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Internal versus External Management in REITs

The external or outside management requirement is perceived to create a conflict of interest since REIT sponsors usually own the management company and not much of the REITs themselves. They have more of an incentive to grow the REIT to increase assets under management, and hence receive more management fees, rather than manage the REIT to maximize shareholder value. By contrast, internally managed REITs staff compensation and incentive is based on corporate level performance rather than property level cash flows - and are perceived as providing better alignment of management and shareholder interests.

Why is External Management Frowned Upon?

Fee Contracts: Fees are based on (i) either total AUM or (ii) % of property level income or (iii) % of transaction volume or a combination of these.

Since compensation is derived primarily from asset-based or property-income-based management contracts this creates incentives for external managerial actions that may not be optimal for shareholders. They are compensated on metrics that are not related to growth in shareholder wealth.

More Leverage: External advisors would prefer to expand their asset base using more leverage, since they are compensated as described above.

Leverage at Higher Rates: Externally managed REITs have incentives to issue debt with rates that exceed the rates on debt issued by internally managed REITs. Since they are compensated on % of AUM/property level cash flows they have little incentive to negotiate for favorable debt rates. It is the use of debt negotiated at above market rates that systematically reduces cash flows available to shareholders. Indeed, since issuing debt and using the proceeds to purchase more assets increases property-level cash flows, they have incentives to issue more debt, regardless of the interest rate. This can lead to a reduction in equity value and they supposedly underperform and therefore are priced at a discount.

Higher G&A: In the past they generally have tended to have higher G&A expense ratios.

Riskier Diversification: Since they are compensated on assets or income, they have incentives to choose higher yielding properties when they diversify. Typically their compensation contracts do not explicitly accommodate for differences in risk, so external managers may have a preference for assets with higher levels of both expected return and risk.

Underperformance: Externally advised REITs have, depending on the period examined, underperformed their internally managed counterparts. Property-level cash-flow yields may be like Internal advised, but corporate-level expenses and especially interest expenses (see earlier point) are responsible for lower levels of cash available to shareholders.

Smaller Size: They tend to be smaller than internally managed REITs, as smaller REITs do not have an asset base that justifies the attention of a full-time management team. As a result, external (part-time) advisors are selected.

Governance Risks: Rating agencies generally see them as having higher governance risks.