

2 Corporate Governance and REITs

This chapter introduces the concept of corporate governance and the associated agency theory from a general finance perspective. It then discusses what corporate governance means given the many special features of REITs and how these corporate features add to the identification strategies of the papers.

2.1 Corporate Governance and Agency Theory

This section lays the foundation for the thesis by introducing the theoretical background for the corporate governance discussion. Agency theory, in turn, substantiates the need for corporate governance and, therefore, both agency theory and corporate governance are treated jointly. Further, the economic relevance of corporate governance and associated agency conflicts are illustrated against the background of the historical development of financial markets and with special reference to recent market distortions.

Corporate governance “deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer and Vishny, 1997, p. 737). Credible and efficient corporate governance promotes the supply of large sums of money to firms and the repatriation of returns to the financiers. It reduces the cost of capital and ensures an efficient allocation of resources. Countries that lack corporate governance receive less investment from foreign investors as a result of greater information asymmetries, uncertainty and

monitoring costs.²

The necessity for corporate governance results from the separation of ownership and control, which leads to agency conflicts and agency costs.³ The associated agency theory is “the study of the inevitable conflicts of interest that occur when individuals engage in cooperative behavior” (Jensen, 1993, p. 870). The focus of agency theory is on the people in a company with their individual interests and incentives rather than on the firm as the sum of its assets. It deals with the costs resulting from the discrepancy between managers’ and shareholders’ interests that may materialize in the entrenched and self-interested decisions of the manager. Opportunistic managerial behavior in the form of perk consumption and selfish risk choices can lead to costs that impair corporate performance and shareholder wealth.

Our discussion of agency theory departs from that of Jensen and Meckling (1976) and Fama and Jensen (1983). In a principal-agent relationship the principal delegates the management duties to an agent. Their relationship is based on trust, transparency and accountability. The principal trusts the agent to diligently pursue the maximization of the principal’s wealth. Transparency is achieved through fair and accurate financial reporting. To establish accountability, the agent has to justify his actions regularly and assume liability

² Leuz et al. (2010) find that foreign investors favor strong outsider protection, disclosure requirements and ownership structures that are conducive to corporate governance.

³ In contrast to the separation of ownership and control, there are firms with a sole proprietorship that involve no conflicts of interest.

for damages arising in the case of mismanagement.

However, the actions of the agent are not always in the best interest of the principal. If the incentives of the manager and the objectives of the shareholders are at variance, agency costs may arise. The discrepancy widens as information asymmetries between principal and agent become more pronounced, which limits transparency and complicates the evaluation of managerial actions. Agency problems are not only of concern to shareholders; they also affect external stakeholders, employees, suppliers and customers (John and John, 1993). The economic significance of agency costs is discussed in many studies (e.g. Shleifer and Vishny, 1997; Gompers et al., 2003; Bebchuk et al., 2009a).

Agency theory has changed corporate finance and organizational theory. It calls for a detailed behavioral foundation of corporate decision making. The neoclassical assumption that firms maximize shareholder value is not any longer considered a valid assumption. The view that the performance of a company is solely driven by the skill, economic foresight, rationality, creative innovativeness and knowledge of customers' desires neglects a behavioral component (Morck and Yeung, 2010). The view of company decision making is now a different one: Executives may not act in the best interest of shareholders but rather in their own self-interest. Hence, corporate actions are the result of individuals pursuing own interests to maximize their utility. Firms are only maximizing shareholder wealth if the utility functions of the people in the company are consistent with the wealth maximization objective.

Company managers that demonstrate their compliance with corporate governance standards have a competitive advantage in the market. In contrast,

investors will charge those firms that fail to engage in such efforts a risk premium. Firms can commit to compliance by applying well-structured compensation schemes, establishing independent boards, employing trustworthy directors and voluntarily disclosing information. Such efforts may contribute to lowering agency costs and improving the efficiency of capital allocation.

Corporate governance has only recently attracted a significant amount of attention. What factors initiated the resurgence of corporate governance? The reasons are rooted in the changing incentive structure in financial markets; the utility function of managers has changed significantly over the last 30 years. Far-reaching financial innovation and deregulation have altered the way financial markets operate. For both institutional and individual investors the markets have become more accessible, liquid and efficient, and barriers that restricted innovation and competition have been eliminated. As a result, financial markets have experienced enhanced financial engineering, portfolio optimization and securitization, amplified by technological advancements that have facilitated greater transparency and a reduction of information asymmetries. Throughout this development, managerial incentives have become increasingly performance-linked with the intent to increase shareholder wealth. Competition among firms in the financial sector has increased in tandem with deregulation. Pressure has also come from capital markets as investments have become more liquid, which has enabled investors to “vote with their feet” if they are dissatisfied with the management. To keep pace with this development the fixed portion of compensation has successively decreased while the variable portion - bonus payments - has increased. At first sight, a largely sales-volume-related

compensation appears to be in accordance with shareholders' interests. While performance based compensation has motivated managers to perform better, it has also changed the nature of risks associated with an investment; managers have become more inclined to pursue aggressive risk strategies and, in rare cases, to engage in deceptive accounting practices to achieve performance targets.⁴

Although this historical development has increased managers' willingness to take on more risk, their compensation contracts have often failed to adequately consider risks relative to returns.⁵ Distorted incentives can be the result: Managers benefit from the upside potential of the firm through bonuses, but do not generally participate in losses as costs of poor decisions are passed on to shareholders and creditors. This compensation structure, which is convex in returns, incentivizes managers to take on even more risk. In particular, managers have become inclined to take on tail risks, which have a severe adverse impact in improbable instances but increase returns otherwise.⁶

There are numerous mechanisms to deal with the far-reaching, mostly unobservable threat of opportunistic behavior. One way to control opportunistic

⁴ Rajan (2005) critically reflects on the additional risks involved in today's financial systems and insistently stresses his concern about distorted incentives.

⁵ Measuring risk is far more difficult than measuring return. The difficulty of measuring risks in today's complex financial markets becomes apparent considering recent appraisals of rating agencies. Although the measurement of risk is their core competence, rating agencies often fail at new financial products (Morgan, 2002). This materialized, for example, in overly optimistic ratings of structured asset-backed securities, which contributed to the inflation of the subprime bubble.

⁶ Investments with pronounced tail risks produce low volatility but have the risk of a large loss. Taleb (2007, p. 204) gives the illustrative, yet exaggerated, example that harvesting returns of investments with great tail risks or, in his words, "black swans" is like "collecting nickels in front of steamrollers".

risk choices of managers would be to incorporate greater accountability and liability through a legal framework. The Sarbanes-Oxley Act (SOX) constitutes such a legal framework in the US and was enacted in 2002 in a response to accounting scandals, such as those of the energy company Enron in 2001 and the telecommunications company WorldCom in 2002.⁷ The SOX aims at restoring confidence into corporate governance of public companies. Stricter requirements for disclosure and greater penalties for fraudulent mismanagement are intended to provide investors with greater transparency and accountability of managers' actions. The SOX requires chief executive officers (CEOs) and chief financial officers (CFOs) to personally verify financial statements and evaluate the effectiveness of internal control in the annual report. Furthermore, SOX requires management's judgment to be confirmed by external auditors. As part of SOX's greater disclosure requirements, special-purpose vehicles and off-balance-sheet transactions as well insider trades and bonuses have to be reported in greater detail. In addition, the penalties associated with fraudulent misconduct have been widened and defined more clearly.

Yet, legal structures are not sufficient to ensure that managers will act in the shareholders' interest. The SOX failed to prevent poor governance and consequent failures of the US investment banks Bear Stearns in March of 2008 and Lehman Brothers in September of 2008, with the latter triggering the financial crisis. Top

⁷ Europe and Asia followed with corporate and accounting scandals of their own: the Dutch retail group Royal Ahold in 2003, the Italian food corporation Parmalat in 2003 and the China Aviation Oil in 2004. The fraudulent activities in these companies involved false accounting, deception of investors, insider trading and violation of securities law.

executives of these companies received vast amounts of performance-based compensation in the period 2000 to 2008, which encouraged them to take on excessive risk. Subprime debt was hidden off-balance sheet through Repo 105 transactions, which helped polish financial statements. During that period the compensation of Lehman's top management amounted to US \$ 2.4 billion, which could not be reclaimed after the company failed (Bebchuk et al., 2009b).

Academics were the first to point out the possible threats associated with misaligned compensation schemes. Numerous studies (e.g. Morgan, 2002; Rajan, 2005) exist that should have alerted investors and supervisory authorities to exercise greater prudence in the market prior to the subprime and the financial crisis. Academic research has a role to play not only in monitoring the markets progress but also in fostering financial innovation. As part of this role it should continue its efforts to (a) identify agency conflicts, (b) point to possible consequences and (c) suggest counter measures and preventive actions for a safer development of financial markets while at the same time maintaining an unbiased and critical perspective. The academic contribution is valuable to managers, investors and policy makers as it can help them to deal with the uncertainty about incentives, understand why people act opportunistically and overcome agency conflicts via legal boundaries, appropriate incentive structures and effective monitoring.

The academic literature frames corporate governance broadly, beyond the legal framework. Corporate governance includes internal and external control mechanisms that facilitate continuous monitoring of the management, assure risk control, provide incentives for responsible management and establish an

alignment of managerial incentives and shareholders' interests. The mechanisms that alleviate agency problems and promote corporate governance are subsumed under six categories that follow the definition of Brealey et al. (2008):

- Regulations and laws to protect shareholders from managerial opportunistic behavior,
- disclosure requirements and reporting standards to provide a transparent view on the company's business,
- monitoring by institutions and financial intermediaries to guard their investments,
- supervision by the board of directors,
- the threat of a takeover that presents the manager with a risk of being replaced,
- compensation structures that align the interests of shareholders with those of managers.

Market efficiency does its own part to reduce agency conflicts according to neoclassical theory. In efficient markets the founder of the firm pays most of the agency costs by issuing his shares at depressed prices, which reflect costs for monitoring and control mechanisms. Firms that do not ensure that their corporate officers will diligently handle shareholders' funds are likely to be punished by a greater stock price discount and an associated increase in the cost of capital.

However, the costs and benefits of corporate governance should find a balance. A nearly complete protection of shareholders from opportunistic actions of

managers would not only be difficult to implement but would also confront shareholders with excessive costs. Empirically, it is complicated to predict and judge a manager's behavior; control mechanisms are expensive, difficult to implement and hardly accurate. Monitoring mechanisms that aim at knowing every detail of managers' actions and why they are doing it, therefore, would generate new inefficiencies, such as managerial inflexibility and excessive risk aversion. Giving managers freedom and discretion in responding to unanticipated opportunities and problems is essential for efficiency. This freedom and discretion, however, can motivate managers to act according to their self-interests to the detriment of shareholders' interests; as a result agency problems are very likely. Hence, neither overly strong nor lax corporate governance will maximize shareholder wealth (Adams et al., 2005; Adams and Ferreira, 2007). The ideal balance of corporate governance mechanisms depends on the regulations set by policy makers and the efficiency provided by capital markets.⁸

2.2 Corporate Governance in the REIT Market

The REIT market provides a unique laboratory for studying corporate governance issues. Its key features and how they are useful for the studies of corporate governance is laid out next.

⁸ Strongly regulated legal frameworks and highly efficient capital markets may reduce the need for strong internal corporate governance mechanisms. In contrast, a weak legal framework with lax disclosure requirements, and inefficient capital markets with high information asymmetries may increase the need for corporate governance mechanisms.

The real estate investment trust is a tax-transparent corporate entity that invests in real estate. Its special feature is the reduction of corporate tax. In return it requires the distribution of a great portion of earnings to investors (USA: 95% prior to 2001, 90% thereafter). REITs provide a liquid structure for the illiquid real estate asset. They can be traded publicly on stock exchanges or held privately. Depending on their mix of assets they are classified as equity, hybrid or mortgage REITs. Equity REITs own real estate, mortgage REITs invest in loans secured by real estate. Hybrid REITs combine both types of investments.

This thesis focuses on publicly traded equity REITs, because they provide a fairly homogenous group of real estate investment firms that conform in terms of the dividend payout strategy, underlying asset portfolio, and organizational and corporate structure.⁹ Most importantly, US equity REITs exhibit three corporate governance issues that make them particularly useful for the studies of this thesis:

First, ownership limitations due to the “five or fewer” rule limit the functionality of the market for corporate control for REITs (Ghosh and Sirmans, 2003; Eichholtz and Kok, 2008).¹⁰ Therefore, a functioning corporate governance

⁹ Real Estate Operating Companies (REOCs), which are included in the dataset of paper two, are less restricted than REITs. REOCs are flexible in their dividend payout strategy and can reinvest earnings to grow with internal funds. They are also more flexible in their operations and focus more on the development of real estate, whereas REITs rather buy, hold and sell real estate. There is tendency of REOCs to favor hotels because REITs are legally not allowed to operate or manage this type of real estate.

¹⁰ The “five or fewer” rule (US Internal Revenue Code of 1986, Section 856(a)(6)) prevents five or fewer shareholders from holding 50 percent or more in a REIT. However, the passing of the “look-through” provision as part of the Omnibus Budget Reconciliation Act of 1993 relaxes the

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