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**THE VALUE CREATION OF THE BUSINESS MODEL OF FINNISH RESIDENTIAL REITS  
AS OBSERVED THROUGH THE ANNUAL STATEMENT - EVIDENCE FROM ORAVA  
RESIDENTIAL REIT PLC**

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Abstract <p>The thesis evaluates the value creation of the business model of Finnish residential real estate investment trusts (REITs) by observing the annual statement of Orava Residential REIT Plc. for the financial year ending 2016. The theoretical framework discusses peculiarities of REITs, company and its management and financial accounting. Different concepts and aspects have been highlighted in all of the chapters of the theoretical framework.</p> <p>The empirical research is qualitative and done by selective coding. The research method has been abductive. The most important research findings are related to fair value accounting, corporate governance and their role in real estate investment trusts. It seems that fair values are related to all different aspects of the operations of a REIT, the uncertainty related to it possibly enables the management to practice real earnings management. Moreover, unrealized gains and due to the changes in fair values play a significant role in the net income of the company. Considering corporate governance, major concern was raised from the independence of the board of directors. The board has assessed majority of its members to be independent, still, evidence is found to justify that majority of the board members cannot be considered to be truly independent. Also, the cash flows from the realized gains, from the point of view of private investor, have been discussed.</p> <p>More research should be conducted to validate the findings of the research. For example, corporate governance, real earnings manipulation or leverage and capital structure could be inspected more.</p>			
Keywords <b>Fair value, corporate governance, tax exemption, Orava, Real Estate Investment Trust</b>			
Additional information			

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## 1 INTRODUCTION

### 1.1 Introduction and Motivation for the Research

According to the Statistics Finland (2010, 2016a, 2016b), during the last two decades, the value of the financial assets of the Finnish households has been quite steadily increasing, however, also the level of indebtedness has been increasing in the recent years. Other assets, such as land and building, still have a significant value in the total wealth of the households, covering around sixty (60) percent of the total wealth. The statistics also show that the households have been moving their wealth from listed shares to different funds and from long-term deposits to short-term ones. Even if the level of investments in financial assets is low compared to the beginning of the millennia, majority of the growth in the wealth of households shall be accounted for favorable development of the equity markets leading to holding gains of financial assets. Based on the previously mentioned statistical observations, we may quite safely assume that the value and especially the growth of the financial assets of the Finnish households is widely depending on the success of their equity investments.

It is generally accepted principle in accounting and finance that returns over the risk-free rate can be only expected as compensation for risk, and one way to control risk is diversification of the investment portfolio (e.g. Lintner 1965, Goetzmann & Kumar 2008). Real estates can be one way to diversify the investment portfolio. Falkenbach, Niskanen and Kiehelä (2013) argue that inclusion of real estates in investor's portfolio poses several barriers such as need of ongoing real estate management, need of specific knowledge and the high value of the initial investment. They suggest using indirect means, such as *real estate operating companies (REOCs)* or *real estate investment trusts (REITs)* as a possible way to overcome the barrier. Indeed, Oikarinen, Hoesli and Serrano (2011) have found out that in long-term there will be similar diversification benefits for a stock portfolio, regardless if the investment was made on REITs or directly to real estates.

By the time when Falkenbach et al. (2013) wrote their paper, there was not any Finnish REIT listed yet, however, in autumn 2013 Orava Residential REIT was listed

in the Helsinki Stock Exchange (Simola 2015). Simola (2015) as well as Kynäräinen (2016) write, correspondingly, in Finnish financial newspapers *Taloustaito* and *Kauppalehti*, that REITs have had remarkably high returns during the last years, reaching up to annual return of 10 percent. During the autumn 2016 there has been a debate going on in the Finnish financial press discussing the business model and risks associated to residential REITs in Finland. Herrala (2016) refers to several specialists and argues also by himself that the risks of residential REITs are not properly communicated for the public and their business models are not sustainable, due to the high proportion of the earnings coming from raise in book values of assets, and that the trusts also pay dividends from those unrealized gains. His claim got a response from Peiponen (2016), the CEO of Orava Residential REIT, saying that the company follows IFRS-regulations and funds the dividend payments by selling its assets. Hertsu (2016) contributes to this discussion by stating the comments of Peiponen (2016) related to accounting standards to be correct, but still she confirms Herrala's (2016) claims and argues that Orava Residential makes its profit basically by raising the book values and pays its dividends with debt.

Considering the importance of the development of equity investments for the financial wealth of households, private investors perhaps being relatively unsophisticated (Bartov, Radhakrishnan & Krinsky 2000) and the attention of residential REITs gained in media, it should be interesting to gain understanding of the business model of such trusts in Finland. We may, with caution, assume that private investors are not efficient in evaluating the true economic conditions of different investments. Thus, excessively hyped investment forms might attract unsophisticated investors, who will take more risk than they realize, possibly leading to unexpected losses. If the speculations of the business model of residential REITs are correct, they might in the future be in financial problems, causing also damage for the financial situation of households. However, there seems to be lack of research about Finnish residential REITs. Also, world-wide, the research seems to rather being mostly published in journals related to real estates and property management than accounting, even if the topic seems interesting also from the point of view of accountants.

Moreover, the success and business model of residential real estate investment trusts should also have some public interest. The Finnish government (2008) proposed changes to the law regulating the taxation of residential REITs, that was later made valid by the parliament. One motivator for giving the tax exemption for residential REITs was to promote the construction of market priced rental apartments. By the time the rents were increasing relatively fast in areas where many people were willing to move to, meanwhile, there was not enough supply especially for small flats. Also, pension funds had started to show higher level of interest on investing to real estates, but the double taxation of limited liability companies might have set constraints for investing to real estates in this specific company form. Thus, we might consider that success of REITs should have an effect on the general economic situation and create incentives for policy makers.

## **1.2 Research question and purpose of the research**

The research question is as follows: *What is the core of value creation in the business model of residential real estate investment trusts in Finland, as reflected through their annual statements?* The key aspect is to evaluate the business model of residential REITs based on their annual statements. Attention is specially paid on the sustainability of the model and earnings formation of residential REITS. From academic perspective, the thesis aims to make an overview on the business model of REITs, as so far most of the research has been concentrating on inspecting certain aspects of real estate investment trusts. On the other hand, the thesis aims to contribute to the discussion seen in the Finnish media during the autumn 2016 and different issues raised there. Meaning, for example that special attention will be paid on evaluating whether the choices related to using fair values and the estimations related to those seem to be reasonably justified by the management and assured by other information sources.

As there seems to be little research conducted on the field of securitized real estate investments in Finland, and basically almost nothing in concentrating on the residential real estate investment trusts, this study is rather qualitative than quantitative from its nature. This research aims to contribute to the research gap of residential REITs in Finland, critically evaluate residential REITs and communicate



the results on a way that can be understood not only by academics but also by common people. Moreover, the thesis may work as basis for further research, as there will be need to confirm the findings after time has passed and there is more data about performance of residential REITs. It is hoped that the thesis can bring some contribution both for the academic world and for the private investors.

### **1.3 Research methods and data**

Residential REITs are rather a new form of securities in Finland, having existed basically less than five (5) years, thus there is only a limited amount of data available. This research is aiming to evaluate the core of their value creation. Therefore, the nature of the thesis is explanatory and concentrates in approaching the financial information of Finnish residential real estate investment trusts from different angles, based on different theories and concepts of accounting. The fundamental idea arises from the separation of ownership and control, on which agency theory is constructed, creating the need to evaluate whether the management of a company is using the wealth of the owners on best possible way.

The research data is gathered from the latest published annual report, being for the year ending 31.12.2016, of the Orava Residential REIT Plc, which, at the time of writing this thesis (2016-2017) was the only stock listed Finnish residential REIT. There are other funds operating in Finland that have similar investment sector and similar laws applying to them, however, those funds are not listed companies. In addition, there are also real estate operating companies listed in Helsinki stock exchange, but their business is somewhat different and there are major differences for example in income taxation between REITs and REOCs. The funds investing in residential real estates could be comparable with REITs into some extent, however, it should be noted that those are not publicly traded. Thus, even if being somewhat similar, those possess different risks and face different regulations than REITs.

The analysis will consist of discussing the data from the points of view of different accounting standards and concepts. Furthermore, comparisons for earlier research findings will be conducted, for example related to corporate governance characteristics of residential real estate investment trusts. However, the analysis does

not include comparisons with or companies and is not supplemented by benchmarking the data of REITs against real estate operating companies (REOCs) in Finland, or against average returns on direct real estate investments for example. This kind of limitation has been set due to the limited research resources. Moreover, such a variety of analysis relate to the research was seen to be too large for the scope of master's thesis.

#### **1.4 Research findings and structure of the thesis**

The research results show that fair value accounting is in the very core of Finnish residential real estate investment trusts. It is related to most of the operations of the company and can create possibilities for real earnings management and plays a crucial role in the net income. Moreover, it looks like corporate governance is closely related to the operations of the REIT and that there possibly are some significant issues with the board independence. It appears to be so, that only two members of the board are truly independent, even if four of the six board members have been assessed to be independent by the board itself. Moreover, the cash flows of the company give the image that it is not able to finance itself by rental operations or by trading real estates, rather, it has to issue convertible bonds and take more loan to acquire real estates and to pay dividends. Also, it looks like for a private investor the proportion of net cash flows from the realized gains will be lower through REITs than through direct real estate investments. The research finds similarities with earlier research results and seems to be among the first ones in Finland, that observe this form of businesses as a whole.

After this chapter, the previous research is discussed in three chapters. The second chapter concentrates on real estate investment trusts, third one on company and its management and fourth chapter discusses the aspects related to financial accounting. The empirical research is discussed in chapter five. The research findings are first discussed under different topics and in last chapter of the findings an overview of the most important topics is made. In the last part of the empirical research the research results are discussed. The summary chapter summarizes the purpose of the research, the research findings, limitations and conclusions as well as suggests some ways to use the research and proposes new topics to be researched.

## **2 REAL ESTATE INVESTMENT TRUSTS**

This chapter is going to illustrate what are real estate investment trusts, what kind of legislation and special rules apply to those in Finland, how the trusts can be valued and how they behave in a mixed-assets portfolio and finally basic principles of valuation of real estates are defined. While this chapter concentrates on the specific form of equity instrument, the chapter three will discuss about fundamental issues related to companies and their use of capital. The fourth chapter will focus on the core aspects of financial accounting and its role and limitations as a communication tool.

### **2.1 Characteristics of Real Estate Investment Trusts**

As real estate investment trusts are a specific kind of business, there are also some characteristics related to them. The core of their operations relies in owning and trading real estates, therefore, also the most of their income and value creation relies on real estates. Oikarinen et al. (2011) have found evidence from the markets in the United States of America supporting the assumption that REITs and direct real estate investments bring similar diversification to mixed-assets portfolio when the investment is made for long time-period. They explain that the similarity is caused by the nature of REITs, as they are entities investing to real estates and thus, they will reflect the development of real estate markets as well as the income from the real estates. However, they recognize that securitized form of real estate investments is reacting more timely to the changes in the market situation due to the higher market efficiency. In addition, Oikarinen et al. (2011) note that REIT performance does not seem to be predictable, at least on quarterly level, while the returns of direct real estate investments are predictable. Mühlhofer (2013) has found out that in short-term the returns from REITs is driven by the income from real estates, while the change in the value of the real estates is not effectively seen in the values of the market securities. He argues that this is caused as the REITs face trading constraints in the real estate markets, thus, they have barriers preventing them from realizing the gains timely. Moreover, he suggests that REITs cannot be used as substitutes for real estate investments in short term.

Considering that REITs are listed companies, being public limited liability companies from their company form, there are certain requirements for them specified in the laws and regulations. Such laws and guidelines are for example Limited Liability Companies Act (LLCA) 21.7.2006/624, Accounting Act (AA) 1336/1997, and Rules of the Exchange (2017) issued by Nasdaq Helsinki Limited. First of all, limited liability company exists for creating profit to its owners (LLCA 1:5) and the managers of the entity are by law required to work for the best of the company with due care (LLCA 1:8). Moreover, companies are required to issue financial statements that faithfully and materially represent the results of the business operations and the financial position of the company (AA 3:1-2). Materiality is a concept of information, a single piece of it or information as whole, where not disclaiming something or misrepresenting it could reasonably be assumed to affect the decisions of the users of financial statements (AA 3:2a). Closely related to REITs, Accounting Act (5:2b) allows recognizing investment real estates in financial statements by using fair values. However, Barth and Landsman (1995) argue that due to imperfect market conditions there is always need for making estimations and assumptions when fair value accounting is used. Thus, there is also risk of making mistakes when conducting the estimates. Nevertheless, they say that fair value accounting creates basis for evaluating the firm value as the accounting represents the total value of the assets, assuming the estimations do not contain serious errors.

The research evidence of how real estate investment trusts reflect the value created through income from real estate and development of the real estate markets, requirements of financial statements, fair value accounting and concept of materiality create together a rather interesting combination. Moreover, capital markets and the way it works, and is assumed to work, make the situation perhaps even more complicated. Intuitively it seems that fair value recognition of real estates is contradicting the idea of Oikarinen et al. (2011) about the development of real estate markets being reflected in REITs in long term. However, they also pointed out the securitized real estate investment reacting to market changes more timely than direct real estate investment due to lower market constraints. According to Bernard and Thomas (1990), there is some evidence from the inability of the market to fully reflect the expectations of future earnings based on the released information of current earnings. They also say that this holds true even in highly competitive capital

markets. Thus, there is no single answer for defining what is the “correct” value for a company. We may consider the stock markets to be the efficient unbiased measurement of the firm value, still, we should take into account that it is rather evident that the market price is not fully capturing all the aspects of the value of the company.

According to Cotter and Roll (2015) REITs are the only form of residential real estate investments that are truly liquid. Their research results provide evidence of REITs being less risky than the stock market in general, even if the difference has been diminishing over decades, during the financial crisis of the end of 2000’s, the market beta of US REITs was even higher than one. Their findings of lower risks associated to real estate investment trusts in relation to stocks is similar to findings of Oikarinen et al. (2011). However, Cotter and Roll (2015) note that residential REITs seem to have higher risk associated to them than does generally used real estate indexes published S&P and Case-Shiller, that measure the development of private real estate markets. They also note that some of the difference in the risk and returns of REITs and private real estate investments is caused by different ways to calculate the indexes. As real estate investment trusts are traded in stock market, one might also consider it to decrease the trading constraints, possibly leading to higher volatility in the prices.

I argue that we need to separate at least two levels when considering the value development of REITs, as demonstrated in table one (1) below. First, we should think about the entity itself and how its value is reflected in the financial statements. It is crucial to understand that despite all the regulations and auditing as well as other assurance actions done within the company, the financial statements are still prepared by people. Therefore, there is also room for intentional or unintentional errors. Second, we must understand that the market security (company’s stocks) is priced by market participants, based on their expectations of the future cash flows from the investment. Moreover, for theoretical simplification we may assume that the market is perfectly efficient, but in real world it basically never is perfect. In case of companies listed in Finland, one should understand the size of the capital market and its effects on the efficiency of the market.

**Table 1. Separation of value estimation of REITs to company and capital market levels**

Capital market	Company (financial statements)
Market participants make the valuation	Requirement of truthful and material representation
Use of all publicly available information	Access to insider information
In practice, imperfect market conditions	Insiders make the assumptions
	Fair values include risk of estimation errors
	Cost/benefit of revealing information

## 2.2 Finnish legislation considering Residential REITs

Apart from the laws and regulations that generally apply to Finnish companies, Finnish limited liability companies or public limited liability companies, there are some laws that are specifically designed to regulate the operations of residential real estate investment trusts in Finland. These laws, which still miss official English translations, are “Act on real estate investment trusts” (kiinteistörahastolaki 19.12.1997/1173) and “Act on tax exemptions on some limited liability companies operating in residential rental business” (Laki eräiden asuntojen vuokraustoimintaa harjoittavien osakeyhtiöiden veronhuojennuksesta 24.4.2009/299). The laws set stricter standards for REITs than those of other limited liability companies, however, they also grant the exemption of paying taxes. The most notable sections regulate the residential REITs to be free from paying corporate taxes. The key requirements for tax exemption is that the REIT operates solely in rental business of the properties it owns, at least 80 % of the value of the assets of the company are based on the properties that are mainly used for residential purposes, a single owner may only own up to one tenth of the company and the company follows the “Act on real estate investment trusts”.

According to the documents about preparing the law granting the tax exemption issued by Finnish government (2008), one reason for it is to set direct real estate investments to be equal to indirect real estate investments. Before the tax exemption was granted, indirect real estate investment would be subject to double taxation for the owner. First, corporate tax would be paid from the earnings and second time tax would be paid from the dividends or returned invested capital. Thus, the matter is a question of equality and effective capital allocation. Also, the matter of tax exemption has roots in demographic changes and economic situation within Finland.

From one point the law was designed to increase capital inflow to residential real estate investment trusts for generating more residential flats to high-growth residential areas. In those places, typically the demand for flats was usually higher than the supply, leading to increasing rental costs, thus, making consumers to relatively (and absolutely) more of their income on living. Therefore, the tax exemption serves interests of the state. Moreover, after financial crisis big investors, especially pension trusts, had started to invest on real estates to diversify their risks. Making this kind of investments more profitable by changing the legislation also serves the good of the state.

Highlights of the “Act on real estate investment trusts”, regulating the operations of residential REITs, includes following aspects. The REIT must distribute the gains to the owners, the minimum amount is 80 % of the realized gains. One should note that the unrealized gains are not counted as part of the requirement of payout ratio. The REITs are also required to publish information about the valuation of their properties in every quarterly, semiannual and year ending financial reports. They have to publish information of the basis of valuation. Also, valuation of the properties has to be done when buying or selling properties, or if the change in value could otherwise materially be relevant for the company and its owners. Moreover, the law states that the residential REIT has to work solely for the benefit of its owners and treat all owners equally. According to Falkenbach et al. (2013), the laws applying to Finnish real estate investment trusts are similar to the corresponding laws within Europe. However, one should note that the only type of REIT with the tax exemption in Finland is the residential one.

What kind of practical implications could we consider the residential REIT rules to have? From one point the payout requirement of realized gains might set some limitations to the investment strategies and growth opportunities of residential REITS. On the other, the compulsory payout might attract more investors who are looking for dividend income. As the operations of the companies are limited, it is quite clear for investors to what they are putting their money in, thus, we may consider that some of the information asymmetry is removed by the legislation. Moreover, the limitation of how big parts of the company one owner can have protects against aggressive takeovers. Still, it is important to note that residential

REITs do not pay the money back to shareholders if they sell the stocks, but the money comes from other participants in the stock market. Thus, the REIT itself cannot have direct liquidity problems if owners start to sell their shares, rather, it might affect the stock price and be later reflected in the ability of the REIT to access capital.

### **2.3 Valuation of REITs**

In general, value of a single company can be defined as the today's value of the future cash flows the company will provide to its owners. However, the researchers are still finding mixed evidence on whether the net income (NI) or the cash flows (CF) are a better tool for valuing a company. In case of REITs the industry has long argued that the best way to evaluate the trusts is to use funds from operations -figure (FFO), which basically takes the net income and adds back the realized gains or losses from selling real estates and the depreciation. Thus, it ignores the effect of accounting based division of cost or drop in value (depreciation), which often in case of real estates does not reflect the real development of the real estate values. Moreover, the depreciation falsifies the proportion of rental income to the value of the properties. As selling real estates is not considered to be a remarkable part of operations of REITs, the industry has wanted to eliminate its effects on the valuation of operational performance of the companies. However, there has been concerns about value relevance of FFO-figures, as it is a non-GAAP figure and thus can be calculated by using different components of income, possibly leading to situation where REITs may mislead owners or potential investors. (Fields, Rangan & Thiagarajan 1998, Gore & Stott 1998, Graham & Knight 2000.)

The researchers are having quite uniform results supporting the claim of the industry to use the funds from operations as basis for valuation of real estate investment trusts. It seems that the FFO figures are better at predicting the future FFOs and cash flows than the net income. Also, funds from operations has stronger association to stock returns than does the NI. Thus, it appears to be so that the information content of FFO is higher than the one of net income. However, even if the funds from operations can be justified to be useful figure for REIT valuation, it ignores the realized gains and losses of sold properties, even if these gains/losses have a value



relevant impact on the stock price. On other words, the importance of net income cannot be clearly said to be lower than the importance of FFO. Moreover, one should note that especially young REITs tend to manipulate their financial numbers. Manipulation seems to be highest when the company plans to issue equity capital. The effect caused by manipulation of accruals appears to reverse as time passes, but the same does not happen with FFO figures. (Fields, Rangan & Thiagarajan 1998, Gore & Stott 1998, Graham & Knight 2000, Zhu, Ong & Yeo 2010.)

## **2.4 Value of real estates**

The real estate markets are driven by sort of internal and external factors. The national economic situation affects the real estate prices as well as the markets of real estates. Moreover, the rent levels, amount of people wanting to build houses, price of houses and the building space available within certain geographical area works as a whole system. The valuation of a single property can be seen to maximize when free building is scarce and demand for housing is high, leading to situation where both the price of the residential buildings and the rent tenants are willing to pay increase. Unlike in stock market, in residential real estate private information can be utilized in wealth generation, or in wealth lowering purposes. It seems that agents who buy and sell houses use the professional knowledge they have for their own benefit. When they are selling their own property, the prices tend to be higher and selling times longer than those of the customers of real estate agents. The difference might be caused, as there are not enough incentives for the agents to sell the residential real estates of their customers with high enough prices, as the customer probably will not be interested, or able, to observe the later market price of their properties. Moreover, the dealers hold information knowledge that is specific to the area they operate in and are therefore able to perhaps make better evaluations of the houses or flats than people outside of the profession. (DiPasquale & Wheaton 1992, Levitt & Syverson 2008.)

For residential real estate investment trusts this kind of characteristics of real estate markets can be seen to create opportunities and threats. If they have the professional knowledge specific for the areas they operate in, they might have the chance to utilize the knowledge to maximize their gains on the sale of their properties. On the

other hand, if they do not possess this kind of knowledge, they may risk gaining too low prices of their sold real estates. Considering the size of the residential REITs, one could assume that they can afford longer selling times than private sellers. However, the decision making in selling property of real estates of REITs is perhaps also having other incentives and considerations than just maximal gain on the selling.

### **3 COMPANY AND ITS MANAGEMENT AND THEIR ROLE IN VALUE CREATION**

In the previous chapter, we discussed about peculiarities and characteristics of residential real estate investment trusts. In this chapter, an overview of the role of company as an instrument for using private money and issues related to is made. Also, the capital structure choices of companies is discussed, as it gives valuable information for investors for example on how much gearing has been used for their investment within the company and is closely related to risk and cost of capital of the company. Moreover, capital structure could be seen as one of the fundamentals of separating the liabilities of a company between debtors and equity holders and it is compulsory part of the financial statements to separate those.

#### **3.1 Separation of ownership and control**

Typically, large companies have several owners and the organizational structure is built on a way where the owners are not taking part to everyday decision making. On other words, the management of the company is separated from the owners. Thus, also the fundamental risk of the business is carried by different entities than the ones who run the business. Evidence shows that the more diversified the company is, less is the share of ownership of the management. This kind of structure creates agency problems, where the company management, as agents of the principals, have incentives to work on a way that is best for them with the cost of the owners. However, due to the survival of the arrangement, we may consider that it is the most efficient way to run a large-scale business – otherwise, due to the competitive operational environment, some other way to organize business actions would have become more common way for organizing companies. A crucial part of overcoming, or at least limiting, agency problems is different contractual structures. These contracts aim to generate a situation where the decision-making power is efficiently divided so that agents do not have enough power to make decisions that increase their private benefit, where there are incentives to generate more wealth for the company to gain more compensation for the agents themselves and where the agents are being monitored enough. Monitoring is a concept of overseeing the actions taken by the agents, it can be both internal and external monitoring. Internal monitors

can include for example board of directors and agents higher in the organization hierarchy, from external monitors perhaps one of the most important ones is the capital market. The market forces evaluate the performance of the agents and price the securities of the company accordingly. Especially in case of the company needing to change the focus of their business, the market forces play a crucial role. Research has found out that the managers themselves rarely start to change the focus of the company from their free will, rather it is the pressure created by the market participants monitoring the management that creates the incentives for the refocusing. (Fama & Jensen 1983, Denis, Denis & Sarin 1997.)

Residential real estate investment trusts are, due to the laws and regulations, stock listed companies, thus, their ownership and control is separated. Considering that Orava Residential REIT Plc. pays management fees, both fixed and performance based, to a management company Orava Funds plc., and both having partially same people as decision makers, it seems that an interesting question of agency problem raises (Orava Funds 2017, Orava Residential REIT 2017). According to Orava Residential REIT (2017) the annual fixed fee is based on the fair value of the company's assets and is 0,6 %, the compensation based on performance is 20 % of the part of annual return that exceeds threshold of 7 % calculated for the net assets value (NAV) per share, unless the share price is lower than the NAV, when the stock price is used as basis for the calculation of the performance fee. We may question how efficient this kind of contracts are for overcoming agency problems. If the management gets remuneration through the management company, what kind of incentives do they have to work on the best of the shareholders of the REIT? On the other hand, if the calculation basis for performance-based compensation changes within certain limitations related to the NAV and stock price, what does it cause for effectiveness of the stock markets as external monitor? Ambrose and Linneman (2001) mention that externally managed REITs face more severe agency problems than the internally managed ones, which is supported by their findings of internally managed REITs market capacity growing much higher in the 1990's than that of externally managed ones. However, they note that the research results considering the superiority of the internally managed REITs is mixed, on one hand the internally managed ones have lower cost of capital, lower payout ratios and higher part of their total revenue is generated from rental income. On the other hand, profit margins,

return on equity and return on capital do not seem to have significant differences between the two types of REITs. Nevertheless, still our question about the agency costs and efficient monitoring remain valid.

### **3.2 Capital structure**

Capital structure of companies has been widely researched by academics. However, some controversies are found within the research evidence. The capital structure of companies can be inspected for example through control aspects of a company, agency problem, market interactions and asymmetric information. It is generally agreed that the choices of the funding of a company sends some kind of message to the stakeholders, yet, it is not clearly defined what is the information content of the message. For instance, so called pecking order is one of the fundamental theoretical assumptions of company financing. It assumes that companies primarily use internal funding, secondarily debt funding and thirdly equity funding. This order is justified by explaining that it is the order of least costly funding to the costliest one. However, researchers have also found evidence of the validity pecking order diminishing from the 1970's till 1990's. These findings suggest that companies issuing equity only when they have problems to get financing in cheaper ways does not hold true in every case. Moreover, it seems to be that companies aim to time their equity issues on the moments of time when the price of their stock is relatively high compared to the book value of the assets or to historical market values. On the other hand, companies also tend to repurchase their shares when the price has fallen low on historical perspective. Thus, the current capital structure of a company can be seen to reflect the past value of its shares. (Myers 1984, Harris & Raviv 1991, Rajan & Zingales 1995, Baker & Wurgler 2002, Frank & Goyal 2003.)

It seems that there are different incentives for borrowers and lenders, while these differences lead to conflicts between the entities and shape the debt policies of companies. Often supply of capital is bound to contracts, so called debt covenants, that limit the freedom of the funded company, or have a threat of losing some decision-making power if certain criteria are not met. In case the covenants are violated, lenders may excess their rights to take more control on the borrower, often leading to the company trying to limit their amount of debt-taking in the future, in

order to limit the power of the lenders. Moreover, borrower's capability to access capital from different sources and the costs related to different financing methods are important part of the formation of the capital structure of a company. Thus, we can say that current capital structure of a company is created by historical moments, cumulating from debt contracts, market price and assumptions based on theory of optimal capital structure. (Roberts & Sufi 2009, Baker & Wurgler 2002.)

Despite capital structure being researched relatively much, often real estate investment trusts are excluded from the researched population due to the special properties of this type of companies. One of the peculiarities of REITs is their exemption of liability to pay corporate taxes, thus, they also do not enjoy tax benefits over the interest beard from having debt financing. Also, they have specific requirements to pay relatively large part of their realized income out as dividends. Moreover, investing in real estates is a kind of business that consumes rather large amounts of cash. Due to the special characteristics, REITs do not fully follow the traditional model of pecking order, as especially the use of debt is priced differently than in companies following standard regulations. However, research has found out some general principles that apply to debt related aspects of real estate investment trusts. REITs having relatively illiquid assets tend to have use capital structure with lower leverage and issue debt with shorter maturity than those with more liquid assets. Also, real estate investment trusts that have banking relationships have more often the possibility to gain long term credit ratings, allowing them to access public debt markets, use more debt without securities and generally also have lower leverage than the REITs without banking relationship. As the secured financing from banks works as gatekeeper to public financing, we may also conclude, as the researchers have found, real estate investment trusts having higher amounts of secured debt have also higher leverage ratios. Thus, securing some debt allows the companies to access more overall debt. Also, it seems that higher leverage ratios are positively related to higher market-to-book ratios and that the history of this ratio has a significant effect on the current leverage ratios of the companies. (Giambona, Harding & Sirmans 2008, Hardin & Wu 2010, Feng, Gosh & Sirmans 2007.)

## **4 FINANCIAL ACCOUNTING AND UNDERSTANDING THE FACTORS AFFECTING THE INTERPRETATION OF IT**

In the previous chapter an overview of company's capital structure and separation of ownership and control was made. In the following pages we will discuss central characteristics of financial accounting related to evaluation of the value creation of the business model of residential REITs. Financial accounting can be seen as not only a compulsory report, but also as a tool of communication for revealing the insider information of the company for the public. The information given can be widely utilized by investors, competitors, authorities and other stakeholders. Understanding the purpose of financial accounting as well as what kind of uncertainties and discretion for creating the accounting could be said to play a crucial role in interpreting the financial information of a company.

### **4.1 Purpose of financial accounting and international standards of accounting**

The international accounting standards board (IASB) is an organization developing accounting standards worldwide and issuing standards related to accounting. They have developed a conceptual framework to set the general guidelines for accounting and publish the international financial reporting standards (IFRS) that are being adopted in many countries all over the world. In the conceptual framework (IASB 2010) the basic purpose of financial reporting is defined to be a tool that provides useful general level information about the financial situation of the reporting entity to the current and possible entities providing resources for the reporting one. The possible resource providers must estimate the returns and risks related to the entity, thus, they need to know about the possible future cash flows. The information about the assets and liabilities of the company is a necessity for making the cash flow estimations. However, the standard setters acknowledge that the financial statements cannot provide all the necessary information, but the stakeholders are required to seek for other sources of information too. Moreover, the standards take the stance about financial statements not being an extremely accurate description of the financial situation of the reporting entity, rather, they are a sum of different models, expectations and justified decisions. The financial statements are said to include different reports, such as balance sheet, income statement, cash flow statement and

notes, that separate the assets and liabilities and changes in those to causes cumulated from business actions and from other sources.

Dichev (2008) argues that the balance sheet approach to financial reporting, taken to be the primary approach to financial reporting by the international accounting standards board and the United States financial accounting standards board (FASB), is not the most suitable way to represent the business results of most of the companies. He points out that in most of the cases the business model of a company is heavily based on creating revenue by making expenses, and creating earnings with this process. In this perspective, assets are just devices helping in revenue generation, being consumed or used in order to have income and profits, thus, assets of a company themselves are not having remarkable value without the business process related to them. However, he points out that in a business model where the earnings are solely a representation of unrealized or realized growth in assets, and the core of the business is that the company aims to generate wealth by trading, holding and growing assets, the balance sheet approach makes sense. Moreover, Dichev claims that increasing use of fair values creates a need to make estimates and changes in the values of assets, ultimately leading to noise in the earnings making the information content of the earnings to be lower. The noise in the earnings reflects the incomes and expenses of the company that are not created by the daily business operations, the core of value creation, of the company.

It is not only Dichev (2008) who is concerned about fair values and international standards, also Ball (2006) states that the international financial reporting standards has some negative sides, but also some positive ones. The main negative sides pointed out are the use of fair values and uncertainty created by it, misuse of the image of using IFRS even with low-quality accounting, decreasing competition of accounting systems, local incentives of the users of the global standards and the fact that the standards have not been throughout tested in bad crisis situations. Also, there is a risk of the standard setting board and the standards itself starting to get politically motivated content, leading to a system that does not anymore serve its original purpose. The most important benefits for investors, as mentioned by Ball, is the lowered cost of gaining information. Uniform standards make it easier to compare business across the borders of countries. He states that, at least in theory and during



long time span, the lower cost of gaining information should lead to lower cost of capital, making the companies more profitable for the investors.

When it comes to residential real estate investment trusts, it intuitively seems that there are some clear highlights related to the previously mentioned standards and arguments. Perhaps the clearest one is the use of fair values, REITs use those to constantly update the value of their property. Fair value accounting will be discussed more in depth later in this thesis. Also, as per Dichev (2008), it seems that the use of the balance sheet approach makes sense. The core of the business is to buy property and hold it for the purposes of revenue and earnings generation. Moreover, this kind of business might underline the importance of seeing the financial statements just as one source of information among many others. One could logically come to the conclusion that the income generation of such a company depends rather heavily on the economic and demographic development of the areas the REIT operates in. Thus, we should understand the role of financial statements as a one single piece in the information puzzle surrounding the investors. Nevertheless, it does not necessarily mean that the importance of this source of information would be small.

## **4.2 Fair value accounting**

As defined by the IASB (2011: A427):

“IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie an exit price).”

Fair value accounting (FVA) has been replacing the historical cost accounting (HCA) during last decades, currently use of it is guided by International financial reporting standard 13 Fair Value Measurement (abbreviated as IFRS 13), issued by the IASB (2011). A discussion about the pros and cons of use of FVA has been going on within the academia and business life already for some time already. Fair value accounting has been even claimed having escalated the financial crisis, however, little evidence is found to support or to invalidate the argument. The debate reflects one of the fundamental questions of perspectives on what accounting should reflect and how, should it rather be an accurate and reliable historical tracking of the value

of the assets, or should it be a useful measurement of the current value of the assets of a company. (Laux & Leuz 2009.)

Fair value accounting has been said to change the perspective the company is being observed through. Especially for the agency problem the use of FVA puts extra attention on the way the agents use the property of the principals, as the method itself makes the balance sheet to reflect the whole value of a company in a certain point of time. However, for this claim to hold completely true, perfect and complete markets are required, which in the real world is not the case. It is important to understand that the IFRS 13 specifically defines the fair value to be defined by the markets and that the value has no dependency on the entities related to the assumption of trading an asset or a liability. Thus, the standards set limitations and guidance for overcoming the problems caused by the uncertainty of the imperfect market conditions. Requirements of recognition and disclosure are used as a tool to make the FVA process transparent. The uncertainty arises from situations where real market value of assets and liabilities cannot be taken from the market. This makes it necessary to estimate the value in use of the assets and liabilities, thus, there will be an inbuilt risk of making severe or less severe errors in the valuation. Nevertheless, if the estimation errors are not excessively big, the value in use is the best possible FVA measurement, assuming there are no problems with the going concern of the company. The fair value recognition takes into account gains and losses of the company, regardless of the realization of them. Research results point out that it is justified to recognize both realized and unrealized gains and losses in the financial reports, however, it seems to be that the separate disclosure of both has information content when making valuation of the whole company. Still, the users of financial statements should note that accounting discretion of the management of the company can have an effect on the informativeness of those figures. (Barth & Landsman 1995, Barlev & Haddad 2003, IASB 2011.)

The IFRS 13 sets different levels of hierarchy for methods of valuing assets and liabilities to their fair values. In the first place, market approach should be used for the valuation, if it is not possible, cost approach or income approach may be used. The standard sets the principles that need to be used when present value techniques are used for income valuation. The leading idea of the standard is valuing assets to

the price the market would use it in real situation. This includes the assumption of the value not being related to the entity, but to the asset itself. Thus, all the aspects that can affect the value of the asset should be considered when making the estimation of the fair value. Moreover, the valuation must be based on trade within so to say arm's length, meaning that the value cannot be based on opinion of some entity that has intention to pay lower or higher price for the good than does the market. Moreover, difference between the transaction price and market value can arise even when the deal is done with arm's length for example from financial conditions of one of the transaction participants. It might be the case that the seller is forced to accept an offer that does not meet the market price, in which case the fair value for the buyer would be different than the actual buying price. Overall, all risks related to the asset, or possible differences to market price are required to be taken into account and added or eliminated in the books, so that the final valuation is as close as possible to the value that efficient and complete market would be assumed to set for the asset. (IASB 2011.)

### **4.3 Earnings and management discretion**

Earnings could be considered the most important figure in the financial statements of a company. It is a measurement that captures the financial performance of the whole entity during the reporting period, taking into account not only the actual cash flows, but also the accruals. Accruals are the part of income or cost that is caused by the activities of the reporting period, but no movement of money has occurred to the related transaction, thus, some uncertainty is related to the amount of earnings. One purpose of using accruals is to display the results of the decisions of the management, as the cash flows are not necessarily reflecting the performance in defined, relatively short periods. Also, the matching principle requires accruals to be used. Without them it would be practically impossible to show what costs are related to the income generated. Moreover, the principle of revenue recognition tries to overcome the uncertainty of accrual earnings. It demands the companies to recognize revenues only when underlying transaction is completed, or the firm has completed a substantial portion of the transaction. Also, the firm has to have a justified expectation of receiving the cash from the transaction. As part of the earnings is speculative, there is also room for management discretion, leading to possibly lower

or higher quality of the earnings depending on the choices made by the management. This variation is caused by the use of private information, that may be used to show more truthful representation of the firm's performance or to show better or worse performance than the actual expectation would be. (Dechow 1994.)

Earnings, in the view of CFOs, may be considered be of high quality, if they are repeatable and sustainable, driven by true economic performance of the company, using the accounting standards similarly over different reporting periods, not using one-time items or long-term estimations to manipulate the earnings and having the earnings supported by real cash flows of the company. This kind of definitions for earnings quality implies that it is one tool for valuation, for a situation where the investors see the company as a unit that generates returns during long time span. However, this kind of view also supports the use of earnings as basis for internal reporting and business management, as well as for the uses that are targeted to overcome agency problems. Often earnings are used for example as basis for management compensation schemes, in which case the long-term performance measurement perspective of earnings seems to validate the use of earnings as benchmarking tool of management decisions. (Dichev et al. 2013.)

CFOs believe that around half of the quality of earnings is outside of the control of the management, such as the general economic condition. Also, roughly one fifth of companies is managing their earnings with the purpose of misrepresenting the true economic performance of the company and one tenth of these companies manage the earnings per share (EPS) figures. This means that in roughly two out of one hundred companies the management uses their discretion with the purpose to manage the EPS in order to give wrong kind of image of the results of their work, on other words, on the performance of the company. Around three out of four CFOs would rather make decisions that sacrifice potential long-term value creation to keep the earnings less volatile. Interestingly, this choice seems to be more popular than using discretion within the scope of generally accepted accounting principles (GAAP), company management seems to be doing cost benefit analysis of what kind of information they want and need to publish. Moreover, prior accounting scandals are argued to be one possible reason for avoiding GAAP adjustments for earnings, as there still might be an assumption of using those adjustments to hide a fraud. Most of the managers try

to keep the earnings predictable and give enough disclosure information for keeping the stock market participants believing in the predictability of the performance of the company and to lower the information asymmetry between the investors and the management. However, the managers also try to only issue information on a level that can be communicated each reporting period. They aim to avoid making negative surprises to the investors by trying to create situation where the amount of published information does not drop, but also the information published does not communicate idea of potential increase of volatility in the earnings. In addition of smooth and predictable earnings, the market expects companies to meet or beat the expectations for the earnings. In case the expectations are not met, even if the difference would be rather small, it might be seen as information that tells about yet unrevealed issues within the company, causing a strong reaction in the market, making the stock prices to drop even drastically. It seems that managers see the earnings to be the single most important figure used by outsiders to evaluate the financial performance of the company and more real actions are used to manipulate them than those allowed by generally accepted accounting standards. (Graham, Campbell & Rajgopal 2005, Dichev et al. 2013.)

It seems that REITs having problems to generate cash flow and keep them stable, having low quality corporate governance, issuing often new equity and being highly levered are more like to manipulate their financials than are those without these characteristics. Moreover, it seems that the managers of REITs tend to rather take real actions to manipulate the earnings than use different methods to manage the accounting numbers based on general accepted accounting principles or managing the FFO. Despite the stricter regulations applying to residential real estate investment trusts, internal monitoring of the management is still needed for decreasing the agency costs. Notably board size and independence, financial expertise of the audit committee of the board of the company and amount of board meetings seems to have a positive effect for limiting the earnings management. However, also the stock price seems to work as an external monitor of the management. The real earnings management of REITs is reflected in the volatility of their stock prices and their prices have not been found to be misprices compared to other companies. Considering management discretion in real estate investment trusts, it seems that real earnings management is perhaps the most common way to manage earnings, by

doing this the companies can possibly lower the amount of compulsory payout but they pay the price in increasing volatility of their stocks. (Ambrose & Bian 2010, Zhu et al. 2010, Anglin et al. 2013.)

So far, we have covered the theoretical framework of the research, including real estate investment trusts, company, its management and its role in value creation and key aspects of financial accounting related to understanding the business model and value creation of a company. In the follow basic aspects of research will be shortly introduced, the research process of the thesis will be illustrated and findings of the research will be discussed. In the last chapter a summary of the research will be conducted.

## 5 EMPIRICAL RESEARCH

### 5.1 Research approach

Approaching data through research can be said to have two main approaches, inductive and deductive, from which the first one observes the data and makes theories or upgrades them based on the observations, while the latter one does the opposite. Inductive approach is most often used for qualitative research, as in it major part of the interpretation arises from the conclusions made by the researcher. Moreover, one of its aims is to gain understanding of the phenomena and the specific context, also, the research made with this approach is often constructed on a way that it can be flexibly adjusted as the research process goes on. Deductive approach organizes research on a way where earlier knowledge guides the researcher to observe the current data by applying the already existing knowledge to answer to the current research question. It is mostly used for quantitative researches, as by definition it is suitable for confirming and exploring dependencies and relations between different variables. One should note that it requires enough observations for making a conclusion that can reliably be generalized to a wider population. In addition to the previously mentioned approaches, there is abductive approach that combines both basic research approaches. This approach is perhaps more inductive than deductive from its nature. However, it does not let the researcher to rely solely on observations for building new theories, but it suggests combining also previous theories for gaining understanding to the researched phenomena. (Dubois & Gadde 2002, Wilson 2014: 6-19.)

For the purposes of the thesis abductive research approach is used. It was seen as the most valid approach, as there is basically no academic research yet published on Finnish residential real estate investment trusts. Moreover, the REIT industry seems to be rather little research topic within accounting perspective in general. It has some special characteristics, like tax exemption, that makes it a research environment that is different from most of other businesses. Thus, it might be excluded from some researches, but on the other hand, it seems to be a suitable platform for researching things where the effect of certain aspects may be ignored, at least into some extent. Therefore, it seems that deductive approach could create misinterpretation in the

research results due to the characteristics of the industry researched. However, into some extent the existing theories may be applied to REITs, thus purely inductive research seems to be rather inefficient work for master's thesis. The research question also guided the choice of the research approach, as the value creation is inspected through the financial statements, it seems justified to include some theoretical framework of generally accepted accounting theories as part of the research approach.

## **5.2 Research strategy**

In general, research is often classified under qualitative and quantitative strategies. The basic idea of these strategies is based on different models raising from research philosophy, or on other words, on different ways to comprehend the reality. A positivist model takes a view where different independent variables can explain a dependent variable, thus, there is a relation between the different variables and subjectivity of the researcher can relatively well be eliminated. This kind of a view is often used in quantitative research. Quantitative approach aims to recognize systematic differences in the sample data and process it on a way that it may be reliably generalized into larger population. Qualitative approach, on the other hand, is usually set to follow non-positivist model, seeking rather for understanding different relations than explaining systematic variation. Often qualitative research is used to explore the researched phenomena to find the relations within it, or to even find the core research problem. After the relations within the variables have been found, quantitative research must be done to validate the findings, describe the phenomena and to take the knowledge to next level. However, it should be noted that there is no clear line for defining when research belongs just into one of these categories. Indeed, if the research resources allow, sometimes the best results might be reached by combining or mixing methods from both research approaches. It is important to understand that the research approach and methods should be chosen based on the research question, not vice versa. The researcher should aim to choose the methods that can provide, with the resources available, the best possible answer for the research question. (Zikmund 1994: 31-42, Silverman 2005: 5-16, Wilson 2014: 6-19.)



So far, there is only one stock listed residential REIT in the Helsinki stock exchange, and it has been listed just for some years. In general, the REIT industry is not yet widely covered in accounting research, causing it to be kind of research environment where the amount of industry specific theories is rather small. Considering the research problem, it seemed that best research strategy for answering the questions arisen would be qualitative. One case company is being researched and the potential connections between different factors have yet to be discovered. Thus, qualitative strategy was chosen. Moreover, it seems that there is not yet enough data to make justified analysis with quantitative methods. Also, due to the lack of theory, it would have been hard to define different relations to be confirmed.

### **5.3 Research methodology**

Wilson (2014: 2-9) says that *research methodology* is the combination of research approach and research strategy. Basically, it is about everything related to conducting the research on a level of principles and something higher than practical actions themselves. It should be noted that the practical level tools are called *research methods*, and these two definitions are clearly different from each other's and thus, should not be mixed. Moreover, one could say that research methodology is the outcome, or binding factor, of all aspects of research – starting from rather theoretical and philosophical considerations such as what knowledge is, ending to very practical parts of the research like drafting a survey for data collection.

The research methodology in this thesis could be said to be non-positivist in the core of the problem, as the aim is to find what creates the value in Finnish residential real estate investment trusts. Thus, the view is rather observing and exploring than providing hard numeric evaluations of seeing whether and argument can be validated or not. However, part of the implementation of the thesis could also be seen to follow positivist methodology, as there has been some theoretical framework to guide the empirical research. The framework sort of points out what kind of relations and patterns could be considered to be looked for during the research.

## **5.4 Research data**

### **5.4.1 Selection of the data**

The research problem requires to answer to question of how the value creation of the case company seems to be constructed. The set way to observe this is through the financial statements and other official materials the company has published. It was seen that those are the key documents for investors and potential investors to look for data about the company. Moreover, due to the research resources other possible sources of information, such as financial newspapers and magazines, were excluded from this thesis. Thus, the annual report of Orava Residential REIT Plc. for the financial year ending 31.12.2016 has been used as the data source of the research. Those are the most recently published financial documents available from Orava Residential REIT Plc. at the moment of writing the thesis.

### **5.4.2 Description of the data**

The annual report 2016 of Orava Residential REIT Plc. is a 99 pages long document containing text, pictures, tables and graphs. It contains CEO's review, information about the strategy of the company, balance sheet and income statement, as well as other information the company finds useful to provide or is required from a public limited company. The report also includes Auditor's report, in which they have given unmodified opinion, on other words, they have stated that the financial statements give a fair and truthfully representative view over the financial situation of the company and the parent company. The materiality level the auditor has defined is 1 % of the total group's assets, equivalent to 2 000 000 euros.

## **5.5 Data analysis**

### **5.5.1 Preliminary coding**

After writing the theoretical framework and description of the data, preliminary coding was done in order to analyze the data. The purpose of the coding was to systematically arrange the data on a way that reflects the previous theoretical

knowledge. However, the list final list of the codes was to be changed during the coding, as my knowledge on the topic grew. Since the research approach was abductive, this kind of way to construct the analysis was appropriate, or even necessary when conducting the research.

The preliminary coding was done as follows. First, list of preliminary codes was created on the basis of the theoretical framework written before. After the list was finished, the annual report of Orava Residential was moved, together with the codes, to NVivo 11 program and coding was started. As the coding proceeded, new codes were created. I went through the annual report and made the preliminary coding. Finally, I had a look on the summary of the nodes and decided to keep all the codes created so far, and didn't see need for creating new ones.

For example, on page 53 of the annual report it is stated:

“On the balance sheet date, the major credit risks faced by the Group were due to rental receivables. The Group does not have any significant concentrations of receivable or credit risks. On 31 December 2016, rental receivables totalled EUR 223,000 (31 December 2015: EUR 187,000).”

Which has been coded under “capital structure” and “rent income”, as this part of the annual report is related to both aspects of the annual statement. On one hand, it reflects the capital structure and most important risks related to the assets of the company. On the other hand, the issue is closely related to the operations of the company, as it is part of the rental income that is yet uncertain. However, this part does not only tell us that it is unknown if the company can collect part of its operating income, it also gives us the information that the company's greatest credit risk raises from the core of its operations. The example illustrates the process of coding, but also, it is an example of how interconnected the different aspects of the value creation and operations of the company are.

### 5.5.2 Final coding and summarizing the nodes

After the preliminary coding was completed and decisions about keeping the codes made, I started to go through the annual report again. In this phase, I reconsidered

whether the coding was appropriately and consistently done through the material. During the process, some parts were coded under several nodes. However, I did not see need for removing any of the coding. When all the material was coded, I read through the nodes once again. After developing understanding of what the different nodes include and what is their information content, I started to summarize them one by one. Finally, the summarized codes were compared with previous knowledge on the topic and draft of the research findings was written. Final research findings were conducted by looking for connections and relations between the different aspects found before. These findings were used added to the drafts, making the last version of the research results, which also included comparing the textual parts to the tables and numbers within the annual report.

## **5.6 Research findings**

### **5.6.1 Capital**

The company aims to manage its capital in order to be able to create income to the owners and benefits for the other stakeholders it has. It constantly monitors the situation of liquidity to secure the capability to operate. The company is trying to maintain capital on such levels, and with such a structure, that it can have enough liquidity and the capital structure is optimal for the current situation. They also try to change the capital structure to correspond to the changes in its operations, for example when the interest rates change. The board has the responsibility to oversee that dividend payouts will not cause risk of the company not being able to continue its operations due to lack of liquid capital.

Orava Residential REIT uses shares that it has issued for itself for free in order to manage the capital structure, issue convertible bonds, as payment methods when buying real estates and for developing the business of the company. Major credit risk the company bares is the credit risk related to rent receivables. Accounts payable, consisting mainly of liabilities related to acquisition of subsidiaries, are recognized with the fair values at first, later on they are recognized at amortized cost.

Rather small amounts of the capital structure of the company has been explained in the annual report. One interesting point from the capital structure is the use of shares for strengthening it and for using as payments. The theory around issuing equity seems to have some features that could cause contradictions and make it hard to evaluate about what the use of shares as payment methods informs the outsiders about, or does it really have any information content at all. For example Feng et al. 2007 note that due to the tax exemption regulations REITs do not enjoy the tax shield effect of debt financing, therefore, the pecking order theory does not perfectly work for this kind of companies. On the other hand Zhu et al. (2010) have found out that the REITs that are issuing seasoned equity offerings more often tend to have more problems with generating cash flows and they also tend to manage the earnings and funds from operations more aggressively than REITs with less frequent equity issuances. Therefore, we cannot evidently clearly state that we can interpret the use of equity as payment method to be either a good or a bad signal for the investors. With certain assumptions, it could indicate that the company has problems to generate enough cash flows from the operations and the debt financing for it is not anymore available, or at least it is more expensive than the equity capital. On the other hand, issuing equity could also be seen a signal of a distorted pecking order. In which case the equity funding for the company would be cheaper than the debt financing, due to for example non-existing tax shield of interest rates, limitations set by covenants or other risks related to debt financing such as the possible unpredictable changes in the interest rates or the margins paid for the loans.

### 5.6.2 Corporate governance

According to the annual report, the management and board of directors are not employed by the REIT. From the operating expenses section of the annual report it can be seen that the board members still get compensation based on monthly and meeting fees. Nevertheless, in the annual report it is stated that the skills and knowledge of these people plays an important role in the trust. Their decisions, reflecting their expertise, affects the operations of the company and therefore also the outcome of their business operations. Orava residential REIT specifically names the expertise of the board of directors and managers as possible risk, in case their level of knowledge drops or their knowledge is outdated.

Based on the annual report, the board has six (6) members, they have met 18 times during the financial year and the attendance rate was 95 %. Four of its members have been sitting in the board since Orava residential REIT was established. According to the board, four (4) of the members are independent. However, in the list of ten largest owners of the company it may be seen that of these members reported to be independent two, equaling half of the independent members, are having companies under their control that own altogether ten (10) percent of Orava Residential REIT. These companies under the control of these two independent are three out of the ten biggest owners of the trust. Thus, we may question how truthful is the claim of independence, even if these board members would independent by some kind of definition.

The annual report contains several parts, however, nothing is mentioned about audit committee. The auditor of Orava Residential REIT is PricewaterhouseCoopers, authorized public accountants. According to the annual report the information on the consolidated financial statements has not been audited. The auditor has stated that they have audited the financial statements of the Orava residential REIT, but, as usual for auditor's report, that the company's board of directors and managing director are responsible for other information. The auditor has only read through the report and has to point out their opinion, if they consider something to be materially inconsistent with the information they have audited. Therefore, even if the financial statements have been audited, we should keep in mind that the other information may cover claims that are not under the assurance provided by the auditor.

In the annual report is stated that the REIT presents all fees and transactions paid with or done with related parties in the notes of the financial statements. Interestingly, such kind of transactions are not elaborated more in detail within the textual part of the annual statement. This kind of transactions could include for example related party sales or purchases, that are not done with fair market prices. Stating existence or non-existence of such transactions could be in the interest of the current and possible investors.

It seems that the company has not justified why it is using so to say external managers for the company. Many of the board members have ownership in

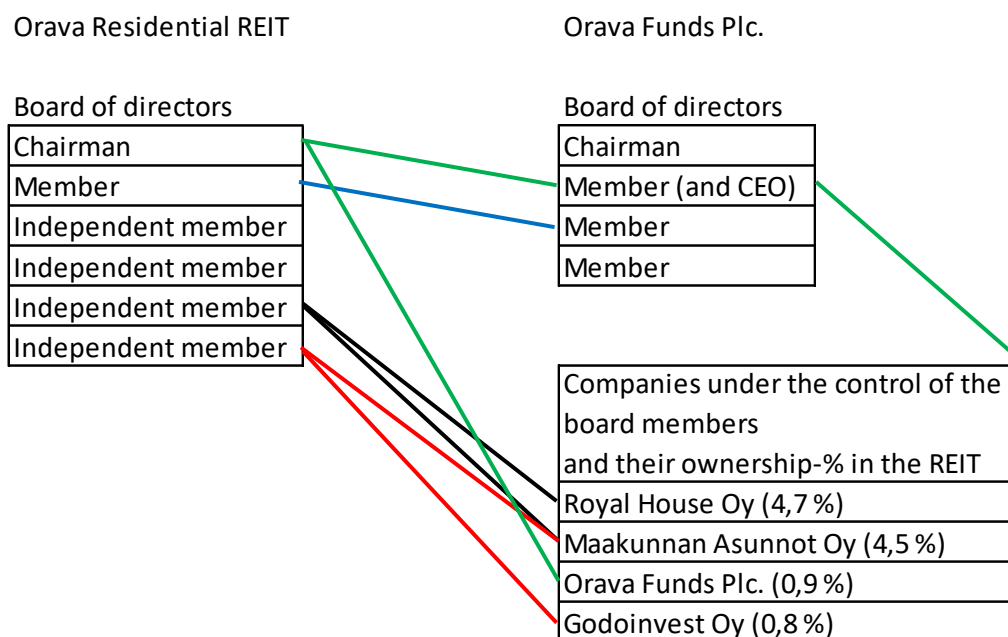
companies owning stocks of the REIT, or have decent income due to the management fees paid by the trust or from the compensation for working in the board of the fund. Therefore, it might look like the board members are not purely outsiders managing the company. Taking into account the claim of Ambrose and Linneman (2001) of externally managed REITs facing more severe agency problems than internally managed ones, it should make sense to justify why the management has been outsourced. Also, it would be interesting to know why the members of the board have been seen as the best possible ones for the trust. Basing part of the positions in the board on memorandum seems rather emotional and non-rational explanation.

Moreover, it would be interesting to know if the Orava Funds plc. is the management company of the REIT due to the memorandum, due to superior capability to manage the trust and whether changing the management company has ever been considered. Considering that the fees for the management company were 1,265 million euros in the financial year 2016, equivalent to 13,6% of operating expenses and 9,1 % of the total revenue, it could be that there is some space for competition in the prices. In the previous financial year the fund paid fees for Orava Funds plc. for 0,967 million euros, while the total revenue according to Fonecta (2017), basing the knowledge on the information of Suomen Asiakastieto Oy, was 1,246 million euros. Meaning that approximately 78 % of their revenue came from the investment trust. The chairman of the board of the REIT is also member of the board and CEO of the management company, also another member of the board of the trust is a member of the board of the Orava Funds Plc, while the management company has in total four members (Orava Funds Plc. 2017).

Zhu et al. (2010) mention that poor corporate governance has been seen to be one of the factors that seems to be driving REITs to manipulate their earnings more than those with better corporate governance. Anglin et al. (2013) point out the board independence as one of the most important characteristics of real estate investment trusts' corporate governance. The relations between the members of the board of the REIT and the management company is illustrated in figure one. Also, the relations of board members with the companies under their control that are among the ten biggest owners of the Orava Residential REIT are shown in the same figure. From the figure,

it can be seen that two out of the four board members that have been assessed to be independent by the board itself do not seem to be clearly independent from the company. These two members of the board control companies that own altogether 10 % of the residential real estate investment trust. In order to have control over the companies these board members have to control more than half of the voting power in the companies, therefore, we may with caution assume that they own at least half of the companies owning stocks of the REIT. With this assumption, these two members would own at least five percent of the whole trust. Regardless of the actual amount of ownership these board members have, we may assume that based on the information on the annual statement and the information accessible through the website of the management company, only two out of six board members are truly independent. This also means that the independent members are in minority in the board, leading to situation where the non-independent members have majority of the power in the board. This kind of situation is remarkably different than what is the image gained by the statement of the board claiming that four out of the six members are independent from the company. It might mislead investors, who think that outsiders are looking after their good in the company, while actually most of the decision makers can be assumed to have incentives to look for private benefits.





**Figure 1. The relations between the board members of the REIT and the management company, and relation of the board members to companies under their control that belong to the group of the ten biggest owners of the Orava Residential REIT**

### 5.6.3 Fair value

From the annual statement it can be seen that fair value and its measurements affect many parts of the financial statements of the company, and overall, it seems to be important part of the business model of Orava Residential REIT. By law the trust has to measure its real estate properties by using fair values, with the exception of the real estates in the own use of the company, that are not required to be measured at fair value. When the fair value of the properties under the requirement changes, the gains or losses are recognized in the income statement as valuation gains or losses. On other words, these changes create income or expense for the company. They affect the equity of the company through the profit or loss of the financial period. The requirements are similar with those of IFRS 13.

It is stated that the fair values of the real estate properties booked at fair values are measured every month, however, the company is required to report them only

quarterly. Notably, the annual report notes that prices of real estate usually include some room for bargaining, thus, the valuation of their real estates has to take into account that the actual price of real estate typically is not the asking price of similar properties. Moreover, different transaction costs related to sales of a property have to be taken into account when making estimates related to prices of the investment property. The valuation the trusts uses is based on estimates that are said to be commonly used in the real estate sector. Nevertheless, it is also said that the exact model for the valuation of the real estate properties is developed by the management company. The model has been described in the annual report as well as the strengths and weaknesses of it have been discussed. The model is a regression model taking into account several factors, including for example type of the building, age and other properties of the apartment. However, the explanatory power of the model has not been described in the annual report. According to the annual report, the real estates are valued using the same model during acquisition and fair value measurements. Such a policy is established in order to prevent model shopping, meaning that the model used for the valuation would be selected to fit the needs of the management, so that the company could show lower or higher values than the comparison value for a specific real estate, according to the needs of the situation of the valuation.

The REIT reports using external experts to validate the valuation made internally. According to the auditor's report, also the auditor has made their own valuation models to estimate the validity of the estimates made by the management. In the report, it is stated that there has been material differences in the valuations, but the auditor has gained information to explain these differences. Also, same process has been followed for the material differences between realized sales prices and fair values. The importance of the fair value use for the company can be also argued based on the auditor's report. They have raised the use of fair values and the truthful representation of these and the related estimations and discretion to be the key audit matter in Orava Residential REIT. The materiality, according to the auditor, has been two million euros, equal to one percent of the total assets of the group. As a possible risk, the auditor has pointed out using management discretion on a way that can cause the fair value estimates to create incomes or losses that are meeting the market expectations.

It is said in the annual statements that the fair values of the balance sheet for the investment properties are recognized at full fair value, without deducting the part of loans related. Instead, these loans that are on the liability of the shareowner of the property companies are presented as liability on the balance sheet of the investment trust. For buildings under construction the REIT allocates to the balance sheet the amount of the fair value that corresponds the amount of the building project that has already been completed. When construction projects are finished, the trust recognizes them at the accumulated construction, capitalized borrowing and other costs, later on, the properties are recognized at their fair values. Worth of noticing is that the company aims to use wholesale discounts to buy the real estates under market prices, but the fair value measurement is based on values that are estimated to be gained by selling the apartments one by one. This kind of valuation is justified, as the company declares that their strategy is to sell 5-10 % of their investment property portfolio annually by selling apartments that are not rented. The sales are aimed to be done for individual apartments instead of selling bunch of those at a time.

In addition to investment properties, according to the REIT, the liabilities and swaps used for hedging are recognized at fair values. This kind of valuation could be argued to make sense, as mostly they can be considered to have directly observable market value that corresponds to the fair value without requirement of making large estimates. The company notes in the annual statement that division between corporate restructuring and acquisition of real estate properties when acquisitions are completed is one of the most material considerations together with the estimations related to fair value recognition.

The annual report seems to be mostly pointing out similar aspects related to the fair values as the researchers have found out. For example Ball (2006) pointed out that use of fair values increase the uncertainty related to the valuation of assets of a company on the balance sheet. Similar opinions have been also said by Dichev (2008), who also notes that keeping the balance sheet as the most important financial statement does not make sense for most of the companies, that typically, are creating the value through business operations. However, for residential real estate investment trusts this approach could make sense, as Dichev (2008) points out that balance sheet

approach to accounting would make sense, if the company's operations are based on its assets. This is the case for REITs.

Barth and Landsman (1995) pointed out that use of fair values, in theoretical level, fully reflect all the value of the company's assets. However, they also said that perfect conditions do not hold in realistic situations, therefore, there will be a risk of making estimation error when defining the fair value of different assets of the company. Considering that majority of the wealth of a residential real estate investment trust is in the form of investment properties, also most of their assets is recognized at fair values. Therefore, major errors in the estimations could lead to a situation where the assets of the company would be materially mispriced. The assets could be valued in the balance sheet over the real value, or under the real value. Considering the transactions from selling the properties within the financial years 2016 and 2015, it seems that the REIT has been selling the properties with loss compared to the fair values. Therefore, we could also assume that their model includes some risk of estimation error related to the balance sheet. Moreover, the auditor has stated that they have found out explanations for material differences in the valuation. This would indicate that there are material mistakes, that have been reasonably explained by the management of the company. Nevertheless, the group materiality is one percent of the total assets. This threshold has not been exceeded as the auditor has given standard opinion on the audit. Still, it could also mean that there are relatively big errors in the valuations, that have not been detected by the auditor, that have been under the total materiality or that could have been reasonably justified, so that the auditor has not been forced to modify their opinion.

According to Dechow (1994) earnings can be considered the single most important figure of the financial statements of a company. Therefore, possible mistakes in the fair values of REITs seem somewhat worrying. The changes in fair values are recognized through the income statement, meaning that all the possible mistakes in the fair values will flow through the income statement and affect the earnings numbers of the company. Meanwhile, it also affects the assets and equity of the company. In a sort of worst case scenario, the value of the assets of the company would be grossly overvalued, causing a need to write down the assets. This could possibly lead to a situation where the company loses its assets, creates deficits and

will lose part of their equity. Further on, it could lead to situation where the debt covenants will make the cost of capital higher for the company. This kind of a series of events could also be assumed to increase also the cost of equity capital, that seems to be rather important way for Orava Residential REIT to finance their acquisitions.

Interestingly though, even if fair values allow management discretion to be used, the managers might have a tendency to rather take real actions to manage the earnings than use the methods that are allowed by the generally accepted accounting principles (Graham et al. 2005). The losses on sold apartments, meaning that the transactions have been made with a price less than the fair value on the books, could possibly be one indication of taking such real actions instead of accounting estimation based actions. Selling apartments that would otherwise be written down on the books can be used to remove the effect on the balance sheet of drops in the fair value of the properties. Increasing fair values of the assets and simultaneous increase in the losses on the sold apartments would be an aspect that could be inspected more. It would be interesting to know, if these are normal business transactions done for the best of the company, or if these are earnings management in the form of real actions taken to manage the earnings.

Further on, intuitively it seems that managing the fair values allows the company to manage the dividends paid out. As the tax exemption regulation applies to the residential REIT, overvaluing the fair value of the assets does not create taxations costs, even if the profit is entered to the balance sheet through income statement. However, the dividends have to be paid from the realized gains. Thus, selling investment properties at a value that is less than the fair value on the books creates realized losses. This loss can be used to cut down the total realized gains or losses. Still, the company can be in a situation that it sells their apartments at prices that are higher than the price they have paid for it during the acquirement. This way the residential REIT can first create unrealized gains to boost the net income, then create realized loss to push down the dividend distribution and still have positive cash flow from the investment.

#### 5.6.4 Fund development

Development of the fund itself is discussed rather shortly in the annual report. Basically, the company mentions that they aim to channel capital into residential real estates in order to generate growth in the apartment base they have rented out. Also, they aim to increase the equity in medium term on average by one fifth per year. The budgeted target for the financial year of 2017 is stated to be 110-120 million euros. For the year ending 31.12.2016 the company has noted that the development of the fund has been in growing only slowly, this has created a situation where acquisitions of real estates has not been possible to be used to give as big impact on the financial results of the company like in the previous years during the time when the company has been listed in stock exchange.

Interestingly, the amount of discussion on the matter is rather small. Perhaps the management has thought that it is enough to discuss about the strategy and objectives of the company in other areas without connecting them clearly to the fund development. Also, as the REIT is stock listed, unlike some other types of funds where the owners either sell or buy their parts directly from the trust, there might be less incentives for aiming to convince the owners about their investment being safely kept in the fund. The stock price of the Orava Residential REIT does not have instant direct implications on the amount of money that the management of the trust can use. However, changes in the value of the stocks of the company can affect the possibilities and costs related to accessing funding in the future.

What comes to the fund development, it seems to be a rather important aspect for creating value for the investors. Without the fund developing it cannot grow and create increasing returns for the owners. Only by growth and ability to trade the real estate properties the residential real estate investment trusts loses perhaps some of its advantages over direct real estate investments. The pooled cash and ability to create return on return without paying taxes seem to be one of the key strengths of the REITs for a private investor.

### 5.6.5 Maintenance and management costs of the real estate properties

The trust notes that important part of the rental income is amount of the costs related to the maintenance and management of the real estate properties. These services have been outsourced to external experts, such as assets management companies and real estate managers. These service providers are taking care of everything related to the daily operations of the properties, including management from technical and administrative perspectives, financial reporting and rent administration as well as giving the apartments for rent. Separate budgets for the maintenance, administration and repair costs of different properties are made and the subsidiaries approve those budgets.

According to the annual report, the management services are one major risk related to the operations of the trust. The operations of these service providers are directly affecting the operations of the trust itself, thus, lowered performance, bankruptcy or other reason for not continuing the operations of the service providers creates a risk for the success of the REIT. During the financial year of 2016 the proportion of the maintenance and management costs have decreased from the previous year, the level of the cost proportion was reported to be 2,7 % of the value of the investment properties of the REIT. The company aims to further decrease this proportion during the financial year of 2017. In long run they want to cut the relative price of the maintenance costs to be 5 % under the statistical benchmark, for repair costs corresponding cut is sought to be one tenth under the statistical benchmark. The costs related to management of the properties are recorded on accrual basis on the financial statements. In addition to administrative costs, rents based on land leases are booked in the maintenance costs in the financial statements.

Considering the ability of the real estate investment trust to create revenues, the aspects pointed out in the annual statement seems to make sense. However, the reporting of these costs seems to be rather confusing. For example, booking land leases as administrative costs related to buildings could be argued to not to give a truthful representation of the costs related to the operations of the real estate investment trusts. These costs are related to the housing companies owned, but as the land lease contracts are typically made for decades at once, it probably is not a cost

the company can easily influence, unlike for example the rental management services where the REIT can make a bidding between the service providers. Moreover, the costs related to the payments for the housing companies cover many other costs than just the management fees of the service providers. When thinking about the ability of Orava Residential REIT to push down the administrative costs, it should be taken into account that in housing companies where the trust does not possess control over half of the voting rights among the shareholders, it is questionable how much the trust is able to influence the choice of the service providers.

#### 5.6.6 Debt financing

It is said in the annual report that the company aims to have around half of its financing through debt. They are going to achieve it by refinancing the existing loans by taking new loans. Moreover, they are planning to diversify the sources from where they can gain the debt financing to more sources than they have used in the financial year 2016 and earlier. Considering the relation of loans to the value of the company, the REIT aims to keep the loan to value ratio between 0,30 to 0,60. There are loans that are maturing in the upcoming years, Orava Residential REIT has states that they believe they will be able to renew these loans. The loans that the trust has allocated to housing companies were uncovered in the closing date of financial year 2016. For acquisition of real estate properties, the trust uses loans that have variable interest rates. Roughly one third of these loans is protected from changes in the interest rates by hedging the variable-rate loans to fixed-rate loans. The tax exemption act sets some limits for how the REIT can use derivatives for hedging the risk related to the interest rates. Use of interest-rate swaps, within the limitations of the laws, is defined in the risk management policy of the investment trust. Moreover, the company claims that its financial results will not have significant changes if the short-term market interest rates would change by one percentage point.

The financial expenses of the REIT in financial period of 2016, as reported, totaled 3,0 million euros, around 0,4 million euros more than the year before. The expense consists of the interest as well as from different costs related to financing activities, like issuing bonds, hedging agreements and credit limit agreements. The hard predictability of market interest rate changes and possible changes in the loan



margins create interest rate risk for the trust. They note that the business operations of the trust can have major effects, if there would be fast and remarkable change in the loan margins or interest rates.

The REIT points out that the most remarkable covenants the trust has are related to the relation of capital from different sources to the amount of assets the company has. They apply directly to the REIT itself by setting limits for equity to assets ratio and to their investment properties by defining the boundaries in which the debt to value of the housing has to be. The covenants affect the margin the trust pays from their loans. Therefore, we might consider that the leverage level of the REIT is partly limited by the loan providers, and increasing the leverage can cause the cost of capital to increase.

Many of the loans maturing in upcoming years seems to be consistent with the findings of Giambona et al. (2008) of REITs having relatively short debt maturity periods due to the low liquidity of their assets. Having a time span of just some years for the maturity of the debt issued by a company intuitively seems to be rather short. However, more research should be conducted in order to compare these debt maturity times with other companies listed in Finland. Still, it might be hard to compare a REIT with other kind of companies, as major legislative differences occur even when comparing to REOCs. According to the annual statement, the net gearing ratio for the year ending 31.12.2016 was 113,7 %, while for the previous year the same ratio was 98,5 %. Interestingly, the proportion of current liabilities has been decreasing and the proportion of long term liabilities increasing, which contradicts the ideas that also Giambona et al. (2009) point out about the leverage and debt maturity being substitutes. Moreover, they have also said that companies that own assets which have characteristics of low liquidity would choose short maturity and low leverage for their debt. They report similar findings also from previous research. Therefore, it seems that either Orava Residential REIT does not follow this kind of pattern with the choices for their debt financing, or there has been some change in the business conditions that has made this kind of debt structure to be considered more optimal for the company than one with lower leverage and shorter debt maturity. More research should be conducted to find out what is the reason for increasing leverage and longer debt maturities.

### 5.6.7 Management fees

The annual report clearly states that the financial results of the company depends on the income from the income from renting activities, after the related costs, realized and unrealized gains and the expenses related to the liabilities and from the expenses related to the administration. The administration of the REIT consists from the fees for the real estate service providers, auditors and other service providers, compensation of the members of the board and fee paid for the management company. The management fee is based on fixed fee and performance based fee.

The fixed fee, as stated in the annual statement, is based on the fair value of the assets of the REIT and is 0,6 % of their total fair value. Calculation of the management fee is done quarterly and IFRS fair value of the last quarter is used as the basis of the fee. During the financial year the total fixed management fees were 1,265 million euros, while in the year before the fees were slightly under one million euros. Performance based management fees are paid if the annual return, of the REIT exceeds 7 percent calculated as earnings per share compared to net assets value per share. If the stock price of a share is lower than the net assets value per share, the stock price is used for the calculation. The amount of the performance based fee is one fifth of the return exceeding the threshold of 7 %, based on earnings per share and total amount of shares. Worth to notice, another condition for the performance based management fee is set, the closing price of the stocks in the stock exchange for the financial period has to be higher than the comparable price of the previous financial periods. Share issues, splits and dividends paid out are taken into account when calculating whether this condition has been met. During the last two financial years the performance based management fee has not been paid.

Management fees are closely related to corporate governance. More on the issues related to corporate governance has been discussed before in the thesis. Therefore, the topic is not discussed further here. Further research could be conducted to evaluate the levels of the management fees and whether the returns for the fees are reasonable or not.

### 5.6.8 Operating environment

The company recognizes as a risk the development of the general economic conditions. However, the issues related to the operating environment of the company in larger scale are barely discussed in the annual report. More or less, the only things mentioned are the growth rate estimates and expectations for the years 2016 and 2017 and that development of economy and changes in the population base of different areas are important for the REIT through their effects on the demand for leased apartments. In addition, the REIT notes that in history the sensitivity to the changes in environment has been smaller for residential apartments than for those that are in commercial use.

Mostly the factors raising from the operating environment of the company is reflected in the prices of real estates and rental levels. These matters have been discussed in other parts of the thesis. Regarding the operating environment, political risks have not been discussed in the annual statement. Intuitively it would make sense that possible shifts in the political powers can cause legislative changes that affect for example the taxation or payout requirements applying to the residential real estate investment trusts.

### 5.6.9 Payout

The company notes that due to the regulations, it has to pay out 90 percent of its realized gains as dividends. One of their strategic targets is to create dividend return for investors that is annually from seven to ten percent of the value of net assets per share. They have stated aiming, with equivalent measurement, to minimum total return of 10 % per share. Basically, net assets per share consist from total assets less liabilities, we can say that the targets are set for returns on equity, that is equivalent to the net assets of the company.

The annual general meeting has authorized the board to decide how much dividends are paid out within certain limitations. However, the board has to follow the 90 % minimum payout requirement on realized gains, if they wish to comply with the tax exemption act. Still, the board is responsible for overseeing that the payouts will not

endanger the going concern of the company. On other words, if the payout risks the liquidity of the company and causes it to not to be able to continue its operations, the board has to annul the payments of the dividends. The dividends of Orava Residential REIT are paid out quarterly. It is not possible for the REIT to distribute its wealth to the owners in other forms than dividends, other methods, like acquisition of treasury shares, is prohibited by the tax exemption regulations.

In the lower border of the targets of total returns and dividend returns, assuming that minimum amounts of dividends are paid out, this would equal to creating realized gains of 7,78 % per share, meaning creating in addition an unrealized gain of 2,22 percent per share on the net assets per share. Nevertheless, the company has not stated specifically stated that it would aim to always create more returns than the realized gains. However, considering the importance given for fair values, it would be rather contradicting to not to interpret the targets on a way that assumes some part of value creation being made in the form of unrealized gains. Considering the requirements for dividend payout, it seems intuitive that this kind of policy limits the possibility of the REIT to make new investments. Recalling that the tax exemption act was created to bring private and residential REIT investments closer to each other from the taxation perspective, this kind of minimum requirement is fair. If payout requirements were remarkably lower, or did not exist at all, the residential REIT industry would get clear taxation benefits compared to private investors. With the current legislation, the investors investing directly to residential real estate pay taxes on the realized gains, while investors investing in residential REITs pay taxes on 85 % of the dividend income, 30 % till income of 30 000 euros and 34 % on income exceeding the threshold (Finnish tax administration 2017). The minimum amount of dividends paid for the investors is in minimum 90 % of the realized gains.

When considering the difference of payout, from the point of view of investor, when investing on a residential REIT or directly on real estate some differences arise. In a real estate investment trust the company itself does all the work related to owning, trading and managing the apartments. Also, investing in such a company means owning part of the equity, that includes fraction of all the assets the company has. Therefore, the invested amount of money is very diversified among different properties, comparing to a situation where the investor owns one or just a few

properties. The basic income formation in both forms could be seen to be the same, the owner gets rental income, pays costs related to the earnings and finally pay taxes on the profit made. The main difference in the taxation is that as long as the money stays in the REIT, no taxes are paid, while the private investor pays taxes every year from the whole profit made. Another difference is that an investor investing directly to real estates can deduct in taxation the interests paid from making the income to be realized. A REIT does not have such an opportunity, if they operate as the tax exemption law has defined, as in that case they do not pay taxes. However, one major difference arises from the form of financial instruments. Real estate properties are rather illiquid assets, while stocks are one of the most liquid form of financial instruments. Therefore, as also stated by Cotter and Roll (2015), only form of residential real estates that can be considered to be truly liquid are residential real estate investment trusts. This creates an extra factor to the total payout from the investment, the market prices the stocks and creates higher uncertainty than investing directly to real estates.

In table two the difference in taxation is compared from the point of view of an investor, considering the cash flows received from both investment instruments. However, this explanation ignores everything related to the operations of a residential real estate investment trust. Moreover, it also does not take into account the change of value of the properties or the changes in the stock price. As REIT only pays the dividends from the realized incomes, the change of the value of the properties, when being unrealized, is not affecting the cash flows paid to the equity holders. The illustration of the taxation also assumes the REIT to operate on a way that it does not have to pay taxes.

**Table 2. Comparison of taxation for a residential REIT or direct real estate investment properties from the point of view an investor. The changes in fair value have been ignored and the illustration only takes into account the real cash flows from the investment to the investor.**

Determinants of the cash flows	Cash flows from residential real estate investment trust	Cash flows from direct real estate investments
Rental income	Stays in the REIT	100% to the investor
Costs related to the rental income (excluding interests)	Covered by the REIT	100% paid by the investor
Interest costs	Covered by the REIT, not affecting the taxation	Covered by the investor, deductible in taxation
Net income	Incomes less costs and interests	Incomes less costs and interests
Cash flow to the investors	At least 90 % of the realized income in the form of dividends	Equals to the net income
Taxes paid from the cash flows	85 % of the dividends are taxable capital income, from which 30 % or 34 % is paid as capital income taxes	30 % or 34 % of the net capital income, the threshold between the tax classes is 30 000 euros of capital income per year
Effective tax rate paid from the cash flow	25,5 % until 30 000 euros annual capital income, 28,9 % for the income exceeding the threshold	30 % until 30 000 euros annual capital income, 34 % for the income exceeding the threshold
Net cash flow from the realized gains (assuming 90 % payout rate from the REIT)	67,05 % until 30 000 euros annual capital income, 63,99 % for the income exceeding the threshold	70,0 % until 30 000 euros annual capital income, 66,0 % for the income exceeding the threshold

As the dividends are paid out from the realized gains and losses, there are some things to take into account. For example, if the company realizes losses, it can push down the amount of dividends it has to pay. Meanwhile, the company can actually create cash flows that can stay inside the company. Realized gain or loss related to sale of an investment property occurs when the sales transaction has, respectively, higher or lower value than the book value of the asset on the balance sheet. Furthermore, the net income of the company perhaps cannot be directly used for efficiently comparing with other companies for how much the REIT pays out from its results as dividends.

#### 5.6.10 Real estate price development

The company notes one part of its results being the changes in the value of real estate, both realized and unrealized ones. They note that the single most important

factor in the value development are the changes in the operational environment of the company. Major part for the demand for apartments for lease or for buying one is the demand for housing in a specific area, mostly affected by the attractiveness of the area, changes in the population base of the area and the general economic conditions regionally. The trust also points out that ages of different houses plays a role in the price development. The older the house is, the bigger is the possible increase in value, however, it comes with the risk of the need to do major renovations. Newer houses bare less risk of expensive renovations, but on the other hand they somewhat lack the potential of value increase compared to older buildings. The company aims to diversify its risks by having diverse investment portfolio in the sense of age of the buildings.

According to the annual report, in the wholesale market of residential apartments the properties are sold at 10-30 % discounts compared to the normal real estate market. This kind of discounts have been accessible by major investors and Orava Residential REIT is aiming to make deals with the wholesale market in order to utilize the favorable price level. This kind of discounts are more common in older properties and in smaller towns. Considering that if the wholesale price is utilized, the company can get relatively higher rental income for the investment and use the difference in the transaction price and fair value of an individual apartment to create unrealized gains. The fair values of the apartments are verified by external evaluators, either based on reviewing the actual properties or making assumptions based on their professional knowledge.

The REIT reports that the demand for their apartments seemed to strengthen in the last quarter of the financial year 2016. Still, they note that the Finnish housing markets have continued to recover slowly during the year. Directly after reporting the year ending 31.12.2016 financial results being poor they point out that the housing prices have developed poorly, as also in previous years. For the year 2017 they expect to reach slightly positive increase in the value of their investment properties. Considering the notion of real estate price development after reporting poor results for the financial year, it appears to be so that the price changes in the real estate market have a crucial role for the whole operations of the company.

All the claims of the annual report related to price development of the real estate seem to be corresponding to the model of DiPasquale and Wheaton (1992). Also they report that the general development of the national economy have an effect on the prices of housing. Considering selling apartments of the residential real estate trust, they should be able to utilize the longer selling time and have enough professional knowledge for selling the houses on higher prices than individual sellers, as is described to be done by professional traders on the paper of Levitt and Syverson (2008). However, more research should be conducted in order to check whether the REIT is able to fully utilize the possible benefit of the professional knowledge. During the financial year 2016 the company has made losses 303 000 euros when selling the apartments under their fair value, in the year before the corresponding loss was 201 000 euros. Therefore, it would be interesting to inspect more on the possible reasons causing the sales transactions to happen on loss.

#### 5.6.11 Rent income

In the annual report, it is told that one part of the REIT's income is the net rental income. They are aiming to acquire apartments that provide good rental income, the main target areas are main cities and towns around Finland, as well as medium-sized towns. The net rental yield during the financial period of 2016 was 3,8 percent. When taking into account the costs related to renting, Orava Residential REIT has estimated that locations outside the capital area provide roughly one to two percent higher rental yields than the investment properties within the capital area. Considering the age of the real estates, older properties seem to provide approximately 1,5 percent higher rental yields than the new properties. The income from leasing operations consist from the rents itself and from different fees collected as compensation for use. These compensations can include for example fees collected from using sauna, water or car parking spots among other things. The REIT recognizes the income from renting operations on its income statement monthly over the lease period, meaning that the income recognition is basically done on accrual basis.

The long-term aim of the company is said to be to reach 95 % level of occupancy rate. This means that less than five percent of the residential apartments they own



would not be rented. In the last quarter of the year 2016 the rate was 93,2 %. Considering the income formation of the REIT, the occupancy rate appears to be important. Empty flats do not generate income, but still the company must be able to cover the costs related.

Renting, according to the annual statement, is one of the main sources of funding for the REIT. As it is in the core of the business, also central risks the trust bears are related to renting. The major credit risk it has is related to the rental fees. However, they note that the credit risk is spread over different lessees, on other words, the risk is coming from several sources instead of some big ones. Thus, it seems that the credit risk is rather diversified. The trust notes on its annual statement that the operations it can engage in are limited by laws and regulations. Therefore, they have to mainly stick to operating in the residential real estate business, concentrating on leasing apartments and to the services related to it. For the future they estimate the gross and net rent yields to remain approximately on the level of the financial year 2016. Still, they have stated to aim on decreasing the costs of managing the investment properties, which probably should increase the net rental yield. Last but not least, renting is said to be one of the tools for creating value for the investors by allowing the company to pay dividends and by increasing its share price on the stock market.

Considering that Mühlhofer (2013) found out the income from real estates driving the short-term returns of real estate investment trusts, it seems obvious that income created through renting activities is important for Orava Residential REIT. Taking into account the limitations, defined by the tax exemption act, set for selling investment properties it intuitively makes sense that liquidation of residential apartments cannot be efficiently used to generate cash flows. Moreover, selling real estates decreases the amount of company's assets that can create income, unless money gained from the sales transaction is used to acquire real estate properties that will bring higher yield than the sold one.

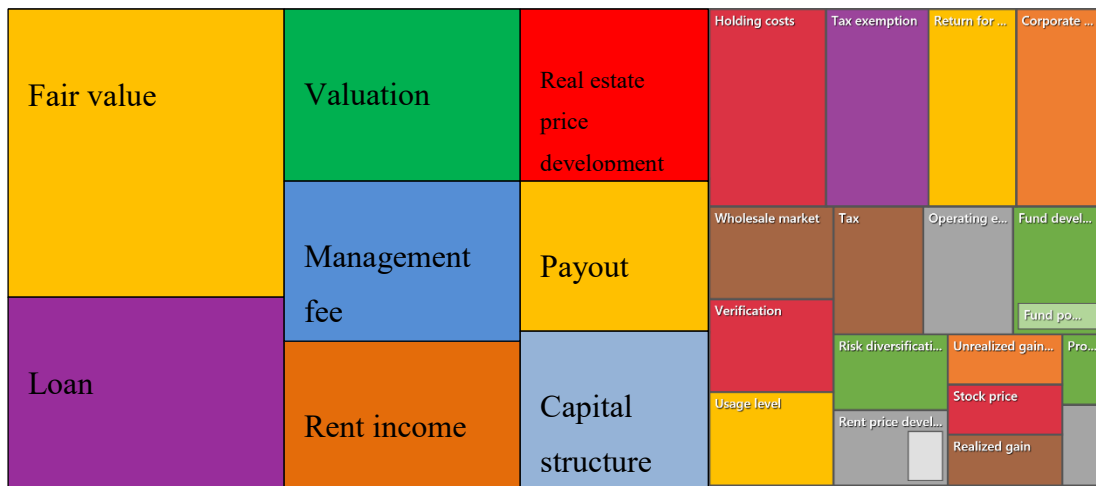
Apart from the cash flows required to run the operations, the rental income has another important purpose. When the company seems to create losses when selling their apartments, rental income balances the realized gains of the company.

Therefore, it also raises the amount of dividends that have to be paid for the investors. This forces the company to pay higher amounts of dividends, that can be bad for the company, but however, is a benefit for the owners, at least in short term. However, it seems that the rental incomes are not enough to cover the operating costs.

#### 5.6.12 Overview of the operations of a Finnish residential REIT

Overall, it seems that the operations of Finnish residential real estate investment trusts are a rather complex combination of different drivers and barriers, requirements and freedoms. Many of the aspects discussed above are, naturally, interrelated. Often REITs are excluded from the population when researching different phenomena of accounting (e.g. Feng et al.), as the regulations that apply to them make them to operate on a unique way. Moreover, it seems that so far research has been focusing on specific aspects of residential real estate investment trusts, instead of seeing them as a holistic system of different business and accounting choices.

Immediately after finishing the final coding of the annual report of Orava Residential REIT, it started to look like some aspects are clearly highlighted in the report. The references of each final code on the total amount of the referred text, has been graphically illustrated in figure two (2). The figure has been simplified to illustrate the final findings of the coding. It can be seen, that fair value is the most referred code among all, also valuation, loans, management fee and rent income are discussed relatively much. The price development of real estates, dividend payout and aspects considering the capital and capital structure still belong among the most referred codes. The rest of the final codes are referred remarkably less than the main ones. However, it should be taken into account that due to the interconnectivity of the codes and matters related to business operations of the REIT, some of the content of the final codes have been merged to another ones and parts have been used to bring more perspectives under a single header. The choice was done in order to simplify the text, make it more readable and to create a holistic picture over the matters discussed in the thesis.



**Figure 2.** The amounts of the final codes in the total amount of coded text, compared by number of coding references. The figure has been created based on the final coding with NVivo 11 program and simplified by presenting the most remarkable codes arising from the final results.

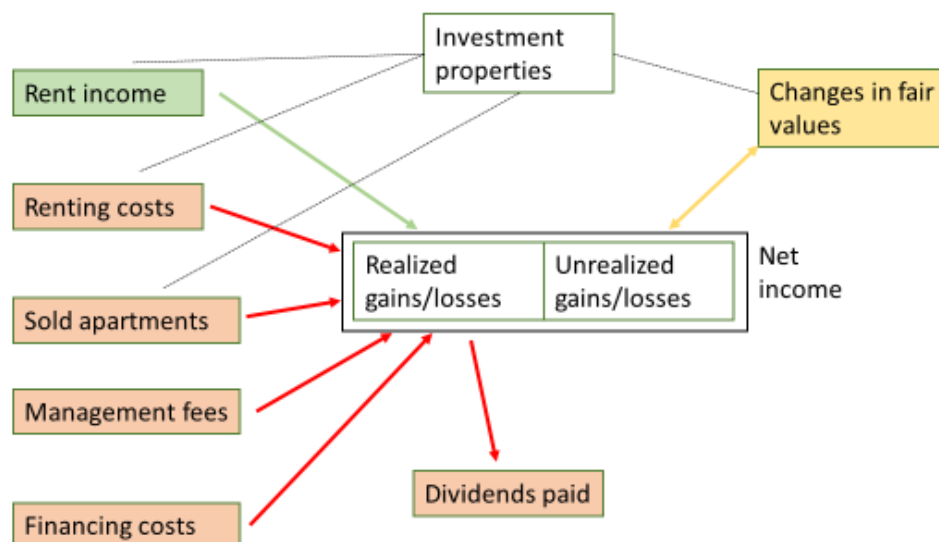
Fair value and issues of it seem to be related to almost everything within the company. Fair value recognitions for example create unrealized gains or losses, are related to covenants, management fees, rental yield calculations and possible losses or gains from selling investment properties happen under or over the fair value. As the changes are recorded in the income statement and balance sheet, it is rather evident that fair value accounting is in the core of the business itself. Adapting the idea of Dichev (2008) for considering whether balance sheet approach or income statement approach makes sense for companies, we could perhaps conclude that for REITs both could make sense. The assets are used for creating returns to the owners, but on the other hand all the gains and losses are coming to the balance sheet through the income statement. Thus, changes in fair value being recognized in both, it appears that this accounting principles is one of the keys of the value drivers in the company. Among others, Ball (2006) pointed out that there is always uncertainty related to fair value accounting. This uncertainty comes mainly from the estimation required in order to use fair values, meaning that management discretion plays an important role in fair value accounting. Anglin et al. (2013) have found out that real estate investment trusts tend to make real earnings management for the purpose of manipulating the final earnings, and that some characteristics of corporate governance, namely board size and independence, play a crucial role in preventing it.

Considering the importance of corporate governance for setting constraints for real earnings management, it appears to be another important topic related to residential real estate investment trusts in Finland. As mentioned before, the board of Orava Residential REIT assesses that four out of the six members from its board are independent from the company. However, two of these independent members are owning relatively large parts of the trust through companies under their control. This kind of a situation might create reasonable doubtfulness towards the incentives of the board members, especially, since they have claimed to be independent.

Increasing fair values of the investment properties and simultaneously growing realized losses could, perhaps, be indicators of real earnings management. The company can make unrealized gains without any taxation costs or requirements to pay dividends. Rather, they can inflate the balance sheet values of the assets and the equity of the company. Meanwhile, selling the investment properties at transaction prices under the fair values the REIT can push down the cumulative amount of realized gains and losses, which defines the base for paying out the dividends. This way, the company can boost its results and inflate the balance sheet, while decreasing the payout amounts and still making real profits from the properties. In addition, they can have cash inflows from the sales.

Fair values are also related to the development of the fund. As the assets of the fund grow, it can possibly allow the trust to gain access to larger amounts of capital through increasing the amount of loans, while keeping the proportional level of the leverage at the same level. Fund development could also be seen as one important aspects of the residential real estate investment trusts, as it allows the company to create more returns for its owners. The matter of fund development is also presented in the first paragraph of the CEO's review in the annual statement, thus, we can quite safely assume that the company's management sees it as an important part of the business. Furthermore, as the REIT is an instrument for funneling large amount of capitals to acquire, hold and sell apartments, it would intuitively make sense that fund development is one part that differentiates the residential REITs from direct real estate investments. Therefore, it can also be a tool for acquiring equity investments for the company, and on the other hand, be a reason why an investor would choose to invest to the trust instead of direct real estate investments.

The relations of the most important aspects of the residential real estate investment trust's earnings formation has been illustrated in figure three (3). The boxes with red background color are costs related to the operations of the REIT. Also, dividends are grouped to together with the costs, as it is mandatory to pay them from the realized gain. Green background color has been used for the sources of income. Yellow background color is use for sources that can create either losses or gains. The arrows point from the cause towards the result, respective colors with the boxes have been used to mark the effects of each aspect. Dotted lines show how the investment properties are connected to the different aspects of the value creation of the company. In the middle it can be seen that the net income is formed from realized gains and losses together with unrealized gains and losses.



**Figure 3.** The relations of the key aspects of the value creation and their relations to the unrealized and realized gains and losses. Red color indicates costs, green incomes and yellow the aspects that can be both. The dotted line shows connections of the different aspects and the investment properties.

From the point of view of an investor the returns created by the operations of a residential real estate investment trust is also a complex thing. On one hand, investing in REIT means giving the decision-making power to someone else, paying fees for the management as well as for the other services and taking a risk related to

the volatility of the stock price development. On the other hand, this kind of an investment is the only truly liquid real estate investment (Cotter & Roll 2015), it allows pooling cash together and benefitting from the prices of the wholesale markets. Moreover, by investing to a REIT the investor sort of outsources the management of the real estates. Also, the initial investment on the form of stocks is significantly lower, than the one needed for direct real estate investments. In fact, the high value of initial investment has been pointed to be a constraint for direct real estate investments by Niskanen and Kiehelä (2013).

Considering that smaller proportion of the realized gains are distributed to the private owners in REITs compared to direct real estate investments, the strengths of the investment trusts have to be big enough to compensate the investors for the lost cash flow. The difference is illustrated earlier in the thesis in table two (2). The assumption of the smaller proportional cash flows holds true, when the REIT uses the minimum rate of divided payouts. As they increase the payout rate, the difference diminishes, and finally the cash flow from the trust can exceed the one of direct real estate investment, due to the lower effective tax rate the REIT enables the investor to have. The benefit seems to be created mostly through the trust's ability to trade the real estates, utilize wholesale discounts and due to the large amount of capitals in use, combined with the relatively small initial investment.

It should be noted that the stock market reactions and valuations of the residential real estate investment trust are excluded from the scope of the thesis. The research has aimed to explore the business model through the annual statement, without directly taking into account the interpretations the markets make about the company. Still, the annual report also aims to inform the markets and thus the historical stock prices and the management's perceptions about the market expectations may have somewhat guided the creation of the annual statement. However, when considering the total returns from REITs for an investor, the stock price changes should not be ignored. Yet, it should be kept in mind that, according to Oikarinen et al. (2011), only in long term the investments on REITs will bring similar mixed-assets portfolio diversification benefits as does direct real estate investments. Similar results are found by Mühlhofer (2013) who argues that in short-term REITs cannot substitute

real estate investments in the portfolio, and that the stock prices do not efficiently reflect the changes of the values of the real estates.

From the point of view of cash flows and operating incomes, it seems that the situation is not very sustainable in long-term. The cash flows from operations alone are already negative, partly due to taxes paid, and the company consumes more on new investments than it gets from selling the old properties. Still, the REIT has to pay dividends from the realized incomes. Therefore, it is forced to take new loans and issue convertible bonds. In the financial year 2016 the net increase of loans was 9,102 million euros and convertible bonds were issued for 9,133 million euros. In the year before the corresponding numbers were 0,79 million euros and 15 million euros. Even without making more investments than disposing old properties, the company would not be able to pay its loans and dividends. At the moment it seems that this kind of way to operate can only last as long as the company can renew its loans and have at least a satisfactory stock price for issuing convertible bonds.

## **5.7 Limitations of the research**

The research, as all research, has some limitations. First of all, due to the limited research resources the depth of discussion on each inspected aspect of the research has been rather limited in some parts. Moreover, the lack of resources has been a barrier for making a wider research, that could, for example, compare the Finnish residential real estate trusts to other forms of companies or funds operating in Finland that have real estates as the core of their business. Also, comparison between different countries could have been conducted to compare Finnish REITs with REITs of other countries.

Apart from the resources, the research also is limited due to the materials available. Annual report and financial statements are always a report designed for outsiders. Therefore, management discretion and reporting standards play a role in the formation of the information. Grouping different costs under different groups can for example hide some parts of the business operations behind the figures. Figures from the actual bookkeeping should be used, if Finnish residential real estate trusts would be wanted to be inspected in depth. However, the research question was specifically

designed to overcome this problem, as it sees the company and its operations through the annual statement.

Another limitation related to the research is naturally reliability. With qualitative research the opinions and interpretations of the researcher are always affecting the outcome. During the research process, scientific means have been used to systematically analyze the data and to build connections within the data, with relation to previous theories and for making justified conclusions. Still, with this type of research the results are more suggestive than confirmatory from their nature. Thus, more research should be made to validate the findings. To avoid bias from my personal incentives, I have not owned stocks or any other financial instruments related to Orava Residential REIT, or any other common fund investing in residential real estates in Finland, during the research was conducted or immediately before it.

Furthermore, the research is limited due to the scope of it. The research has been concentrating on qualitative evaluation of the value creation of the Finnish residential real estate investment trusts. There is only one such a company currently in Finland, that naturally decrease the generalizability of the results. The results are gained by inspecting the annual statement of the company through some accounting concepts. This has created some selective bias to the results, as only a few concepts have been used to create understanding of the operations. Moreover, the numeric information has been in the role to support the textual analysis, which somewhat limits the depth of the research. Also, stock prices and market reactions have been excluded from the scope of the research, as explained above.

In this chapter of the empirical research the basic of research were discussed, conducting of the research of the thesis was illustrated and finally the findings of the research and limitations of it were discussed. In the next chapter a summary of the whole research will be conducted.



## 6 SUMMARY

The purpose of the thesis was to inspect the value creation of the business model of Finnish residential real estate trusts as whole. Furthermore, it has aimed to contribute to the discussion seen in the Finnish media about the operations of the REITs. The research question was: “*What is the core of value creation in the business model of residential real estate investment trusts in Finland, as reflected through their annual statements?*”.

The most important finding of the research was that fair value accounting plays a crucial role in Finnish residential REITS. It is basically related to all operations of the company, and can heavily influence the earnings of the company. The fair value estimates cause risk of errors, which is also found out to be one of the characteristics of fair value accounting for example by Ball (2006). Closely related to fair value accounting, management discretion, and especially corporate governance seems to be a central issue in the REIT. The board size and independence have been named by Anglin et al. (2013) as one of the key factors increasing the risk of a REIT to engage in real earnings management. In case of the Orava Residential REIT especially board independence may cause a threat for real management of earnings and for overcoming the agency problem. It seems that even if the board has assessed four out of its six members to be independent, in reality it is hard to justify why two of these independent members would be considered as such, as companies under their control own roughly one tenth of the trust. Many of the findings are supported by earlier research, however, due to the nature of this research it is hard to say whether there are many contradictions with other research results. Moreover, it looks like the company cannot finance acquisition of real estates, payment of loans or payment of dividends by its rental operations or by trading real estates.

The reliability of the research has been aimed to be ensured by systematically inspecting and combining the findings of the research. Also, comparison to findings of other researchers has been made to validate or disqualify the findings. The most remarkable restrictions for the research were the research resources and scope of the research. The analysis is based on one annual statement and stock prices have been excluded from the research. Moreover, comparisons with other kind of businesses

has not been made. The results should not be generalized without caution, due to the research limitations. More research should be made to validate the findings of this thesis.

The research results can be used to evaluate some of the key risks related to Finnish residential real estate investment trusts. Also, the results may be used to help to compare REITs and direct real estate investments from the point of view of a private equity investor. The basis for tax exemption could be re-evaluated after the research results of the thesis has been validated by other researches. Moreover, the results can, into some extent, work as a basis for further research. It would be interesting to know for example, what is the reason behind selling real estate properties at loss. Is it caused by bad initial investments, by errors in the fair value estimates or is a way to do real earnings management. Also, researching more on the leverage and debt maturity should be interesting, as well as getting to know more about the corporate governance issues related to the residential REIT.

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