
Real Estate Investment Trusts (REITs): Management Structure and Performance

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Abstract

The REIT concept originates from the United States and invests in an income-producing real estate. Tax Return Act of 1986 allowed conversion of externally managed REITs to internal management structure to reduce conflict of interest and increase efficiency. Significant findings give merit to internally managed REITs showing they outperform externally managed REITs and have stronger corporate governance. However, REITs regimes in Asia Pacific region (Hong Kong, Singapore, Japan, Malaysia) are exclusive externally managed structure either by default or requirement highlighting some merits exist to the approach. With the rising number of REITs regimes, academic understanding of the effects of management structure and performance of REITs is required. This paper contributes to existing literature by exploring the impact of management structures on the performance of REITs regimes. This study adopts a systematic review of selected academic journal papers using Scopus. Empirical findings point to the benefits of internal managed REITs over externally managed REITs. Corporate governance proxies unique to external managed REIT such as; REIT organisations, remuneration, fees and related party transactions need improvement to boost performance. We find evidence that external managed REITs try to emulate internally managed REITs, increasing institutional investor carrying out more monitoring, employing less leverage and link compensation to performance to increase REITs value. As externally managed REITs become popular, similar results as internally managed REITs are obtainable and may be more applicable to REITs with smaller market capitalisation. To achieve this, high quality of corporate governance, skilled management team and transparency in fee structure become crucial.

Keywords: REITs; agency conflicts; management structure; externally management; internal management; performance

1. Introduction

Real Estate Investment Trusts (REITs) structure was established in 1960 in the United States and arose to allow large to small investors an opportunity to invest in the otherwise capital-intensive real estate sector (Semer 2009). Since then, the concept of REITs has grown worldwide, now in over 30 countries and made up of over 296 individual corporations with a market value as at March 2018 of \$1.14 trillion (FTSE 2018). REITs generate income by owning, developing, and operating income-producing real estate. Income can be derived from rents on a pool of properties or mortgages payments. Shares of REITs are traded not unlike shares on the stock exchange. Owners of REITs shares earn income from dividends from the net income earnings that it generates. REITs offer the benefits of long-term performance, stable dividend yields, higher liquidity, transparency, and portfolio

diversification (CAHF 2017). Regulations of REITs are relatively similar globally with slight country variations and present an avenue for researchers in areas such as corporate governance and firm performance. Hartzell et al. (2006) and Yönder (2013) identified the following unique regulatory setting that allows for empirical research:

- REITs offer a better measure of market value using Tobin’s q as all significant assets are reflected in their financial statement.
- Internal cash flow is restricted as REITs are required to pay almost 90% of earnings as a dividend to be exempt from corporate taxes, requiring REIT managers to be more efficient.
- To maintain REITs status, most REITs must have 75% of their assets in real estate or related businesses and generate almost 75% of gross income from real estate rent, interest, or mortgages on real properties.
- Ownership requirement for most REIT regimes requires that they be widely owned. Institutional owners do not break this rule as their ownership is passed through beneficiaries. The inclusion of institutional ownership by current legislation allows for better monitoring of REIT managers (Wang et al. 1993).

Following the seminal work of Jensen & Meckling (1976) we draw that just like any other large corporation, REITs are not immune to the agency conflicts that are likely to occur when there is a separation of ownership from management. In an attempt to reduce conflict of interest between management and shareholders, corporate governance mechanisms are created to ensure long-term sustainable performance. Numerous researchers have investigated how the REITs management structures can affect the performance of REITs due to the agency conflicts. The principal and agent problems could lead to situations such as; entrenchment and empire building by REIT managers leading to overinvestment or underinvestment, as well as other corporate governance issues (Chong et al. 2017b). REITs management structure takes on two predominate types which are internally managed and externally managed. Under the internally managed structure, managers are employed and controlled by the REIT entity. REITs employ their advisors, acquisition, and asset management staff. Conversely, externally managed REITs control and ownership separation occurs more clearly. The REIT entity employs an intermediary asset management firm to undertake the day-to-day property management, financial and operational tasks. In return, the REIT entity pays managers various fees for management. These fees come in two types, a base fee which is a percentage of the values of the fund's asset under management (AUM) and an incentive fee based on a percentage of the portfolio's income. The inferior performance of externally managed REITs in the US and issues caused by the global financial crisis has brought about the need to question fees paid to externally managed REITs executives (Ooi 2009). Figure 1 below shows the typical structure of externally managed REITs commonly observed in Asia REITs with a Sponsor and Trust Manager. For internally managed REITs, the Trust undertakes the role of Trust Manager with or without a Sponsor.

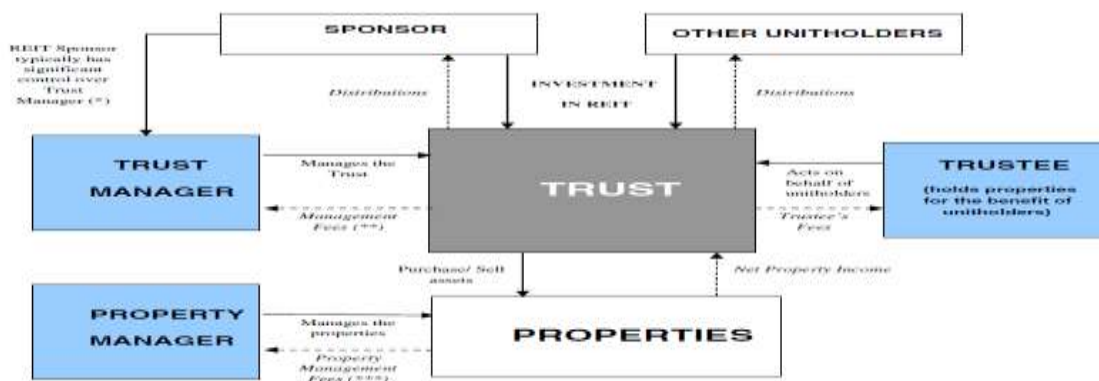


Fig. 1 Generic externally Managed REITs structure Source: (Lecomte & Ooi 2013)

From a historical context drawn from the US, REITs initially acted not unlike mutual funds but with the potential for trading. It was expected that REITs employed advisors that acted as managers with the duties of selection of properties and execution of property investment strategies on behalf of the REIT. Unlike other passive investments such as bonds and shares, property investments require active management hence the need to employ property managers; thus in the late 1980s, several REITs observed this inefficiency and conflict of interest between advisors/property managers and REIT shareholders (Wei et al. 1995; Ambrose & Linneman 2001). In 1986, change in laws allowed REITs undertake self-advisory and management. Fueling the rapid growth of REITs in the 1990s and spurred a range of academic research examining the organisational management structure of REITs and its impact on REITs performance. In Table 1 below, a sample of REIT regimes is reviewed. The justification of REITs internally managed over externally managed as seen from its earliest implementation in the US has not prevented REIT regimes elsewhere from embracing externally managed structure. Predominately, REITs especially in Asia, adopt an externally managed structure either by default or requirement which shows that some merits exist in externally managed REITs. With the increase in the adoption of REITs as a means of indirect investment in the property market, it is essential to understand how management styles and corporate governance strength of REITs have affected performance.

Table 1: Sample of Internally managed vs. Externally managed REIT

REIT/Year of Origin	Internal Management	External Management
US (1960)	169	26
UK (2007)	24	13
Netherlands (1969)	4	0
France (2003)	17	2
Belgium (1995)	8	2
South Africa (2013)	19	5
Italy (2007)	3	1
Australia (1985)	19	14
Ireland (2013)	1	2
Spain (2009)	1	3
Mexico (2004)	0	8
Hong Kong (2003)	0	8
Singapore (1999)	0	37
Japan (2000)	0	45
Greece	4	0

2. Research Methodology

This paper contributes to the body of knowledge on REITs management structure, corporate governance, and performance in both developed and emerging regimes. A systematic critical review of the relevant existing literature is carried out using Scopus search engine to retrieve academic peer-reviewed journals focusing on the key thematic areas. Scopus is selected over other search engines such as Google Scholar and Web Science because of the higher ability to apply appropriate filters and retrieve citation count which increases the relevance of peer-reviewed journal obtained (Tober 2011).

On Scopus, an advanced query search is carried out, under "Article Title, Abstract, Keyword" section, to search for relevant papers the following keywords were used to create the query string: "REITs", "real estate investment trust", "internal management", "external management", "corporate governance", "agency". It should be noted that the keywords used here were not intended to be exhaustive but applied to obtain an initial number of useable papers. Following Tsai & Wen (2005), papers of the types of 'editorial', 'commentary', 'responses', and 'book reviews' have been excluded from the analysis. The date range is left unlimited as the concept of REITs started in 1960 and change in the management structure did not occur until 1986. Additionally, limiters are placed on "Language" for only English journals and "Subject Area". The search using these queries identified 86 papers including papers published in key real estate journals (e.g. Journal of Real Estate Finance and Economics). Further analysis of abstracts was carried out; it was observed that some studies referred exclusively to "earning management", "REITs", "leverage", "capital structure" etc. but not relevant to themes of this study identified above. Consequently, these are excluded. After filtering, 19 papers were found valid for further analysis. Though this sample may be relatively small, it is enough to draw conclusions considerably and gain an in-depth understanding of the academic stand on REITs management structure and performance.

3. Classification and Analysis of the Literature

In this section, a systematic classification of the 19 selected journal publications based on publication year, journal title, country/territory, citation count, REIT regime sampled is carried out, to present a contextual understanding of the literature on REITs management structure and performance. In Figure 2 below, a distribution of the relevant articles published from 2000 is shown. It is observed that the published papers only go above one paper by 2012 with no publications at various points but is at its highest in 2017 with five papers. It is inferred that given the age and growth of REITs and assumed that academic research on REITs management structure should be more plentiful. The literature was further analyzed with respect to the journal of publication to identify the important journals in this area.

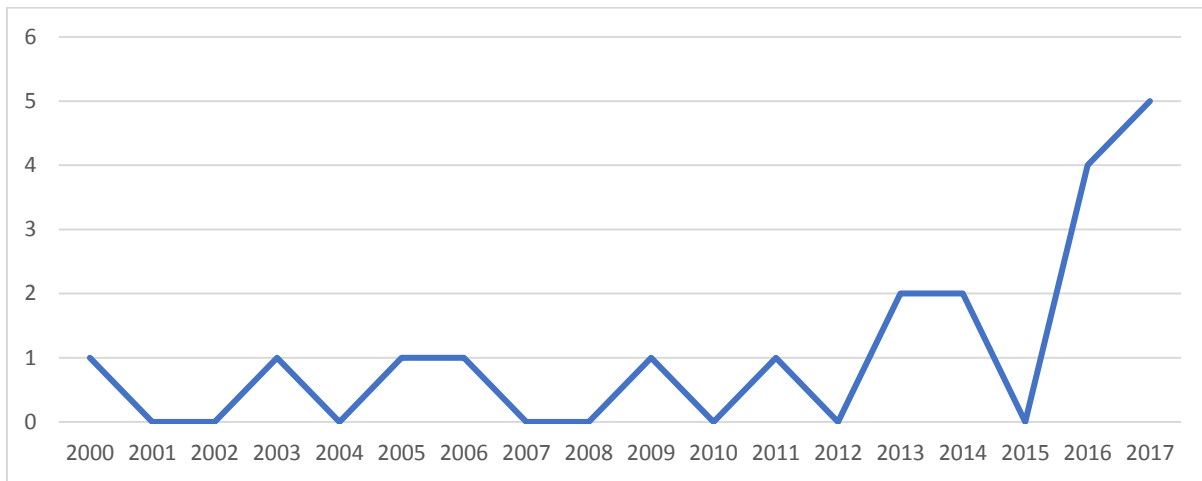


Fig. 2 Analysis of Publication Year

Figure 3 below shows that the twenty papers were spread across ten journals. *The Journal of Real Estate Finance and Economics* had the most publications of seven papers representing 37 percent of the papers obtained, followed next by *The Journal of Real Estate Literature* with three papers with 15 percent of the publications. Majority of journals here represent the popular journals for publication in academic real estate research.

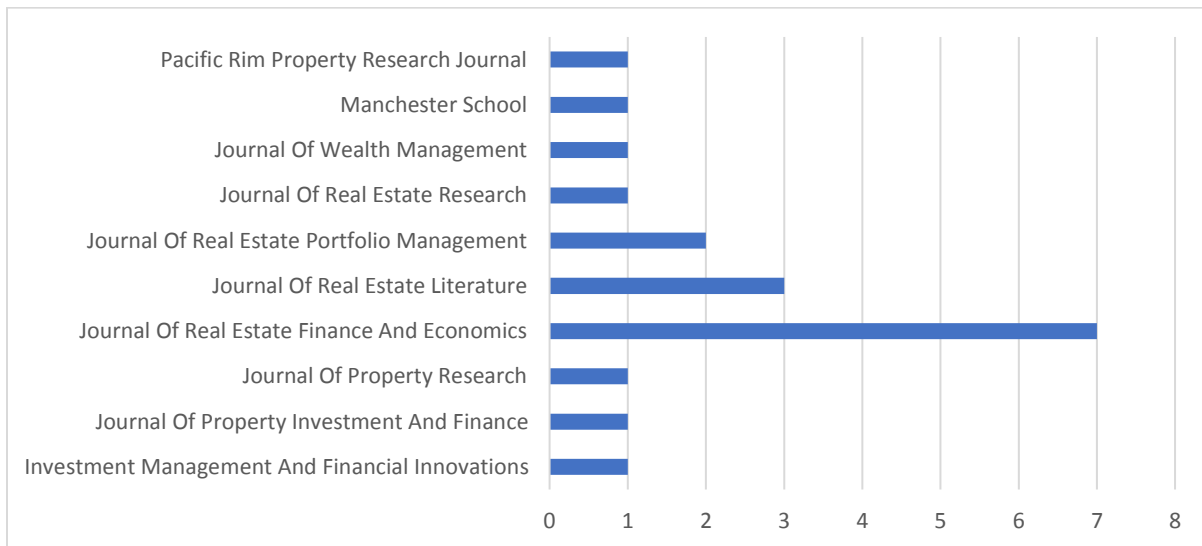


Fig 3 Paper distribution by the journal of publication

Appendix A gives the frequency count for citation, the country origin of the paper author, sampled period, REIT regime sampled and empirical findings. It is observed that majority of the papers (11) originated from the US, followed by Singapore (5) and Malaysia (4). This should not be confused with the country of sample data collection; for this REIT regime sampled for analysis draw mostly from the US and the Asia Pacific region (Singapore, Malaysia, Hong Kong, Japan, and New Zealand). This classification makes it possible to imply that the REITs management structure in other regimes especially emerging regimes has yet to receive enough research on its implication on performance. The exclusion is given to study by Das & Thomas (2016) study of REITs in India. From the sampled papers, the top 5 with the most citations originate and research the REIT regimes in the US and

Singapore with the work of Capozza & Seguin (2000) cited 67 times since publication. The empirical findings from these research papers document below.

4. Discussion of Empirical Findings

Content analysis is further carried out to provide summary information about the empirical findings of the sampled research studies. Content analysis is a technique for the objective, systematic and quantitative description of the manifest content of communication (Bos & Tarnai 1999). From the research papers analyzed, empirical evidence can be broadly broken down into evidence from the United States (has both internally and externally managed) and Asia Pacific (mostly externally) REIT regimes. In the US, the growth of internally managed REITs was linked to the introduction of Tax Return Act in 1986 allowing for the conversion of most externally managed REITs to internally managed REITs. However, the externally managed structure of REITs persists, as it is the most used structure of management in the Asia REITs of Singapore, Hong Kong, Malaysia etc. which are all exclusively externally managed. The 19 selected journal publications are analyzed to document what the effects a chosen management structure of a REIT will have on its performance.

Empirical results from research on US REITs show mixed results. Pre-1986, externally managed REITs mostly underperformed internally managed REITs (Capozza & Seguin 2000; Brockman et al. 2014). For externally managed non-traded REITs, large up-front fees paid to related parties for transactions and conflict of interests resulted in lower return (Henderson et al. 2016). Delcours (2005) find that internally managed REITs enjoyed favourable compensation as well. A study by Miller et al. (2006) show contrary to earlier observations, the performance of external managed or internal managed REITs depend on the measure of output. Measuring using assets showed that externally managed REITs outperformed internally managed REITs as externally managed REITs receive compensation based on assets. Based on revenue, internally managed REITs exhibited more efficiency which is ideal for shareholders. On the other hand, Deng et al. (2017) document that externally managed REITs get better loan contract terms as they are now less information opaque due to the need to keep up with internally managed post-1986. Additionally, post-1986 externally managed REITs limit the agency conflicts by choosing lower leverage levels (Lewis et al. 2003; Striwe et al. 2013).

Empirical results from research on Asian show that REITs with externally managed structure have improved performance and reduced conflict of interest. We ascribe this to the improvement of externally managed REITs post 1992 as they recognise the need to compete and remain relevant alongside side internally managed REITs and institutional investors who carry out more monitoring (Cashman et al. 2014; Park 2017). Compensation structure and application of leverage of externally managed REITs remains a very topical issue. Ideally, benchmarking incentive fees against a predetermined performance level is recommended as instead of higher base fees (Ooi 2009). Additionally, the strength of corporate governance of Asia's externally managed REITs has gradually improved resulting in improved stock performance and market value in most cases. Though when measured alongside their corporate governance strengths, issues exclusive to externally managed REITs such as; REIT organisation, related party transactions, fees and remuneration matters exhibit limited disclosure on these proxies which negatively impacts the quality of corporate governance and performance measures. This has resulted in suggestions for conversion to internal management structure by some researchers (Lecomte & Ooi 2013; Chong et al. 2016; Chong et al. 2017a; Chong et al. 2017b). However, Downs et al. (2016) on related party transactions reports that it tends to be higher in Asia than to those in the US which had a positive effect for higher values for Asian REITs, as more credible transaction increased related party transactions. Tang & Mori (2017) also reports that committed and expert sponsors help enhance the quality of external management and value.

In the context of emerging REIT regimes found in markets such as the Asia Pacific and Africa, the attractiveness of externally managed REITs is because of economic and political instability; civil law based legal systems; lack of development and management expertise; high level of corruption and poor disclosure. The external management structure when implemented should be seen as a strategic decision, based on the willingness of property owners to cede control, a trade-off between the possibility of agency cost and benefits of capturing local soft information which should be attractive for an organization wanting to operate in emerging REIT regimes (Cashman et al. 2014; Das & Thomas 2016).

5. Conclusion

This paper documents the effects internal and external management structures adopted by real estate investment trusts in developed and emerging regimes have on its performance by carrying out a systematic review of published academic papers obtain from Scopus. It is well documented that the separation of ownership from control creates a conflict of interests which becomes more escalated by an external management structure. The tax reforms in 1986 saw US REITs transition from a mostly external management structure to a predominate internal management structure to further align shareholders objectives with management reducing agency conflict and increase efficiency. The internal management structure is popular amongst most western REITs (UK, France, Spain, Greece etc.). On the other hand, we document that most emerging REIT regimes of Asia Pacific are almost all predominately externally managed which in some way clearly show some merits remain for externally managed REITs. From a systematic review, 19 academic research papers are obtained from Scopus with publications ranging from 2000 to 2017 using thematic keywords related to this research during mostly from the US and Asia Pacific REITs. We document that from the research papers evaluated; the US REITs post-1992 saw an improved performance of externally managed REITs to resemble those of their internally managed counterparts as to remain competitive. The externally managed Asian REITs, however, saw mixed results when measuring operating performance and market value. The popular inefficiencies linked to remuneration, compensation structures, related party transactions and gearing of externally managed REIT has been greatly reduced. Disclosure in these areas remains a strong issue for most externally managed REITs. Current studies still prescribe that externally managed REITs convert to internal management. However, contrary evidence also shows that for emerging REITs regimes an external management structure may be preferable as it provides the opportunity to engage local expertise while still tackling issues synonymous with emerging markets.

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Appendix

Appendix A Breakdown of Paper sampled by Citation count, Country/ Territory and REIT regime Sampled and Empirical Findings

Authors	Citations	Country/Territory	REIT Regime Sampled	Empirical Finding
Capozza & Seguin (2000)	67	US	US (1982-1992)	Externally Managed REITs underperformed by 7%. Employed more financial leverage, taking more debt to increase property investment, hence compensation. No clear evidence of asset or business risks for both management styles
Ooi (2009)	12	Singapore	Singapore (2003-2008)	REITs compensation structure affect price during pre and post IPOs. Pre IPO, low base fees alongside pre-established performance linked incentive fee. Post-IPO, the manager on benchmarked incentive fees performed better than those with higher base fees.

Lewis et al. (2003)	12	US	US (1995-1997)	<p>Measuring magnitude of internal and external managerial efficiency, industrial efficiency, they find that internally managed REITs had better operating performance in 1995 and 1996 and used less debt performed more efficiently.</p> <p>Using a scoring framework for measuring the quality of corporate governance of externally managed REITs finds that though corporate governance scores have gradually improved, areas such as fee and remuneration showed deviation and ranked lowly due to limited disclosure. A positive relationship between corporate governance and stock performance but not on operating performance (ROA and ROE). But no link with related party transaction and outperformance</p>
Lecomte & Ooi (2013)	11	Singapore	Singapore (2003-2008)	<p>Externally managed REITs choose lower leverage levels than internally managed REITs. After the 1986 reform, the remaining externally managed REITs limited agency issues by not taking excessive leverage.</p> <p>Estimated returns did not support the economy of scale for all but smaller REITs. Contrary to conventional wisdom that internally managed structure is better than external management, they show different outcomes depending on the measure of output. When measuring output using assets, internally managed associates with inefficiency as externally managers receive compensation tied to assets. When measured using output with revenue internally managed REIT exhibit more efficiency. Revenue growth better captures goal of maximizing shareholder value.</p>
Striwe et al. (2013)	6	US/Germany	US (1994-2000)	<p>The inclusion of institutional shareholders dramatically changed REIT performance. Prior to 1992 externally managed structure underperformed internally managed REITs. Post-1992 saw no clear difference between both management styles attributed to an increase in institutional investors.</p>
Miller et al. (2006)	5	US	US (1995-2003)	<p>Find evidence to show that taking on the external management structure allows REITs to access and act on local information leading to better performance. External management structure is more suitable for countries with a better contracting environment which helps to diminish agency cost. Internally managed REITs invested in more countries had more insider ownership. However, externally managed REITs had more institutional investors.</p>
Brockman et al. (2014)	3	US	US (1985-2007)	<p>Evaluated the managerial challenges and opportunities for the introduction of REITs in India, identifies the potential for some commercial real estate property companies to convert to a REIT structure as it is like global REIT regulations. REITs externally managed show</p>
Cashman et al. (2014)	2	US	Australia, India, Hong Kong, New Zealand, Singapore, Japan (-2011)	
Das & Thomas (2016)	1	US/Switzerland	India	

Chong et al. (2016)	1	Malaysia	Singapore (2008-2012)	<p>similarity with most developing and Asian REIT regimes. They identified that property owners might be reluctant to cede control to external management which may prevent the smooth conversion to the REIT structure.</p> <p>Evaluated the impact of corporate governance on the performance of externally managed S-REIT. Corporate governance not only helped improve performance and ROA but also helped gauge excess return. But no impact on ROE. Individual CG proxies; REIT organization and ownership had a negative impact on S-REIT. They called for a reevaluation of the management structure of S-REITs as agency cost still exists in the external management style.</p>
Delcours (2005)	1	US	US (1999-2001)	<p>Analyzed top managerial compensation using equity REITs and REOCs. Amongst other findings, executive's long-term compensation related to the volatility of funds from operation and that internally-managed REITs managers enjoyed favourable compensation</p>
Tang & Mori (2017)		Singapore	Japan, Hong Kong, Malaysia, and Singapore (2002-2012)	<p>On the externally managed Asian REITs market examined the role of sponsor ownership in relation to agency issues on firm values. Amongst other things finds that higher firm values of REITs with committed sponsors stems from superior cash flows and that real estate expertise from developer sponsor enhances the quality of REITs management team. They also document that managers didn't carry out dividend smoothing to meet expected dividend distributions.</p>
Deng et al. (2017)		Singapore/Australia	US (1987-2009)	<p>Tested for information asymmetry across internal and external REITs on loan contract terms. The result shows that externally managed REITs are offered more favourable loan contract term (lower loan rates, lower collateral requirements and fewer loan covenants). This is linked to banks viewing external REITs as less information opaque and have less pre-contract uncertainty than internally managed REITs.</p>
Park (2017)		South Korea	Singapore, Hong Kong, and Japan (2005-2013)	<p>Examined the potential of conflict of interest between externally managed REITs in Asia and outside advisors /sponsors and its impact on value. They find that sponsored externally managed REITs emulated internally advised REIT in response to market pressure and are forced to operate at higher transparency to remain attractive to global institutional investors. No acute agency problem controlling sponsors is observed.</p>
Chong et al. (2017a)		Malaysia	Japan, Singapore, Hong Kong, and	<p>Examined the impact of free cash flow (FCF) on agency costs and FCF and agency cost on the performance of REITs in Asia. They find risks of FCF is minimal in REITs due to the REIT effect. Though they find the existence of FCF</p>

		Malaysia (2002-2012)	and agency cost in externally managed Asian REITs causing a discount in value. They suggest that conversion to internal management may reduce the cost of adjustment resulting from the agency.
Chong et al. (2017b)	Malaysia	Japan, Singapore, Hong Kong, and Malaysia (2008-2012)	Studied the impact of corporate governance (CG) of the externally managed Asian REITs on performance. They find that CG helps to improve ROA but gauge excess of REIT managers. They find that the CG proxies of REITs organization, remuneration matters, and fees of externally managed Asian REITs decrease performance due to lack of transparency and disclosure policies. Again, a conversion to internal management is made.
Henderson et al. (2016)	US	US (2000-2015)	Evaluated externally managed non-traded REIT investment returns over holding periods starting with initial offerings and ending on the first listing or acquisition date or date of provision of updated NAV. They documented lower returns earned by investors in non-traded REITs which is linked to large up-front fees paid to related parties for management/advisement and conflict of interests which permeate the non-trade REIT structure. This is further enhanced by the lack of proper monitoring by institutional investors.
Downs et al. (2016)	US/Singapore/Malaysia	Hong Kong, Malaysia, and Singapore (2003-2010)	Tests the relationship between Related Party Transactions (RPT) on firm value of externally managed Asian REITs. Results presented show RPT for Asian REITs to be higher than those in the US. However, positive, and statistically significant is shown for Asian REITs with higher values had more RPTs. No significant result was shown for corporate governance and RPT due to the REIT effect.
Chikolwa (2011)	US	Australia (2003-2008)	Identified that capital structure is affected by the conflict of interest between stapled management (internalizing asset management), shareholders, and creditors amongst other things. They identified that the stapled management structure had a negative relationship to leverage and ratio of short-term debt to the total asset. This implies that they may have lower gearing levels.
