outstanding shares in ways less responsive to the investment opportunities they face [6]. The results consist of the opinion that insiders and managers are more likely to pursue their private interest, according to Hartzell et al., ‘empire-building or maintaining control,' instead of simply pursuing corporation value maximization [6].

Therefore, due to the above dilemma discussed about hiring advisors, the corporation might decide to administer the corporation and the trusts by the company itself. Some Asian markets, such as Korea and Hong Kong, permit firms to be internal advisers.

2.3.3. Ownership Requirement

The Internal Revenue Code (‘IRC’) has introduced the “5-50 rule” to act restrictions on the ownership concentration of REITs. This rule requires five or fewer individuals to own directly or indirectly less than 50% of the total outstanding shares. According to Tan's research, they pointed out that as the sponsors hold a substantial number of shares in the external advisory pattern, the conflicts between shareholders and management teams can be partially mitigated [7]. This is because institutions are not considered single investors and do not necessarily follow the “5-50 rule”. Shares left for shareholders and managers are further deprived due to this feature. In this case, the rights of speech of the shareholders and the manager have been exploited so that conflicts of interest can have less impact on pursuing the corporation’s strategic goals.

2.4. U.S. REITs

The United States REIT market operates under one of the strongest regulatory systems. The US REIT regime allows companies to form any legal U.S. entity, such as corporations, partnerships, or limited liability companies. The regime permits the US REIT to own, operate, manage, and develop the assets for its own portfolio. This indicates that the US REIT-owning business entity can have variations in the structure of the management teams.

An enlarging body of literature has been carried out on how the board of directors in the corporation, especially the top executives, is rewarded and what its chain reactions are to the performance of the REIT. Griffith et al. (2011) first applied a panel fixed-effect regression model on the changes in the CEO’s compensation and the impact on the performance of REITs. The regression model is carried out based on the data of the REIT sample from 2000 to 2006. Afterward, Feng & Sirmans indicated that most of the previous academic works focused on the pay-for-performance compensation for CEOs [8]. Feng & Sirmans added more corporate governance variables, such as CEO Duality, the age of the CEO, and so on, to dig out a deeper understanding of the CEO’s power in influencing REIT performance [8]. According to this model, a significant positive relationship between the performance ratios of total return to shareholders over five years of operative company profit and future growth opportunities proxy and TDC CEO and EXE has been proven to exist. This further indicated that long-term CEO and executive compensation are packed with the corporation’s long-term performance.

On the other hand, though the investment and financial committees are no musts in the management framework of a company, their functions are also worth noticing. The investment committee’s main task is to conduct an analysis of available projects and an evaluation of related risks. It focuses on managing the cash flow effectively to realize the companies’ strategic goals and financial returns. At the same time, the financial committees are responsible for managing the whole entity’s finances. The financial committees' tasks include more than just deciding budgets, cost control, and formulating financing policies. Noguera applied panel regression on S&P500 and Non-S&P500 REITs to test ROA and ROE. Based on the regression model that he performed, he has reached the conclusion that for S&P 500 REITs, a negative relationship exists between the existence

DOI: 10.54254/2754-1169/109/2024BJ0173

of investment committees and the firm performance, while the Non-S&P500 REITs groups hold no relationship between these two events mentioned [9]. At the same time, Noguera provided a possible explanation for the lack of a relationship between the existence of financial committees and the firm's performance level [9]. Noguera pointed out that audit committees overlap with financial committees and are later made redundant in managing corporations and their assets [9].

Lastly, we will discuss below how the ownership structure requirement influences REITs' performances. Much academic literature has been written to seek the relationship between the ownership structure and the REIT's performance. Ascherl, one of these researchers, performed a more straightforward firm structure and a better measure of investment opportunities regression model and has reached the conclusion that REITs with higher portions owned by the institutions act more positively to investment opportunities [10].

Based on the above conclusion, the performance of a REIT corporation could be further influenced in various ways, whether positive or negative. For example, management is more active in pursuing investment opportunities. They might take more initiative to seek mergers and acquisition deals to adjust the asset portfolios by purchasing high-growth potential assets to improve the REIT's profitability. To prove this suggestion, Tanger REIT is an outstanding example of gaining more robust profitability after a merger and acquisition deal. Besides, if the corporation seeks investment chances, as long as it decides to make further investments, it has to hold meetings to declare announcements, which could further improve the transparency of information sharing and benefit the performance of REITs.

Oppositely, the rise in the willingness could result in an upsurge in the risks. Pursuing investment opportunities in REITs, such as purchasing new assets, could complicate the whole management process. In the previous discussion, the managers could be motivated to manipulate the asset structure due to the wage-setting mechanism. Therefore, the management teams might make irrational decisions, which in nature similar to gambling, such as putting large amounts of cashflow on risky assets.

Meanwhile, investment decisions force corporation managers to monitor their position and cash flow conditions more frequently as the corporation has a more extensive asset portfolio than before. Frequent observations are necessary since they allow the managers to adjust the operating pattern quickly.

3. Conclusion

In view of the fact that REITs are gaining increasing favor from governments and people in economies around the world, it is necessary to analyze and summarize how corporate governance affects the performance of REITs from various aspects because it can help provide policy-setting ideas for economies whose REIT development is just in the initial stage to catch up with the mainstream faster.

Looking through this paper reviews and quotes a large number of literature to ensure that readers can clearly understand the central significance and characteristics of REITs and corporate governance and also to analyze how the performance of some existing REITs is affected by C.G. based on several factors of REITs, such as mandatory dividend, internal and external consulting, etc.

This article should have made more effort to explain to readers in plain language how corporate governance directly or indirectly affects the performance of REITs in the operation model of REITs, not just limited to stock price and so on. Review many previous scholars' data analyses, enumerate the statistical regression models they have used, and cite their data analysis results for further critical evaluation to summarize the specific impact on company performance.

Given that the United States is the origin of REITs, its system has become one of the most complete in the world today. This article mainly lists the relevant analysis of previous scholars on the U.S. REITs stock market to explore whether there is any relationship between C.G. and REITs'

DOI: 10.54254/2754-1169/109/2024BJ0173

performance. By doing so, it is possible for newcomers to either copy America's REIT system or adapt it to the existing one.

To sum up, the impact of C.G. on REITs is mainly reflected in the company's management, from the top management to the existence of some departments and their related responsibilities, and whether the company needs to manage assets beyond the scope of its management because of its selfish desire to maliciously manipulate the company's operation mode.

REITs with a high proportion of institutional ownership are more proactive when faced with investment opportunities, which undoubtedly gives the company more significant potential to increase its profitability, market value, and other data that investors are concerned about. However, opportunities and risks always exist, which can also pressure management.

In other words, although the unique management mechanism of REITs makes management more cautious in making investment and financing-related decisions, mandatory dividends force management to pay more attention to whether they can guarantee their 90% mandatory dividend rate when facing financing solutions. However, more is needed to eliminate the conflict of interest between the two major entities. The particularity of REITs provides practical help at the level of unified interests of shareholders and managers.

References

[1] *Omokhomion, I., Egbu, C., & Robinson, H. (2018) Corporate governance and investment decision-making in real estate investment trusts (REITs). In RICS COBRA 2018 Conference.*

[2] *European Public Real Estate Association. (2023) EPRA Global REIT Survey 2023: A comparison of the significant REIT regimes worldwide.< https://www.epra.com/public-affairs/global-reit-survey>*

[3] *Ramachandran, J., Chen, K. K., Subramanian, R., Yeoh, K. K., & Khong, K. W. (2018) Corporate governance and REIT performance: A combined study of Singapore and Malaysia. Managerial Auditing Journal, 33(6/7), 586-612.*

[4] *Jensen, M. and Meckling, W. (1976) "Theory of the firm: managerial behavior, agency costs, and ownership structure," Journal of Financial Economics, Vol. 3 No. 4, pp. 305-360.*

[5] *Sagalyn, L.B. (1996), "Conflicts of interest in the structure of REITs," Real Estate Finance, Vol. 9 No. 2, pp. 34-51.*

[6] *Hartzell, J. C., Kallberg, J. G., & Liu, C. H. (2008) The role of corporate governance in initial public offerings: evidence from real estate investment trusts. The Journal of Law and Economics, 51(3), 539-562.*

[7] *Tan, D. (2009) Corporate governance: the case for Asian REITs (Doctoral dissertation, Massachusetts Institute of Technology).*

[8] *Feng, Z., Ghosh, C., He, F., & Sirmans, C. F. (2010) Institutional monitoring and REIT CEO compensation. The Journal of Real Estate Finance and Economics, 40, 446-479.*

[9] *Noguera, M. C. (2023) Investment and finance committees composition and firm performance: evidence from U.S. Real Estate Investment Trusts (REITs). International Journal of Disclosure and Governance, 20(4), 478-489.*

[10] *Ascherl, C. (2018) Essays on the Performance of Listed Real Estate Companies (Vol. 86). Universitätsbibliothek Regensburg.*