Vinson&Elkins

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ELECTION IMPACT ON REIT INDUSTRY

Market Reaction

- The markets had an initial knee-jerk negative reaction to the Trump victory but rebounded almost immediately after the election and throughout the remainder of the week; however, REITs were hit hard by the election results. The REIT sector was down as of market close on Wednesday following the election, and REITs with longer term lease agreements such as Realty Income, National Retail Properties and VEREIT were hit particularly hard. This is contrasted with lodging REITs, which are able to adjust room rates quickly based on market conditions. Immediately after the election, lodging REITs, such as Host Hotels, rose and continued to outperform other REIT sectors and the market as a whole.
- As the election week progressed, REIT stocks rallied. The Vanguard REIT Index ETF, while still down 15% from 52-week highs as of the close on Friday after the election, managed to recover. However, the recovery masked the "dramatic sector re-pricing" that occurred. By the end of the election week, cyclical growth REITs such as the lodging, office, storage and mall sectors experienced a post-election bump. Lodging REITs were the clear winner, gaining nearly 8%. Office and storage REITs came in second, gaining 4.9% and 4.5%, respectively. On the other hand, net lease, healthcare and apartment REITs performed poorly. Healthcare REITs, such as Welltower, Ventas and Healthcare Realty suffered the most, sliding down 5% as a sector. Net lease REITs were down 4% and industrial REITs were down 3.6%.
- By Thanksgiving Day, the S&P 500, Dow Jones Industrial Average and Russell 2000 closed at record highs. Over the week of Thanksgiving, the REIT sector gained over 2%, managing to outperform the S&P 500. While certain REIT sectors, such as net lease, healthcare and apartment REITs were down as of the end of the election week, every single REIT sector managed to recover through the week of Thanksgiving. Data center, net lease and industrial REITs led the rally. Data center REITs, such as DuPont Fabros and CyrusOne, were the winners this week, rising nearly 3%. Even net lease REITs managed to turn around after the initial post-election drop. During the week of Thanksgiving, net lease REITs gained 2.8% as a sector, with Spirit Realty up 4% and Realty Income up 3%. Industrial REITs also did well, gaining 2.8% this week.

Increase in Interest Rates & Sector Effects

- The threat of rising interest rates has loomed for some time, and commentators generally believe Trump administration and Republican policies that are focused on economic growth make rate increases even more likely. Yields on 10-year U.S. Treasuries have increased 50% since July 2016, with a meaningful jump occurring right after the election. The greatest concern is that the rise in interest rates will make stocks owned primarily for their dividend yields, such as REITs, utilities, and telecommunications firms, look less attractive. The conventional analysis goes as follows:
    - Investors expect to be paid more for the risk they take, and investors have typically priced real estate stocks so that their dividend yields are about 1.3 percentage points higher on average than the yields on 10-year U.S. Treasuries;
    - When U.S. Treasury yields rise, dividend yields on REIT shares typically rise, too. For dividend yields to increase in the short term, REIT stock prices generally must fall.
- But some commentators disagree with the amount of emphasis placed on interest rates. For example, Steve Buller, portfolio manager with Fidelity Investments, believes that, despite the rise in interest rates, REITs will still flourish as stronger GDP growth will result in higher rents and same-store NOI. Other commentators view higher interest rates as positive for the real estate industry, as interest rates driven by economic and job growth lead to greater corporate and consumer spending.
- Blanket statements about the impact of rising interest rates fail to take into account the diversity of sectors and sub-sectors within the REIT industry. In particular, office, commercial, housing and storage REITs are expected to perform well as demand and property prices surge. Steve Buller also predicts that industrial, logistics and prison REITs may benefit from Trump's presidency.

Legislative Effects

- NAREIT favored Republican legislators in the U.S. Senate races and supported the winning candidate in approximately 90% of the Senate races and 95% of the House races. These include the upset bids of Republicans Ron Johnson, Pat Toomey and Todd Young.
- A Republican controlled Congress is generally viewed as good news for the REIT industry, as a Democratic sweep would have given the far-left ammunition to eliminate "loopholes" in the commercial real estate industry that could have directly impacted the REIT model.

Tax Reform

- Changes to the tax code seem likely under a Trump administration and Republican controlled Congress. While these changes may indirectly affect REITs, there has been no specific pronouncement from the Trump camp or Republican leadership in Congress regarding the REIT model itself and commentators are not expecting one. The House GOP Blueprint and the Trump tax proposal are similar, but contain important differences. Negotiation between the President and Congress and within Congressional bodies could lead to parts of each ultimately being adopted.
- Overall, both the House GOP and Trump tax proposals will likely result in lower taxes for REIT investors across the board with a considerable decrease in ordinary income rates. A decrease in the corporate tax rate may be offset by plans to reduce business tax expenditures and "close loopholes," retaining or raising some companies' effective tax rates. The potential for infrastructure tax credits and public-private partnerships for infrastructure maintenance and new construction may lead to profitable opportunities for REIT activity in relevant sectors. However, large-scale public construction could lead to a rise in construction wages and crowd-out some private construction.
- **Corporate Tax Rate Cut and Repealing Business Tax Deductions, Credits and Other Incentives**
  - <u>Trump Plan</u>
    - President-elect Trump's tax plan calls for a dramatic reduction in the corporate tax rate—from the current top rate of 35% to a flat rate of 15%.
    - Trump wants to retain the research credit, but repeal most other business tax credits, deductions and other incentives, potentially including: energy industry tax incentives, economic development and infrastructure incentives (replacing infrastructure incentives with unspecified revenue-neutral tax credits, described below) and the domestic production activities deduction.
  - <u>House GOP Blueprint</u>
    - While both plans cut rates, the House GOP proposal calls for a smaller reduction—from the current top rate of 35% to a flat rate of 20%.
    - The House GOP wants to retain the research credit and evaluate options to make it more effective and efficient, but repeal most other business tax credits, deductions and other incentives, potentially including: energy industry tax incentives, economic development and infrastructure incentives and the domestic production activities deduction.
  - A dramatic corporate tax rate reduction is likely under either plan, and will still leave the REIT form as a tax-favored alternative to the corporate form for holding real estate, as a single level of taxation will continue to be more attractive than double taxation, even at reduced tax rates. This effect may be mitigated for some businesses as loopholes are closed—so while a corporation's top line tax rate may be considerably reduced, its effective tax rate might remain relatively unchanged as certain deductions, credits and exemptions are removed. Any such mitigation will likely vary greatly across sectors.
- **Ordinary Income and Capital Gains/Qualified Dividend Structure**
  - ***Ordinary Income***
    - <u>Trump Plan</u>
      - During the campaign, Trump repeatedly called for compressing the number of individual income tax brackets from seven to three and for reducing the top rate from its current-law level of 39.6%. Originally, his tax plan called for brackets of 10%, 20% and 25%. In August, Trump modified his position to match the House GOP Blueprint and called for rate brackets of 12%, 25% and 33%.
      - Based on the entry points, certain individuals could find their income taxed at a higher rate than under current law. Overall, most taxpayers will have a lower ordinary income tax burden—especially the top 1% of Americans, who will average a 13.8% reduction in ordinary income taxes.
    - <u>House GOP Blueprint</u>
      - The House GOP Blueprint calls for a reduction of the current top rate and a compression of the current brackets from seven to three. While it plans for rate brackets of 12%, 25% and 33%, it does not outline entry points.

        - Both plans call for a much flatter tax rate and lower marginal rates across the board.
    - ***Capital Gains***
        - Trump Plan
            - Capital gains rates will remain the same under Trump's proposal, but will align with the new ordinary income brackets. As such, investors under the proposed 12% bracket will pay no tax on realized capital gains; taxpayers in the 25% bracket will pay a 15% tax; and taxpayers in the 33% bracket will pay a 20% top rate. These capital gains rates will also apply to "qualified dividends."
                - Because of the new entry points for these brackets, some investors will face higher rates on capital gains and qualified dividends. No investors will receive a lower rate.
            - Under Trump's plan, carried interest income would be taxed as ordinary income rather than long term capital gains, reducing the attractiveness of the use of LTIP Units by REITs. However, the deferral advantages of LTIPs would remain.
            - Trump also wants to repeal the additional ACA-related net investment income tax of 3.8% as part of his call for a full ACA repeal.
        - House GOP Blueprint
            - The House GOP plan also calls for a considerable reduction in the capital gains and qualified dividend income tax rates. It proposes to tax the income at ordinary income rates (described above) with a 50% exclusion, meaning investors in the 12% bracket will pay 6%; investors in the 25% bracket will pay 12.5%; and investors in the 33% bracket will pay a top rate of 16.5%.
                - A separate plan put forward by Senator Hatch would call for "corporate integration" by exempting dividends from taxation at the entity level (likely through a dividends-paid deduction) and taxing them at the individual level at ordinary rates.
            - No specific changes to carried interest income taxation, but generally lower rates for capital gains and qualified dividends.
            - The plan also repeals the additional ACA-related net investment income tax of 3.8%.
    - Because most REIT distributions are taxed at ordinary income rates, as opposed to lower "qualified dividend" rates, lower marginal rates will create an immediate increase in after-tax returns if the REIT framework remains largely unchanged (which appears to be the case under both plans). Additionally, the elimination of the 3.8% ACA tax will benefit REIT investors. The smaller reduction (and potential increase for some taxpayers) in the rate of tax on qualified dividend income and capital gains may make REITs more attractive compared to typical equities, particularly for companies that already pay an effective tax rate near the 20% proposed top line corporate tax rates, and thus would not materially benefit from the decreased corporate rate.
- **Pass-Through Income**
    - Trump Plan
        - Trump has also proposed a 15% elective tax on pass through business income, which would trigger double taxation if distributions are made to owners. His plan claims this double taxation will only apply to "large" businesses, but does not clarify a cutoff. This rate is intended to match the proposed corporate tax rate. As in the corporate tax rate discussion above, REITs will be attractive tax-favored alternatives to any pass through entities electing this regime, as a single level of taxation will continue to be more attractive than double taxation.
    - House GOP Blueprint
        - The House plan, in contrast, looks to provide a top rate for pass through entities of 25%—higher than the plan's proposed corporate tax rate by 5%, and without the double taxation concept of Trump's plan. This may render investing in REITs marginally more attractive, with a slight increase in their tax-favored status over comparable pass through entity investments.

- **Energy Policy**
  - Trump Plan
    - Trump's multitude of campaign promises to de-regulate energy industries could expand the growth of energy REITs. He also calls for streamlining the permitting and other regulatory burdens on energy infrastructure.
    - But Trump has simultaneously promised to cut tax incentives for special interests in his plan to cut nearly all business tax credits, deductions and other incentives.
  - House GOP Blueprint
    - The House GOP has no specific proposal, but called for a similar slash-and-burn on nearly all business tax credits, deductions and other incentives, presumably including energy industry tax incentives.
- **Expensing of Capital Assets**
  - Trump Plan
    - Firms engaged in U.S. manufacturing may, under Trump's plan, elect to deduct the full cost of their capital investments in year one. The election would be revocable within the first 36 months.
      - The scope and breadth of "manufacturing" for this purpose is unknown.
      - Businesses that elect full expensing in year one under this option will lose their ability to deduct net interest expense on debt used to purchase capital assets.
    - Presumably, these changes would largely eliminate year-by-year depreciation deductions. Further, they may render Section 1031 transactions (for like-kind exchanges of real estate) unnecessary. Currently, Section 1031 exchanges allow REITs and other investors to defer the payment of taxes on gains made on the exchange of property held for investment or in a trade or business for "like-kind" property. Allowing a year one deduction for capital investment may render this obsolete by providing immediate tax relief in the form of a deduction, offering similar benefits to those that Section 1031 currently provides for real estate investing including increasing overall investment, reducing holding periods and lowering leverage levels.
    - Such an expensing regime may also result in "lumpier" taxable income for REITs year-to-year, as opposed to the current system of predictable and fixed annual depreciation deductions. This may affect year-to-year yield on REIT investments to the extent REITs manage their distributions to this taxable income, perhaps troubling investors looking for a steady flow of income through REIT distributions.
  - House GOP Blueprint
    - The House GOP proposal offers full expensing in year one of all assets, tangible and intangible, except for land. It calls for interest expense to be deductible against interest income, but allows no current deduction for net interest expense. Further, net interest expense could be carried forward indefinitely and deducted against net interest income in future years.
      - The Ways and Means Committee would develop "special rules" with respect to the interest expense of financial services companies to "take into account the role of interest income and interest expense in their business models."
    - This proposal, though allowing for a slightly different interest deduction scheme, will presumably impact REITs in a similar manner to the Trump plan for capital asset expensing, as discussed above.
    - Senator Wyden has floated a separate draft proposal, which replaces current tax depreciation rules with a "pooling" system for most tangible personal property. Because REITs focus on real property, this system would have little direct effect on their operations; however, it may be advantageous to other business entities, slightly decreasing the attractiveness of a REIT investment.
- **International Issues**
  - ***Repatriation***
    - Trump Plan
      - Trump proposes a one-time deemed repatriation of accumulated deferred foreign income at a flat 10% tax rate. This repatriation will, in the very short term, cancel out one of the REIT model's many tax advantages:

because REITs almost never pay entity level tax, the REIT structure allows efficient repatriation of offshore income. In the long-term, the brief “repatriation holiday” will not affect the advantage of a REIT structure in bringing home offshore earnings without paying a corporate entity-level tax.

- House GOP Blueprint
  - The House GOP proposal also offers a one-time deemed repatriation of accumulated deferred foreign income, but unlike the Trump plan it provides for differential rates for cash (8.75%) and noncash assets (3.5%). Tax on each asset category is payable over eight years at the taxpayers’ election. This repatriation model will have the same effect on the attractiveness of the REIT model, but will increase the effect very slightly with lower rates of tax for the repatriated income and a longer payback period.

- ***Subpart F Rules***
  - Trump Plan
    - Currently, the Subpart F rules limit deferral for certain mobile and passive foreign income, and U.S. interest deductions for inbound firms may be limited by Code Section 163(j). Trump does not specify any changes to this model.
  - House GOP Blueprint
    - The House GOP proposal eliminates most Subpart F rules, but retains the foreign personal holding company rules for passive income shifting.
    - REITs are currently able to include Subpart F income from CFCs they hold shares in as “qualifying income” for the 95% gross income test, which allows for repatriation of accumulated deferred foreign income without entity level corporate tax.
    - This change would increase deferral opportunities for U.S. investors in REITs operating foreign subsidiaries. The change would apply equally to corporations and pass throughs who are CFC shareholders, and so will not affect a REIT investment’s attractiveness in comparison to these entities.

Healthcare

- Major changes to the healthcare insurance industry are expected as a result of the Trump victory and Republican control of Congress, but it is not yet clear what the repeal and replacement or amendment of the Affordable Care Act (“ACA”) will look like, including how Medicare and Medicaid would be impacted. The Paul Ryan plan involves reforms to Medicare and Medicaid in order to make them more solvent over the long term, but some critics see “reform” as a code word for privatization (phase out of Medicare). In contrast, during the Presidential campaign, Trump and his surrogates avoided any hint of a phase out of Medicare and Medicaid and generally did not focus on the fiscal deficit, opting instead to focus more on economic policies that will spur economic growth and job creation through tax cuts, deregulation, infrastructure spending and trade reform.
- Because of the uncertainty associated with the Republicans’ anticipated rollout of a plan to repeal and replace the ACA, attention has turned to healthcare REITs. The likely effects of the Trump victory on healthcare REITs are unclear, but it is likely that different healthcare sub-sectors will be impacted in different ways. Recent healthcare industry trends, such as a shift away from large hospitals to smaller, more specialized and lower cost healthcare delivery facilities, are expected to continue.
- As healthcare continues its move to lower-cost facilities, the number of medical office buildings, which include smaller, specialized healthcare delivery facilities, has increased. In spite of that trend, shares of healthcare REITs that own medical office buildings (Physicians Realty Trust, Healthcare Trust of America, Healthcare Realty Trust Inc. and Global Medical REIT, Inc.) have sold off to varying degrees post-election. This may be due to speculation that the repeal of the ACA would reduce the number of insured Americans and thus reduce the number of Americans who can pay for healthcare services (fewer insured Americans).
- Hospital owners face issues similar to those faced by medical office building owners. Hospital owners are concerned that profit margins will shrink as patients fail to pay bills due to the lack of insurance.
- While hospital owners’ shares have been down, shares of senior housing REITs and operators have generally gone up. The senior housing industry is not expected to take a hit from changes to the ACA or reforms to Medicare and Medicaid, as most of these are private-pay institutions, which do not rely on government reimbursement.

Infrastructure Spending and Public-Private Partnerships

- President-elect Trump released his 100-day action plan, which includes the "American Energy & Infrastructure Act," a plan that will "leverage new revenues and work with financing authorities, public-private partnerships and other prudent funding opportunities" as well as "harness market forces to help attract new private infrastructure investments through a deficit-neutral system of infrastructure tax credits." Trump promises to spend around $1 trillion in infrastructure investment over 10 years. Financing $1 trillion of infrastructure will require a hefty equity investment of near $167 billion.
- Trump has released few hard specifics on how the plan will be paid for and how it will be made revenue-neutral, as promised. His plan calls for infrastructure-related tax credits to be given to private companies who take on public infrastructure projects. Investors will receive a tax credit equal to 82% of the equity amount, which lowers the cost of financing a project by about 18-20%. These tax credits would be repaid from (1) tax revenues from wage income as new jobs are created and (2) tax revenues from contractor profits.
- Another funding source under the Trump plan would be a repatriation fee where "companies paying the ten percent tax on the repatriation of overseas retained earnings could use the tax credit on infrastructure equity investment to offset their tax liability on bringing the money back."
- Funding for water and environmental infrastructure is planned from the cancellation of "billions" of dollars sent to the United Nations to fund climate change initiatives. The United States currently only gives $10 million a year to the United Nations for this purpose, though President Obama pledged $3 billion to the Green Climate Fund (an independent body) and President Bush pledged $2 billion in climate change-related aid to developing countries in 2008.
- The infrastructure plan appears to have bipartisan support, as Democrats, such as House Minority Leader Nancy Pelosi, have expressed willingness to cooperate on an infrastructure spending package. But Republican members of Congress, such as Senator Mitch McConnell, appear slightly more wary and less enthusiastic, presumably because the increased spending would likely not be deficit neutral.
- Questions still remain about the plan's viability and funding. Despite the lack of clarity, analysts are predicting that infrastructure stocks will do "very well" under Trump's plan. In fact, Steve Sakwa, head of real estate research at Evercore ISI, believes that investors may start re-allocating capital to switch into various industries that will benefit from Trump's proposed infrastructure plan.
- Under Trump's plan, generous spending through tax subsidization will almost certainly lead to economic growth and provide REITs increased opportunities to get involved in construction and maintenance projects. However, a credit-enhanced tax scheme would likely apply only to money-making infrastructure projects, like toll roads and airports. The impact of this involvement remains to be seen, because the plan is unclear on how (or whether) the projects will become profitable for private companies and their investors. If the tax credits are large enough and the public-private partnership agreements are enticing, it will open a new sector for significant REIT activity.
- On the other hand, a significant increase in public construction spending could crowd-out potential private construction spending by significantly raising the cost of construction labor.