Valuation of Real Estate Investment Trust

(REITs)

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Introduction

Real Estate Investment Trusts (REITs) are the type of companies that own, operate, or finance income Generating Real Estate. REITs can be considered as mutual funds of the real estate investment sector. They act as a pool of several investors that aggregately collect dividends without even having to own, manage or finance any properties on their own. Everyone is well aware of the fact how much Indians love Physical Real Estate. So, for most Indian investors to invest in a REIT is an attractive option since REITs enable the investor to invest in the real estate industry without actually owning, managing, or financing any property by themselves making it more convenient for investors to explore the Real Estate segment of the markets more inclusively and liberally.

REITs provide a considerably steady income but offer only a little capital appreciation. REITs operate majorly in three distinct ways, which also categorizes them as follows:

1- **Equity REITs:** These are the type of fund which owns and manages income-producing real estate. All of the revenue generated by these funds is in the form of Rent (And not by reselling property). This rent is then further distributed to the investors as dividends on the invested capital.
2- **Mortgage REITs:** This type of fund does not own any property. In turn, they finance real estate properties and projects. The majority of the revenue generated by this type of fund is in the form of interest income. This interest received is then further distributed to the investors in the form of dividends.
3- **Hybrid REITs:** As the name suggests, hybrid REITs uses a mix of the strategy adopted by equity REITs and Mortgage REITs. They own as well as finance real estate assets and projects.

Type of Assets and Projects in which REITs usually invest

It is very important to understand the assets that these REITs hold/finances before moving on to the valuation of these assets. The characteristics of the assets of these trusts play a crucial role in the valuation of the REITs.

- Apartment Building
- Cell Tower,
- Data Centres
- Hotel
- Medical Facilities
- Offices

- Retail centres
- Warehouses.

Since these funds are traded just like stocks the liquidity, they carry is strong, unlike physical real estate which has a low level of liquidity. This type of investment is very attractive to people who want a stable and steady return. But, Capital Appreciation in this type of investment should be the least of the Investor's expectations.

SEBI (Real Estate Investment Trusts) Regulations, 2014

Eligibility criteria for REIT

The eligibility criteria for setting up of REIT is given u/s 4 of the Regulations as the following:

1. The instrument of trust is registered as a deed under the Registration Act, 1908.
2. The main objective of the trust is to carry on the REIT activities.
3. The sponsor, manager, and trustee are all separate entities.
4. There are no multiple classes of REITs.
5. The parties to REIT are fit and proper persons as defined under Schedule II of SEBI (Intermediaries) Regulations, 2008.
6. Whether any previous application for grant of the certificate has been rejected.
7. Whether there has been any regulatory action taken against parties to REIT.

Under SEBI (REIT) Regulations, there is a requirement to produce a NAV report and a full detailed valuation report by a Registered Valuer (RV) for purposes mentioned in the Regulations. According to these regulations, the NAV Report and the full valuation report carry a validity of 15 (Fifteen) days. As per regulation 21 of the guideline, the valuation of REITs should be done by valuing all the assets held by the trust. Ultimately the decision to choose the method to value these assets lies with the RV.

Valuation of REITs

The traditional way to value a company that is involved in Technology, Retail, Consumer industry, etc is to value them using Income Based Approach or Comparable Company Analysis. In the case of REITs, this is done using the NAV Method and the Discounted Dividend Model (DDM).

The difference here is that, unlike conventional companies, REITs generate revenues from the assets that are usually recorded at book value in the books of

accounts and do not contribute much to a company's valuation implying that are in the business of using these assets to generate cashflows.

One can find several comparable real estate being bought and sold in the market with data readily available for analysis providing a solid foundation for valuation of the assets held by an REIT. This implies that using the Real Estate Market, the fair value of the assets that REITs hold, can be estimated. The availability of historical data also ensures dependable valuations of real estate assets and REITs.

In this section, we will be discussing the methods of valuation that can be used in the to arrive at a fair value of an REITs.

Methods of valuation of REITs

The following ways of valuation can be used by a valuer to arrive at a fair value of REITs.

1. Net Asset Value Method (NAV)
2. Discounted Cash Flow Method (DCF)
3. Dividend Discount Model (DDM)
4. Multiples and Capital Rates Method (Comparable Analysis)

Net Asset Value Method (NAV)

The Net Asset Value method, or the NAV Method, is one of the easiest and simplest ways to measure the value of any company. The calculation involved is simple, and just a basic understanding of financial statements is more than enough to arrive at a fair value using the NAV method. The use of book value of assets and ratios such as price-to-book value are very unreliable when applied to REITs, so the NAV is used more or less to bypass the need for book value in favour to provide more accurate estimation of the value using the Market NAV which considers the market value of the assets for valuation.

NAV used for valuation of REIT would account for several things such as capitalization of operating income, considering capex for regular maintenance of the assets etc. NAV is done to give the investor a good solid initial estimation of the value of the assets that the REITs hold. To perform a NAV for an REIT we follow a certain set of steps:

Step 1: Value the fair market value of the Net Operating Income generating Real Estate assets.

- Take the Net Operating Income (NOI) from several real estate portfolios usually on a one-year forward basis and divide it by the estimated cumulative cap rate, or if the historical data of that asset is readily available, divide it by a more reliable appraisal value.
- When information is available, use distinct Capital Rates and NOIs for each individual property type and property.

Step 2: Adjust NOI down with the required Capital Expenditure for asset maintenance.

- Since Real Estate is the type of asset that required frequent maintenance, REITs incur a lot of Capital Expenditure (Capex) on the maintenance of the assets that they hold. Underestimating the expense incurred on the maintenance would ultimately overstate the value of the asset. So, ignoring the recurring cost of capex would result in an inaccurate value of the REITs, thus it requires adjustments.

Step 3: Value the income that isn't included in NOI.

- Income generated apart from general operations of the REITs like management fee, affiliate and JV income must be included in the NAV valuation of REITs.

Step 4: Adjust the value down to reflect corporate overheads.

- Corporate Overheads are the expenses that are not incurred due to operations but from other activities. These overheads are to be adjusted for, without which the NAV will be overstated.

Step 5: Add any other REIT asset.

- If the REIT is holding cash or other assets which are not accounted for, add them at their book value, or more practically, with a premium or discount which would effectively reflect market conditions.

Step 6: Subtract the debt component and the preferred share to arrive at the final NAV.

- All the non-operating financial claims against the REIT must be deducted from the value arrived at after adding the cash and other assets to arrive at the Equity Value.
- To calculate the fair value per share of the REIT from the Equity Value of the REIT, simply divide the Equity Value by the number of Diluted Shares.

- The value arrived at now is the Net Asset Value of the REIT.

Discounted Cash Flow Method

The Income Approach is widely used for valuation under the "Going Concern" basis. It focuses on the income generated by the REITs in the past as well as future, subjectively assuming its earning capabilities. DCF Method under the income approach seeks to arrive at a valuation based on the strength of future free cash flows.

Under the DCF Method, the trust is valued by discounting its Free Cash Flow for the explicit forecast period and the perpetuity value thereafter. The Free Cash Flow represents the cash available for distribution to both, the investors and other obligatory parties of the business such as creditors.

The reason why one would consider the DCF method to value an REIT is solely embedded in the fact that DCF method is concerned with the cashflows of the REIT and not solely with the assets that REITs hold. This method reflects on the earning potential of the business and not on the assets it holds.

The perpetuity (terminal) value is calculated based on this business potential for further growth beyond the explicit forecast period. For this purpose, "constant growth model" is applied, which implies an expected constant level of growth for perpetuity in the cash flows over the last year of the explicit forecast period.

Once the Free Cashflows of the REIT is projected (explicit period as well as till perpetuity), these future cashflows are then discounted to present value using a discounting factor. A discounting factor (rate of discounting the future cash flows) reflects not only the time value of money but also the risk associated with the business's future operations since it incorporates the Weighted Average Cost of Capital (WACC). The WACC based on an optimal vis-a-vis actual capital structure is an appropriate rate of discount to calculate the present value of the future cash flows as it considers equity-debt risk by incorporating the debt-equity ratio of the fund.

The Enterprise Value (aggregate of the present value of explicit period and terminal period cash flows) so derived, is further adjusted for:

- The estimated value of Contingent Liabilities likely to get crystallized (management estimate)
- Cash & Bank balances
- Surplus assets like land not in use
- Borrowings/loans and advances
- Value of non-trade Investments, if any
- Preference shareholder liability, if any

Peculiarities in REIT's DCF valuation

- Forecasting future cash flows is not easy or objective in many cases (due to industry, organizational factors)
- Huge amount of Capex is involved.
- Finding appropriate beta in Indian market conditions may not be a wholly objective exercise.
- REITs have to pay-out at least 90% of the net cashflows among the investors once at least every 6 months
- The Depreciation portion in an REITs P&L statement is significantly large.

Dividend Discount Model

Dividend Discount Model (DDM) of valuation is based on the assumption that the value of a company is the sum of all the company's future dividends discounted back to the present value.

This method is almost like Discounted Cashflow method (DCF). The only difference is that instead of discounting the cashflows we discount the dividend payments. This model is widely used in the valuation of REITs. The income received by the investors in REITs is in the form of dividends making this model the most well-suited fit for REITs valuation.

There are several approaches/variations to this method. Some of these variations are:

1. **Gordon Growth Model:** This method assumes that future dividends will grow at a constant rate for an infinite time. The formula for the same is as follows:

$$V_0 = D_1 / r - g$$

V_0 – The current fair value of a REIT

D_1 – The dividend payment in one period from now

r – The estimated cost of equity capital (usually calculated using CAPM)

g – The constant growth rate of the company's dividends for an infinite time

2. **One-Period Dividend Model:** This model is less used in valuation since the time consideration is restricted only to one year. Here the assumption is that the investor is ready to hold the asset for only one year. The One-Period Dividend Model uses the following Equation.

$$V_0 = (D_1 / 1+r) + (P_1 / 1+r)$$

V_0 – The current fair value of a REIT

D_1 – The dividend payment in one period from now

P_1 – The market price in one period from now

r – The estimated cost of equity capital

Multi-Period Dividend Discount Model: The cash flows expected in the future will consist of several dividend payments and the estimated selling price of the stock at the end of the holding period. The intrinsic value of a REIT (via the Multiple-Period DDM) is found by estimating the sum value of the expected dividend payments and the selling price, discounted to find their present values. The equation used by this formula is as follows:

$$V_0 = [D_1/ (1+r)^1] + \{D_2/ (1+r)^2] + ... + [D_n/(1+r)^n] + [P_n/ (1+r)^n\}$$

V_0 – The current fair value of a REIT.

D_n – The dividend payment in n period from now

P_1 – The market price in one period from now

r – The estimated cost of equity capital

Multiple and Cap Rates method

This method is rarely used to value an REIT. Though when valuing an REIT, we can use this approach to ensure that our actual valuation is in check with the market comparable multiples/cap ratios.

The 3 most common metrics used to compare the relative valuations of REITs are:

1. **Cap rates (Net operating income/property value) –** This ration takes the net operating income of the firm compares it to the property value to give out a ratio that reflects majorly on the relationship between the assets held by the REIT or comparable (whichever assumed) and not on its operation.

2. **Equity value / Funds from Operations –** This ratio represents the relationship between the Equity Value of the firm arrived at using any of the previously mentioned methods, and the Funds from Operations of the REIT to give out a performance ratio of the trust. FFO takes in to account values like Depreciation & Amortization, Loss/Gain on sale of assets etc. Since, FFO is used in a variety of situations, calculation of the same is pretty standardized. The formula for the same is as follows:

   FFO = (Net Income + Depreciation + Amortization + Losses on Property Sales) – Gains on Sales of Property – Interest Income

3. **Equity value / Adjusted Funds from Operations –** This ratio is similar to the ratio consisting of FFO. This ratio establishes a relation between the Equity Value of the firm, and the Adjusted Funds from Operations. Although there is no standard formula for AFFO but for an REIT it might look something like this:

   AFFO = **FFO** – Capital Expenditures – Routine Maintenance Costs

Concluding thoughts

REITs are some of the most attractive investments of stable source income securities that Indian Investors would love to engage with. The stability of the dividend payments provided by these trusts makes it a good option for investors whose risk appetite is on the lower spectrum of the scale. In terms of the valuation of these trusts, we must be fair and realistic with the assumptions taken in the due process of valuation using any of the above mentioned. The liquidity as well as the strong connection with the physical asset acts as an assurance against the risk concerns of investors.

The complexity arises when there is a pool of different types of Real Estate that the REIT holds with itself which requires separate valuation, subject to the characteristics of the assets held. To tackle this problem, we must break down and understand each asset held to arrive at a fair value of REIT.

Source : REIT Valuation: 4 Approaches Used in Practice (wallstreetprep.com)