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Executive Summary

REITs' for long term Residential rents

Noa Litmanovitz
Milken Institute Fellow

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About the Milken Institute Fellows Program

The Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental challenges. Our goal is to accelerate Israel's transition from a Start-up Nation to a Global Nation with solutions that others can replicate.

Directed by the Milken Institute Israel Center, the Milken Institute Fellows Program awards annual fellowships to outstanding Israeli university graduate students. Through the Milken Institute Fellows program, we train some of Israel's best and brightest young professionals in creating pragmatic financing and economic policy solutions, and they deploy them as resources to government ministries, nonprofits and other key organizations. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own policy studies during their internship aimed at identifying barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support policy makers who shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy processes, and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research workshop where they meet senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course. The course, which focuses on financial and economic innovations, is taught at the Hebrew University School of Business Administration by Prof. Glenn Yago (Senior Director/Senior Fellow at the Milken Institute).

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, accelerating economic growth, and improving the quality of life for Israel's citizens.

The Milken Institute Fellows Program is a non-partisan, non- political organization. It is funded by the Milken Institute and other leading philanthropic organizations and individuals in the United States and Israel.

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During the past seven years, Israel has been confronted with an ongoing crisis in the housing market, defined frequently by the government, the public, and the media as one of the Israel's most severe economic challenges. The crisis affects both the financial reality of countless Israeli households as well as larger political-economic issues. Research has shown that the main reason for the rise in housing prices is an ever growing shortage in housing supply, the result of a construction pace lagging behind the growth in demographic housing needs. This lack of supply is met with a growing demand, which results in the current rise in prices. In addition, claims are made that the rise in prices is also caused by preferences for ownership over rental housing, due to the under-developed rental housing market in Israel.

Following this basic analysis, two central and complementary solutions are needed to address the rising prices in the housing market:

1. **Increasing the market housing supply**, by a degree that will reflect the demographic housing needs.
2. **Developing the corporate rental housing market**, thus creating a valid alternative for home ownership.

Acknowledging this, the government has decided to increase the housing supply by an additional 150,000 dwellings over the coming decade, a third of which are designated for long term rental projects. The large amount of new dwellings needed raises questions concerning the financing of these projects. Up until now the vast majority of credit for mortgages and the construction branch was supplied by the banking system. The developments of the last few years have made it clear that the banking system will not be able to continually provide the needed credit, since it is already highly invested in real estate and is now sensitive and very much exposed to changes in the potentially volatile housing market. It seems that what is needed is a new source of capital, and the obvious choice seems to be institutional investors. Institutional investors are not only rapidly growing players in the credit market, but are also hardly involved in the housing market today.

This paper will show that real estate investment trusts (REITs) can potentially support the necessary solutions for dealing with the housing crisis – increasing supply and developing the corporate rental market while relying on institutional investors as far as financing is concerned. This research was a natural extension of the work of the REIT team led by the Israel Securities Authority, which formed following the 90 days of the Housing Cabinet team. Its goal was to, "allow for more complex financial structures in light of the expected number of projects, by enhancing the existing REIT financial vehicle so it will fit the rental projects of the national housing project" (Inter-ministerial committee for the national housing project, 2012). The work of the REIT team was an important platform for addressing the complexities of the REITs; be it the tax, regulatory or economic environment. In the upcoming months a memorandum which incorporates the team work is expected to be published. The main issues will be brought forth in this paper.

A few words on REITs. REITs have a special tax status, regarding both their tax benefits and obligations. Concerning benefits, REITs are exempt from corporate tax, with taxes being paid only at the investor level when revenues are distributed. In order to be officially acknowledged as a REIT, funds are expected to fulfill a number of criteria regarding their portfolio, sources of income, revenue distribution and more (report of the committee for the examination and regulation of REITs in Israel). For example, the majority of REIT activity must be rental real estate and they must distribute the majority of their gains. This is done to level the playing field between direct investment in real estate and investment in REITs (report of the committee for the examination and regulation of REITs in Israel, PWC, CMS). **Figure 1** explains the financial structure of a REIT.

In Israel a REIT law was passed in 2005 (amendment 147 to the income tax ordinance) following the recommendations of the committee for the inspection and regulation of REIT activity in Israel (the different sections of the law appear in left column of the following table, which also appears in the paper as **table 3**). Since then two REITs specializing in commercial real estate were established, but no further REITs, let alone REITs investing in residential real estate, have entered the market.

As mentioned, REITs have the potential to support the development of a corporate rental housing market as well as to increase the housing supply. The current rental market equilibrium is such that the vast majority of dwellings are owned by private landlords. Inserting tools which offer tenants a different way of consuming their housing services, such as REITs, into the housing market, could have a positive affect on that equilibrium. In order for REITs to expand the housing supply by purchasing new buildings, and not only affect the market and housing ownership structure, it is necessary that they be granted permission to engage in development and other ancillary activities. Removing the restraint will change the nature and the risk of REIT activity, but will expectedly raise the return on investment they can obtain, a highly important part of the economic viability of their existence. Following are the potential advantages of REITs for the housing market, as well as for the economy as a whole:

a. Increasing housing supply to the point it reflects the demographic needs.

b. Optimizing the rental housing market, taking advantage of economies of scale, and creating expertise.

c. Serving as a solution to financing problems through institutional bodies.

d. Enhanced liquidity and transparency in the real estate market.

e. Creating an investment channel for Israeli institutional bodies in the Israeli capital market.

f. Promoting financial stability and risk diversification.

Section	Current law	Proposed amendments	
		REITs – general	Long-term rental housing projects
Restrictions on REIT activity			
Assets that are rental and securities (must be at least from all assets)	95%		No restriction
Assets that are rental (must be at least from all assets)	75%		No restriction
Assets registered in Israel (must be at least form all assets)	75%	without change	
Must have a minimum of capital (millions of ₪)	200	Without change	
Leverage			
Leverage restriction	60%		80%
Distribution of requirements			
Distribution of profits as dividends (at least)	90%		
Restrictions on investors			
Five or fewer entities cannot not hold more than this share of	50%	Up to 5 years from registration – 70% and than 50%	

Mandatory Stock Exchange listing			
REITs must be traded	Yes	Without change	
Stock must be enlisted in stock market (month from organization)	12	36	
Taxation			
Exempt from corporate tax	Yes	Without change	
Institutional bodies exempt from tax	Yes	Without change	
Individual investors are taxed according to the source of the income (rental, capital gains etc.)	Marginal rates	Rates in Encouragement of Capital Investments Law	
Trading assets for stocks	Tax event	Delaying tax event till sale of stocks or assets	

Though REITs are not directly prevented from engaging in residential real estate, there are a number of barriers to their activity in the domain. We will present these barriers alongside the solutions the REIT team has proposed for them. We will also highlight the problems concerning a portion of the proposed solutions.

a. **The rental housing market structure and low returns** – the rental market is characterized by private ownership and low returns. This prevents the creation of an evolved corporate rental market, since the field is not profitable for institutional bodies.

   The REIT team has proposed that this barrier could be overcome by increasing returns on projects through:

   - Decreasing risk by creating loss-protection
   - Decreasing costs, specifically land costs

- Increasing return – entering the project at the development stage and creating higher leverage options

b. Regulatory barriers

1. **Trading assets for stocks** – Inserting assets into REITs triggers a tax event (specifically capital gains tax on real-estate), which in turn creates a negative incentive for creating new REITs.

   Proposal: delaying the tax event until the stocks are sold or the assets are sold by the REIT, only when occurring close to REIT initial public offerings (IPOs).

   Problem: the proposition grants the REIT a small and fleeting window for the entrance of assets and does not encourage long-term sustainable growth.

2. **Ownership** – REITs have narrowly-defined restrictions regarding distribution of ownership, after IPO 50% of stocks cannot be held by less than 5 bodies (five of fewer).

   Proposal: graduating the distribution of ownership over a longer period, giving the REITs a grace period that allows them to achieve the necessary restriction.

3. **Development and ancillary** – REITs are not allowed to engage in ancillary activities. This restriction constricts the creation of residential REITs for a number of reasons. First, REITs need to engage in development in order to increase their returns on rental housing projects and make these projects profitable. Secondly, unless given permission to take on development, they will not be able to take part in the tenders for long term rental project.

   Proposal: allow REITs that specialize in residential real estate to enjoy a number of relaxed entry rules, allowing them alone to develop residential real-estate.

4. **Leverage** – the current leverage rate, 60%, is supposed to preserve the solid nature of investing in REITs, yet it substantially lowers yields.

Proposal: raising the leverage rate for rental project that are given loan securities by the government.

5. **High taxation on private investors** – there is a substantial difference in private investor taxation between direct investment in real estate and investing through REITs.

   Proposal: lowering the tax rate on individuals to the rate of the Encouragement of Capital Investments Law.

   Problem: although substantial, this proposal still does not fully level the playing field between direct and indirect investments.

To summarize, REITs require a certain eco-system in order to develop and grow as efficient vehicles both for investors and for the markets they are a part of. For REITs to become a part of the solution to the housing crisis we must first deal with the barriers facing them. Although the REIT team and the 90 days team are dealing with many of these barriers, there is still a long way to go before residential REITs can thrive and boost the development of the corporate rental housing market.

Although this research has chosen to focus on REITs, and is based the current economic and political reality in which returns are so low that government support of long term rental projects is necessary for them to develop, it is important to remember that this is only the first step. A larger goal of this process is the creation of a corporate rental market that does not weigh so heavily on the government to succeed. The question we must ask ourselves is what eco-system is necessary for incentivizing the development of a healthy and vibrant housing rental market, which encourages efficiency and above all improves the lives of its tenants in comparison to the problematic current equilibrium. This paper demonstrates that REITs can play an important part in such an eco-system. So, we must take the necessary steps to help REITs advance in the housing rental market, and begin to shift the balance towards a more efficient and sustainable situation.

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Milken Institute Fellows Program
4 Washington St.
Jerusalem, 9418704, Israel

info@mifellows.org
www.mifellows.org