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CORPORATE GOVERNANCE AND INVESTMENT DECISION-MAKING IN REAL ESTATE INVESTMENT TRUSTS (REITs)

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ABSTRACT

Corporate governance helps to limit problems arising from the separation of ownership and management interests. The principal-agent problem occurs when managers act in their benefit at the expense of shareholders. Real Estate Investment Trusts (REITs) offer a unique setting to investigate the effect corporate governance has on a firm's performance by tackling corporate governance problems. Corporate governance and REITs research has received notable coverage; mostly in the United States with limited research directed at other REITs regimes (United Kingdom, South Africa and Nigeria). Additionally, researchers have largely ignored the investment decision-making processes undertaken by REITs and the effect this has on performance; as not all decisions are rational. This paper aims to identify the critical elements of corporate governance, investment decision-making by REITs. The findings will contribute to the development of a corporate governance scoring framework based on an analysis drawn from the United Kingdom, South Africa and Nigeria REITs. The framework will be further developed using detailed case studies and secondary sources of data, and a proposed self-scoring measurement of the quality of corporate governance and investment decision-making for REITs.

Keywords: corporate governance, firm performance, investment decision-making, real estate investment trust, real estate.

INTRODUCTION

A Real Estate Investment Trust (REIT) is a company that owns income-generating real estate, like mutual funds. It allows investors the ability to invest in the real estate sector that is capital intensive, enjoying benefits of diversification and capital appreciation. The concept of indirect investment in real estate through REITs has generated significant interest globally with major regimes introduced in both developed and emerging markets. Global REITs has grown at an enormous rate since the global financial crisis of 2007/2009. REITs or REIT-like regimes are now present in over 36 countries, made up of over 480 corporations with a market capitalization reaching US\$1,544 billion and a dividend yield of 3.7% above the FTSE All-world yield of 2.43% as at February 2017 (FTSE 2017a). REITs became operational in 2007 in the United Kingdom (UK) and Nigeria while in South Africa (SA) the legislation for REITs formation was passed in 2013 allowing the conversion of existing listed property companies to REITs. The UK has 28 REITs capitalized at US\$61.67 billion, SA having 11 REITs capitalized at US\$17.9 billion and Nigeria has 3 REITs capitalized at US\$125.949 million (FTSE 2017b; CAHF 2017). Though REITs

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jurisdictions have some differences in structure, strategy and operations, certain key themes for performance remain constant. Ernst & Young (2016) identified 12 broad areas to be focused on for better development and acceptability of REITs. Of these 12 broad areas identified, 9 areas (capital flow to the sector, financing, property specifics, financial reporting, regulatory environment, cross-border issues, transaction activity, risk management, and lastly corporate governance) are represented in every REIT regime and help to portray the level of its maturity. However, corporate structure, capital allocation and market trends are seen to vary across countries, and at the firm level.

The significance of corporate governance and performance of REITs is further observed in the recent publication of the Global Real Estate Transparency Index 2016, which inter alia shows, that when evaluating the real estate market in any country, corporate governance plays a vital role on the index. The UK is ranked 1st in transparency with an established REITs regime, SA ranked 25th with an emerging REITs and Nigeria 88th with low transparency (JLL 2016). These findings suggest a need for better understanding of the challenges facing emerging REITs with the disclosure of corporate governance and financial transaction key to investment in the sector. As REITs continues to gain popularity, there is a need for more research to understand the effects of corporate governance and investment decision-making on the performance of REITs. From preliminary observation, the bulk of prominent research on these themes originated from studies on REITs regimes in the United States and Asia Pacific region. REITs in the UK, SA and Nigeria have so far received limited research. For REITs, to remain an attractive investment option, corporate governance structure and investment decision-making processes are crucial. A review of relevant literature on corporate governance and investment decision-making by REITs will be carried out, on studies of REITs regimes operating in the UK, SA, and Nigeria.

RESEARCH METHOD

The study adopts a literature review to examine; the unique REIT structure; quality of corporate governance, investment decision-making and its impact on REIT performance. The findings will provide insights to develop questions for the second stage of the study involving detailed case studies in the REITs jurisdictions of UK, SA, and Nigeria to understand the critical elements of corporate governance and investment decision-making to improve the performance of REITs further. Relevant literature in the key thematic areas (corporate governance, investment decision-making and REITs) were searched using Google Scholar, to obtain journal articles and reports. The REIT regimes of the UK, SA, and Nigeria are selected due to close similarity in their REIT structure and corporate governance regulation and how it is applied.

REVIEW OF LITERATURE

Corporate governance remains a crucial part of the success of a firm. Disputes exist, as REITs operating in highly developed institutions have shown the limited effect of corporate governance on their performance. Corporate governance as seen from a developed REIT regime perspective may not apply directly to emerging or developing regimes. Using corporate governance in real estate investment trust (REIT), it is possible to assess the impact corporate governance has on the performance of REITs taking account each jurisdiction corporate governance specifics. Parker (2014) examining real estate investment decision-making conceptualized it as when \$1 of

shareholder capital is converted into \$1 of property investment, both authors reviewed the literature around property investment decision-making overall and the decision-making process of REITs. He suggests an identification of the normative model of property investment decision-making from literature, followed by a descriptive model obtained from interviews of decision makers and finally a prescriptive model to show how ideally investment decisions making can be optimized. However, real estate investment decision-making process takes on many stages or phases which have resulted in ambiguity in processes and inconsistency in definitions leading to different classifications of the real estate investment decision-making start and end points in models developed by various researchers.

CONCEPT AND SCOPE OF CORPORATE GOVERNANCE

Understanding the concept and scope of corporate governance can pose some challenges. Notwithstanding, this can be viewed from two prevailing perspectives which are the behavioural pattern and normative framework. Scoping using the behavioural pattern will be carried out in a single country or at firm level looking at the things such as the behaviour of corporations, performance measures, financial structures, efficiency, growth and treatment of shareholders and stakeholders. On the other hand, the normative framework of corporate governance relates to the system of regulations, labour and financial markets under which firms operate. Research on REITs and corporate governance has mostly been carried out using the behavioural pattern.

Claessens & Yurtoglu (2012) identifies that behavioural pattern which studies firms with a country researcher evaluates; board of director's operations, executive compensation on firm performance, the relationship between labour policies & performance and roles of stakeholders & shareholders. They add that weak corporate governance in a country and firm-level caused by a lack of transparency and information asymmetric problem will eventually result in a failing financial market. This study on governance, economic development and well-being find that a better corporate governance framework is of advantage to firms coming with ease of access to funding, reduced cost of capital, improved firm performance and acceptability by stakeholders internationally. Using the behavioral pattern, researchers have examined different subject areas under various themes; agency cost, ownership and managerial behavior (Jensen & Meckling 1976), financing, information asymmetric problem and agency (Myers & Majluf 1984), investment behavior and ownership (Hartzell et al. 2006), corporate governance and capital structure (Brenni 2014). These papers look at the various individual component of the corporate governance discussion analyzed from different underlying performance measures such as Tobin's Q, return on equity or asset etc. These studies demonstrated the significance of corporate governance and the direction which future research may be heading.

REITS STRUCTURE

The unique structure of REITs brings about a different aspect of the corporate governance research due to its peculiar structure which differentiates it from regular corporation. Similarities in the REIT structures of UK, SA, and Nigeria are observed in their; distribution requirement, ownership structure, listing requirement, and asset activities restrictions (see Table 1). The REIT structure and operation changes the rationale of the principal-agent problem; which is a situation where agents take decisions that benefit themselves at the expense of current shareholders. This is as a

result of shareholders lacking the incentive to monitor the principal due to diverse ownership (Jensen & Meckling 1976). Examining the REIT structure and operations, the distribution rule which requires REITs to distribute at least a minimum of 70%-75% in Nigeria and SA while in the UK at least 90%, should check the principle-agent problem by restricting cash flow. The cash flow restriction unique to REITs limit agent's expropriation and requires the agent to make an effective investment decision that provides long-term benefits to shareholders. It is also an essential feature in monitoring REITs as they are forced to return to the capital market for external funding allowing potential investors to analyze firm performance.

Table 1: Analysis of REITs structure in Jurisdiction of study based on corporate governance mechanisms

	Nigeria REIT	U.K. REIT	South African REIT
Listing	Yes	Yes	Yes
Management	Internally mostly	Internally or Externally	Internally or Externally
Income Distribution	Minimum 70%	At least 90%	At least 75%
Leverage	Limited to 15%	1.25 or greater	60% assets
Activity Restrictions	75% of total asset directly invested in real estate. 25% of real estate related assets.	At least 75% of profit and 75% of total asset value must be related to the property business.	75% of income from rental or from indirect property owned
Shareholding Restriction	Minimum of 300	35% shares available to the public. New REITs 'close' to 1 st 3yr	20% held by the public if it must be listed
Taxation at REIT Level	Exempt from income & capital gain.	Exempted.	Exempted
Taxation at Shareholder Level	Corporate and Individual shareholders pay a discounted tax and WT	Domestic corporate shareholders pay CT rate, and individual shareholders are subject to WT, CGT and foreign shareholders pay WT	CGT 22.4%. Individuals pay CGT of 40% of gains on taxable income. Effective rate 7.2% and 16.4%

Source: Compiled author and Adapted from Wai (2013)

Ownership structure requires REITs be widely owned influencing its corporate governance. This rule prevents the build-up of blockholders that influence investment decision-making, benefiting from inside knowledge and preventing hostile take-over allowing REITs to focus more on long-term strategies. Amendments to REITs legislation has allowed for institutional investors without breaking the diverse ownership requirement; this increased monitoring by institutional investors to ensure investments by REITs align with long-term shareholders objectives. From asset activities restrictions, REITs invest largely in real estate. It is possible to observe real estate investment activities and the potential to study the investment decisions making at the firm and asset level as most REITs are publicly listed, and activity restriction rules in most countries require 75% of assets be invested in property, making it possible to identify when a major property is acquired, held and disposed (Eichholtz & Yönder 2015). Though the REITs structure provides a way of tackling corporate governance problems, shortcomings exist. Bauer et al. (2010) identified that the compulsory payout distribution only applies to net earnings, with an allowance of substantial depreciation on real estate income written off from its taxable earning allowing REITs managers to freely decide on the actual payout ratio of the free cash flow. It is important for REITs regimes in the UK, SA, and Nigeria to take note of the unique elements of its structure such as; distribution requirement, ownership structure,

listing requirement, and asset activities restrictions that have an influence on corporate governance and investment decision-making.

QUALITY OF CORPORATE GOVERNANCE IN REITs

The REITs regimes in UK, SA and Nigeria represent a significant part of each country's real estate market. By market capitalization, the UK has the largest operating REITs in Europe; SA REITs the largest in Africa due to its vibrant real estate market and Nigeria operates the largest REITs in sub-Saharan Africa (CAHF 2017). The REITs regimes in Nigeria and SA are relatively immature when compared to those operating in the UK and all have in common a lack in the breadth of research evaluating the concepts of corporate governance, investment decision making and how this affects performance.

Drawing from research from other REIT regimes, it is possible to examine the effect of corporate governance on the performance of REITs using selected individual corporate governance factors such as; ownership structure, executive compensation, board composition. Eichholtz and Yönder (2015) looking at CEO overconfidence in US REIT investment found that CEOs who are overconfident make more investments which usually are suboptimal investment decisions resulting in poor investment and lower net present value (NPV). Hartzell et al. (2006) looking at various ownership and board factors of equity REITs from 1995 to 2004 observed that there is a positive relationship between institutional, insider ownership and Tobin's Q. REITs with a strong corporate governance respond positively to investment decisions that improve performance but decreases with the entrenchment of insider ownership. Looking at executive compensation, Ooi (2009) observed that in 20 Singapore REITs, after IPO there is an inverse relationship between the base fee and performance, but a positive relationship between incentive fees post IPO performance of REITs. These studies provide a multitude of results from the different association between selected corporate governance factors and performance variables. To summarize, the performance of REITs in the long run, just like other investments, will be affected by the major institutional factors; corporate governance, legal quality and accounting standard quality (Edelstein et al. 2011).

On the measure of the quality of corporate governance, there are several corporate governance ratings, indices or scoring framework that has been used in research on REITs corporate governance and performance. These are accepted and used by academics and institutions globally in the measurement of quality of corporate governance (see Table 2). A summary of these include; a self-constructed corporate governance rating used by (Brenni 2014); Governance Index (*G-Index*) based on the Institutional Investor Research Centre (IRRC) applies takeover provisions an external corporate governance proxy for measuring shareholder rights (Gompers et al. 2003); Corporate Governance Quotient (*CGQ*) index developed by the Institutional Shareholder Services measures both internal and external corporate governance proxies used in studies of REITs mostly in Europe and US; *Entrenchment Index* measures external corporate governance proxies that limit shareholders right and resistance to hostile takeover; and the Asia Pacific Real Estate Association Corporate Governance Scoring Framework (*APREA CGSF*) using external and internal corporate governance in mainly Singapore REITs (Lecomte & Ooi 2013). Apart from the G-Index and Entrenchment Index which measures external proxies of corporate governance, a higher score on the other scores (using internal and external proxies) can be translated as having better corporate governance practice that reduces agency

problem translating to better performance. This is considered a more efficient approach, offering a better understanding of the quality of corporate governance, investment decision-making and performance of REIT.

The use of corporate governance scores or indices provides an alternative methodology for the measurement of the quality of corporate governance because of the selection of proxies (internal or external proxies of governance) used in the measurement. Corporate governance scores or indices should be used with an understanding of the underlying criteria for measuring performance. Evidence from strongly regulated economies such as the UK and the United States show that corporate governance has less impact on performance.

Table 2 Analysis of researchers on corporate governance and performance using a score

Literature	Index/Framework	Performance	Finding
Brenni (2014): UK REITs	Self-Constructed	Tangibility, firm size, profitability, volatility, growth opportunities, non-debt tax	Board Size, CEO duality, tenure, and remuneration -VE correlated to leverage. Board independence (non-executive directors) +VE related to leverage.
Bauer et al. (2010): US REITs	CGQ Index	ROA, ROE, Tobin's Q, sales growth, net profit margin	Index not related to Tobin's q or ROA, ROE
Lecomte & Ooi (2013): S-REITs	APREA	1yr forward stock return, Jensen alpha, ROA, ROE	Corporate governance and stock performance +VE. -VE to operating performance.
Gompers et al. (2003): US	G-Index	Excess returns, Tobin's Q, net profit margin, ROE, 1 yr sales growth	Stronger shareholder rights have +VE firm value, profits, and sales growth. No link to ROE
Bebchuk et al. (2009): S&P 500	Entrenchment Index	Tobin's Q, monthly abnormal return.	-VE relationship to index and Tobin's Q. -VE relationship to index with monthly abnormal return
Wai (2013): Hong Kong and Singapore REITs	Integrated (ICGSF)	CGSF ROA, ROE, Sharp Ratio, Tobin's Q, Dividend Yield, Debt/Equity	Index, dividend yield show +VE relationship with Tobin's Q. Debt/Equity no significant impact on Tobin's Q

Bauer et al. (2010) explain this as the REITs effect. However, Daines et al. (2009) on ratings of corporate governance shows that these may be used to change firm practices increasing rating but does not predict future shareholder litigation, operating performance, stock returns and cost of external finance. The failure to anticipate outcomes can be linked to measurement errors, as commercial rating does not occasionally correct for the endogeneity of variables. This gives some merit to an academically provided rating of the quality of corporate governance and a more reliable and valid academic measure that goes beyond the check-and-sum approach which fails to highlight provisions that can be substitutes or complements. REITs regimes in the UK, SA, and Nigeria should note the unique elements of its structure such as; distribution requirement, ownership structure, listing requirement, and asset activities restrictions that influence corporate governance and investment decision-making.

REITS AND CORPORATE GOVERNANCE RESEARCH IN THE UNITED KINGDOM, SOUTH AFRICA, AND NIGERIA

From the review of the literature, corporate governance and firm performance researchers on REITs in UK, SA and Nigeria are limited. However, some studies evaluating these themes in the UK, SA and Nigeria are discussed here. Brenni (2014) on corporate governance and capital structure decisions of UK listed real estate companies, measures the quality of corporate governance and leverage. He finds evidence that listed companies with larger board sizes, and greater CEO remunerations use less leverage, a negative relationship between the number of outside directors and the level of leverage used. Finally, there is an indication of the UK REITs being highly geared contrary to expectations of lower debt levels.

Newell & Marzuki (2016) studied the performance of the UK REITs pre-and post-Global Financial Crisis (GFC). Their results highlight the significant position REITs plays in the UK real estate sector. They identified that pre-GFC the UK REITs significantly underperformed overall stock market with high-risk levels associated with investment in the property sector. Post-GFC results show the REITs regime appreciated speedily exceeding stocks and property companies. More recently, Jadevicius & Lee (2017) examined returns on different days of the week using the five largest UK REITs and non-REITs. Data were obtained during the pre-and-post-2007 period of REIT regulation introduction. Using Kruskal-Wallis test and dummies to control for outliers, the results show that UK REIT returns were significant during the middle of the week and negative on Monday. It suggests that there exists an inefficiency in the UK REITs market and investors should buy on Monday and sell on Tuesday or Friday all things being equal.

Ugwoke et al. (2013) used board proxies to measure the corporate governance and performance of listed companies in Nigeria REITs included; administering questionnaire to three top-ranking managers/accountants in 72 companies and finds that there is significant positive relationship between the board size, composition, frequency of meetings, regularity of members' attendance and performance. Identified is the need for more experienced non-executive board members to check CEO excesses and reduce CEO duality. Olanrele et al. (2015) carried out a comparison of dividend performance in Nigeria REITs benched against the Malaysia REITs. The risk adjustment return analysis, concludes that Nigerian REITs underperforms when compared to Malaysia REIT. Though some differences in the structures of the REIT regimes exist, improvement of the Nigeria REITs is achievable through increased market capitalization and transparency, reduction in the cost of finance, changes in management style and critically issues of corporate governance.

SA REITs differs other listed real estate in areas of taxation, legislation and legal formation. Ntuli & Akinsomi's (2016) analysis of the SA REITs shows its attractiveness to local and international investors. With evidence of a positive correlation between REITs and other listed shares offering good diversification option. Using a portfolio mix of bonds, shares and REITs, they concluded that REITs acted as a return-enhancer to the other investment. Against listed real estate, REITs had a higher return and lower risk. They also show that listed real estate have a weaker correlation with other assets, making REITs a better performer in the portfolio pool. Similar to an earlier research by Ugwoke et al. (2013) of corporate governance in Nigeria, Pamburai et al.(2015) examined 158 listed companies on the Johannesburg Stock Exchange (JSE), extracting corporate governance proxies (board size, non-executive directors, independent non-executive directors and number of meetings) manually from annual reports. Control variables (company size and leverage) are used to control for firm size, capital structure and risk, measured against performance

(Tobin's Q, ROA, EVA). Results from the regression analysis show that board size is negatively related to EVA meaning smaller boards perform better than larger boards. Tobin's Q is higher with more non-executive directors due to more monitoring. The frequent board meeting was, however, negative to ROA and Tobin's Q. Finally, firm size showed a positive relationship with EVA and ROA.

Emerging REITs exhibit issues such as limited market capitalization and transparency, property rights, regional politics protection, etc. which prevents more geographical diversification. Issues such as corruption, politics, and ownership structure of listed firm also affect the overall corporate governance in these regimes. With the onset of an institutional investor in the sector happening more in SA than in Nigeria, corporate governance and transparency of REITs will become of greater importance with possible enforcement better in SA (Afolabi 2015). Tsamenyi et al. (2007) express this as emerging market such as Nigeria and SA having high economic uncertainty, lacking in a legal institution for investor protection, weak stock market and economic performance and frequent government intervention which necessitates the need for the demand of effective corporate governance structures to encourage investors. Ernst & Young (2016) report on the global perspective of REITs in emerging markets identified several young REITs markets (SA, Mexico, and Spain) to observe. They suggest improvement on issues such as risk, real estate transparency, ease of doing business, corporate governance, and market capitalization. It is arguably the case that the Nigerian REITs market has a lot to benefit from these suggestions. The popularity of REITs has grown in SA given as several UK REITs are now cross-listed on the JSE while the Nigerian REITs is yet to reach that level. Research using the corporate governance of UK REIT will help to identify key corporate governance variables unique to emerging REITs in SA and Nigeria that need improvement.

INVESTMENT DECISION MAKING IN REITs

It is assumed that firms with strong corporate governance framework will have managers make investment decisions that align with shareholder's motives, leading to better firm performance. In the US, Eichholtz & Yönder's (2015) study of overconfidence in CEOs of REITs shows the need for a better understanding of the investment decision-making process. By observing corporate investment activities of US REITs CEOs regarding their stock portfolio, which is made possible by the full disclosure policy required to operate as a REIT. They observed that overconfident REIT CEOs in the US carry out more investment when they have access to discretionary cash. It is expressed by 1% increase in cash to asset ratio leads to 3-4% investment activity. In areas of acquisition activity and disposition, they found that the former increases by 0.8%-1.8% while the later decreases by 0.2%. Other results of the study using operating performance show that CEOs may have valuable information and use this to make an investment decision to their advantage showing poor corporate governance practices. They concluded that agency problems are higher in firms managed by overconfident CEOs.

Parker (2014) helps in the further understanding of investment decision-making taken in REITs. From his research, the investment decision-making process used by Australia REITs was identified. Drawing from the literature on property investment decision-making and REITs investment decision-making is used to identify the normative mode (comprising of four stages with 20 steps), then a survey of present investment decision makers in the Australian REITs to develop a descriptive model. These models of investment decision-making by REITs managers are used to develop

a proposed prescriptive model to contribute to the transparency and consistency investment decision-making. Applying a similar approach, it is possible to investigate these models in the developed REITs of the UK, and emerging REITs of Nigeria and SA. From a review of literature, it is possible to identify the models of investment decision-making that applies to REITs and develop a prescriptive model that improves the investment decision-making in REITs.

CONCLUSIONS

From the literature review, the key elements in REITs corporate governance and investment decision-making research are derived from its structure which are; distribution requirement, ownership structure, listing requirement, and asset activities restrictions. While corporate governance proxies such as board structure, remuneration matters, audit, organization matters, related party transactions, ownership and gearing have been used individually or within an index or scoring framework to measure the quality of corporate governance against performance. However, it has been identified that some of these regulations are circumvented still bringing out corporate governance issues.

In measuring the quality of corporate governance using internal and external proxies, institutions and academics have applied several approaches. When using any, it is crucial to understand the underlying methodology. Mixed results are observed from the various studies examined using some index or framework to measure the quality of corporate governance and performance of REITs, showing that corporate governance of highly regulated jurisdictions may have limited effect on the performance of REITs but becomes more crucial for emerging REIT regimes. The critical factors identified for the corporate governance and investment decision-making of REITs include market maturity, capitalization and transparency, management style and board issues. At a firm level, better corporate governance practice is expected to reflect on investment decision making by REITs, leading to an improvement in firm/shareholder value and reduced cost of capital. The behavioural pattern of governance is most suitable for research investigating corporate governance of REITs. Lastly, there exists ambiguity in the definition and scoping of the investment decision-making process of REITs. It is possible to identify normative, descriptive from the interview and propose a prescriptive model for investment decision-making for REITs. Contributing towards consistency and transparency in decision-making, leading to better decisions and optimal allocation of discretionary cash flow to ensure shareholder benefits are optimized. The findings will contribute to the development of a corporate governance scoring framework based on an analysis of the UK, SA, and Nigeria.

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