
FTSE EPRA/NAREIT Global Real Estate Index Series Consultation

Important Information

The proposals set out in this consultation document are included in order to gather feedback and may or may not result in changes to the FTSE EPRA/NAREIT Global Real Estate Index.

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Responding to the Consultation

Please submit your response to the questions included in this consultation online at <https://www.surveymonkey.co.uk/r/8RLCD7H>. If you have any questions about this survey, or if you encounter any technical issues, please contact rpawson@FTSERussell.com.

Introduction

The index partners, FTSE Russell, the European Public Real Estate Association (EPRA) and the National Association of Real Estate Investment Trusts® (NAREIT), are inviting users of the EPRA/NAREIT Index Series, market participants and other stakeholders to participate in a consultation on the FTSE EPRA/NAREIT Global Real Estate Index Series.

The purpose of the consultation is to ensure that the index series continues to capture the investable global real estate universe in a clear, comprehensive and transparent way. The feedback received from the consultation will assist FTSE, EPRA and NAREIT in their consideration of potential future enhancements to the Index Series.

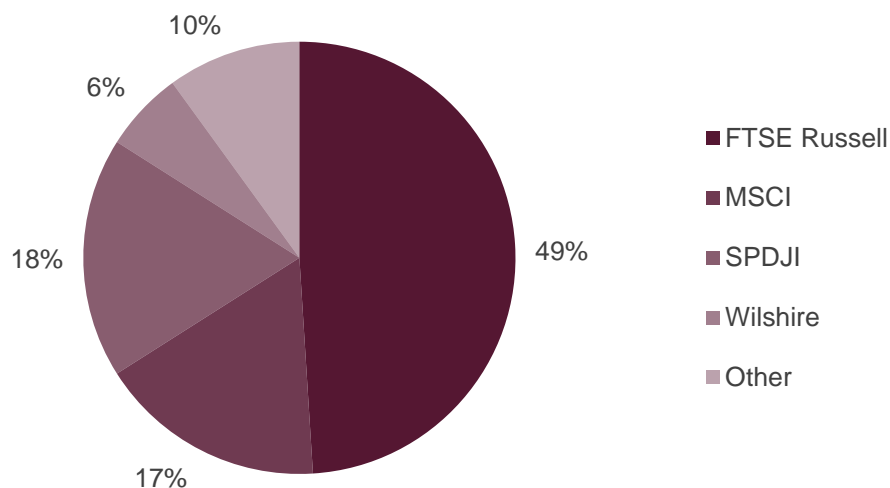
The consultation will close on February 10th, 2017. The results will be presented to the FTSE EPRA/NAREIT Index Advisory Committees for discussion in March 2017. Should the index partners subsequently determine that changes should be made to the methodology of the FTSE EPRA/NAREIT Global Real Estate Index Series, any changes will be announced to the market with a minimum notification period of six months prior to their implementation.

Background

Launched in 2002, the FTSE EPRA/NAREIT Global Real Estate Index Series is the world's leading real estate benchmark, with \$251bn assets under management*. Developed in collaboration with the REIT and listed real estate associations: the European Public Real Estate Association (EPRA) and the National Association of Real Estate Investment Trusts® (NAREIT), the Series has expanded from the original FTSE

EPRA/NAREIT Developed Index to include a wide range of indexes covering developed and emerging markets, high-dividend stocks, specific property sectors, and REIT and Non-REIT indexes.

Real Estate Equity Benchmark AUM by Index Provider*



* Source: eVestment, Morningstar (as at 30 June 2015)

Since its inception, the methodology underlying the series has continued to evolve. The series has recently been further enhanced to meet the growing demand for liquid and diversified real estate investments, with the launch of the highly investable FTSE EPRA/NAREIT Developed Super Liquid Index.

This consultation paper covers the following topics:

1. Eligible sectors
2. Eligible security types
3. Reporting requirements
4. Eligible real estate activities
5. Size thresholds and market classification
6. Index ground rules

1.0 Eligible Sectors

The initial universe of companies eligible for the index consists of those companies with the following Industry Classification Benchmark (ICB) Classifications: Supersector 8600 (Real Estate), Subsector 2357 (Heavy Construction) and Subsector 3728 (Home Construction). A summary of ICB classifications can be found [here](#).

1. Other than those listed above, are there any other ICB classifications which should also be considered eligible?

- Yes
- No
- If yes, please provide the ICB classifications that you think should be considered and the reasoning behind eligibility

2: Are there any ICB classifications which are currently considered eligible which should be considered ineligible?

- Yes
- No
- If yes, please provide the ICB classification that you think should be considered ineligible and your reasoning

2.0 Eligible Security Types

The following are considered ineligible security types for this index series: Limited Liability Partnerships (LLP), Limited Partnerships (LP), Master Limited Partnerships (MLP), Limited Liability Companies (LLC), Business Development Companies (BDC) and preferred shares. Publicly Traded Partnerships are currently considered eligible.

3: Do you believe that any of the security types listed above which are currently considered ineligible, should be considered eligible for index inclusion?

- Limited Liability Partnerships (LLP)
- Limited Partnerships (LP)
- Master Limited Partnerships (MLP)
- Limited Liability Companies (LLC)
- Business Development Companies (BDC)
- Preferred shares
- If you have ticked any of the above, please provide rationale

4: Should preference shares which mirror the characteristics of equity, as opposed to fixed income be considered for index eligibility? For example – preference shares in Sweden?

- Yes
- No
- Please share the rationale for your decision and provide a list of markets where preference shares should be considered for index eligibility

5: Should Publicly Traded Partnerships (PTPs) continue to be considered eligible?

- Yes
- No
- Please share the rationale for your decision

6: Are there any other security types or structures which should be considered for index eligibility or index ineligibility?

- Yes
- No
- If 'Yes' please expand

3.0 Reporting Requirements

The constituents of the FTSE EPRA/NAREIT Global Real Estate Index Series are required to meet a number of criteria in order to remain/become a member of the series. The full list can be found in the 'Index Rules on Reporting Requirements' section of the Appendix.

7: Is reporting in English an essential requirement?

- Yes
- No
- Comments where appropriate

8: The current ground rules require that the EBITDA screen is based on annual audited financial statements. Should other financial statements be used where available to conduct the screen? In all cases please provide your rationale.

- Only the annual, audited financial statements should be considered (as now)
- Other audited financial statements, not just those published as part of the annual report, should be considered
- Unaudited statements made publicly available by the company could also be used if no determination could be made by using audited statements only
- Comments

It can be difficult, in the United States in particular, to interpret from the financial statements of a company whether or not the company passes the minimum earnings threshold from relevant real estate activities using the earnings before interest, taxes, depreciation and amortization (EBITDA) test. Further information on these difficulties can be found in the 'United States Financial Reporting Standards and the Difficulties in their Interpretation' section of the Appendix. In the light of these difficulties, there are a number of extra measures that could be taken when the company reporting does not facilitate a clear eligibility determination for a particular company. For example, if reporting was unclear, the determination of a relevant tax authority on whether a company is or is not a REIT could be used. Alternatively, the index partners could reach out to those companies to encourage a change to their method of reporting so as to make it consistent with the eligibility requirements (including any change that might result from the feedback received in relation to question 2 above).

9: Should additional measure(s) be used to determine the eligibility of those companies whose reporting is unclear? In all cases please provide reasoning.

- The EBITDA requirements should be adhered to; where the reporting is insufficiently clear, the index partners should reach out to those companies and encourage compliance with those requirements (as now)
- Use the determination of REIT status by the Internal Revenue Service in the United States only as an alternative to applying the EBITDA eligibility screen
- Other (please expand)

4.0 Eligible Real Estate Activities

Sections 4.4 and 4.7 of the ground rules (extracts provided under 'Eligible Real Estate Activities' of the Appendix) outlines what the index series considers to be eligible and ineligible real estate activities; however those lists can never be exhaustive. For certain types of real estate activity there may be several types of assets and revenue streams the eligibility of which might benefit from additional clarification. Data centers provide an illustration. Section 4.4 treats leasing of space at data centers as a relevant real estate activity. However, the ground rules are silent with respect to two specific data center issues: (1) whether data center improvements should count as real estate for the requirement that, for a new issue, at least 50% of total assets must be invested in real estate (Rule 5.6.1.C) before liquidity testing can begin; and (2) the treatment of colocation revenue as a relevant real estate activity for the purposes of the EBITDA screen (Rule 4.5). Further information on data center improvements and colocation revenue can be found in the 'Data Center Issues' section of the Appendix.

10: Section 4.4 of the ground rules sets out what are deemed to be relevant real estate activities. Are there any additions or deletions you believe should be considered for inclusion on this list?

- Yes
- No
- If yes, please provide details

11: Section 4.7 of the ground rules sets out what are deemed to be non-relevant real estate activities. Are there any additions or deletions you believe should be considered for inclusion on this list?

- Yes
- No
- If yes, please provide details

12: Are there any types of real estate that are not currently eligible which you believe should be considered eligible?

- Yes
- No
- If yes, please provide details and your reasoning

13: Should the ground rules list examples of real estate activities which are and are not eligible?

- Yes
- No
- If yes, please provide examples

14: Should data center improvements be considered as real estate assets for the requirements above? More details can be found above and in the Appendix under 'Data Center Issues'.

- Yes, regardless of whether the company owns or leases the building

- Yes, but only if the company owns the building
- No
- Comments

15: Should colocation revenue be considered eligible revenue for the purposes of the EBITDA screen (Rule 4.5)? More details can be found above and in the Appendix under 'Data Center Issues'.

- Yes – Only when sufficient granular detail is available so that no ineligible revenue could also be included (as now)
- Yes – Regardless of whether some ineligible revenue may be included
- No
- Comments

16: Apart from data centers, are there any other cases of real estate activities where the eligibility of assets (for the purposes of rule 5.6.1C) and the eligibility of revenue (for the purposes of Rule 4.5) might benefit from additional clarification?

- Yes (please provide examples)
- No
- Comments

5.0 Size Thresholds and Market Classification

The size rule of the FTSE EPRA/NAREIT Global Real Estate Index Series is a relative measure that is expressed as a percentage of the regional index market capitalisation (after the application of investability weightings). Securities that currently are not members of the index series are required to meet a basis points threshold for inclusion that is higher than the basis points threshold set for exclusion of existing constituents. The aim of these different size thresholds is to provide a degree of stability in the composition of constituents of the FTSE EPRA/NAREIT Global Real Estate Index Series while ensuring that the index series continues to be representative of the market by including or excluding those securities whose market capitalisation has grown or diminished. Details of the existing thresholds can be found in the 'Size Thresholds' section of the Appendix.

17: Are the current size thresholds appropriate?

- Yes
- No
- Comments

The FTSE EPRA/NAREIT Global Real Estate Index Series is divided into Developed and Emerging sub-series. Assignment of companies to the sub-series is made according to the criteria set out in the 'Market Classification' section of the Appendix.

18: Are the EBITDA thresholds for classifying securities as either Developed or Emerging appropriate?

- Yes
- No
- Comments

Index inclusion criteria are region specific and are also different if the country to which a stock is assigned is classified as Developed or Emerging.

19: Is it appropriate to have different inclusion criteria depending on the nationality assignment of a particular stock?

- Yes – Having different thresholds for different regions and whether the country assignment is Developed or Emerging is appropriate (as now)
- Yes – There should only be different criteria for Developed vs Emerging
- Yes – There should only be different criteria for different regions
- No – There should be no difference to inclusion criteria for the country assignment of a stock
- Please provide the rationale for your decision

As of the end of November 2016, companies assigned to the United States represented ~55% of the FTSE EPRA/NAREIT Developed Index. Together with Canada the weight of the Americas region is ~58%. The next highest country weight within the index is Japan with ~11%. Other than the different entry and exit thresholds by region, there are currently no rules in the index methodology which would prevent any one country or region from becoming an even greater percentage of the index weight.

20: Is it a concern for you that the United States is/may become too great a weight in the FTSE EPRA/NAREIT Developed Index?

- No – It is not a concern
- Yes – Should U.S. companies become a greater portion of the index this would be an issue. Please specify at what percentage that would be in the comments
- Yes – U.S. companies already represent too great a portion of the index
- Don't Know
- Comments

21: If you have answered 'Yes' to question 4 above, how do you think the perceived issue would be solved?

- The weight of any one country within the index should be capped. Please specify at what percentage that should be in the comments
- The weight of any one region within the index should be capped. Please specify at what percentage that should be in the comments
- The entry/exist thresholds of U.S. companies should be raised. Please provide your reasoning
- The entry/exist thresholds of the Americas region should be raised. Please provide your reasoning
- Other – Please provide details in the comments
- Don't Know
- Comments

6.0 Index Ground Rules

The ground rules for this series can be found [here](#)

22: Do you have any proposed updates to the ground rules which would make them clearer and add to their objectivity?

Yes

No

If yes, please provide details

Appendix

Reporting Requirements

Index Rules on Reporting Requirements

- A. A company may only be added to the FTSE EPRA/NAREIT Global Real Estate Index Series if it provides an audited annual report in English*. This is defined as a current set of accounts in English consisting of a profit and loss statement, a balance sheet, directors' review and full notes to the accounts.
- B. If a company newly introduces English annual reporting it becomes eligible for the indexes at the next quarterly review, providing it meets all other index inclusion criteria.
- C. Existing index constituents are required to produce an eligible annual report, as defined by [Rule 4.7A](#), within 12 months after its fiscal year end. Companies that fail to do this will become ineligible at the next quarterly review.
- D. If a company meets the EBITDA criteria based on its latest annual report ([Rule 4.7A](#)), it becomes eligible for the indexes at the next quarterly review, providing it meets all other index inclusion criteria.
- E. If a company fails the EBITDA criteria ([Rule 4.4](#)), it becomes ineligible for the indexes at the next quarterly review.

* Audited fiscal reports in Japan in English are also eligible.

United States Financial Reporting Standards and the Difficulties in their Interpretation

In the United States, the informational requirements of the EBITDA screen in conjunction with the consolidated financial statements required by the Financial Accounting Standards Board (FASB) can, in certain cases, impede the clear, accurate and transparent evaluation of potential index constituents in the presence of a Taxable REIT Subsidiary (TRS).

- Since 2001, the U.S. REIT rules have allowed REITs to own one or more TRS. These taxable, non-REIT corporations are permitted to provide services to tenants and third parties that REITs themselves could not otherwise provide. The rules stipulate that no more than 25% of a REIT's assets may consist of securities in all TRS (20% starting in 2018).
- While TRS may be used by REITs in all property sectors, they are integral to hotel and healthcare REITs. Because of the extensive tenant-specific services provided at hotels and healthcare facilities, REITs are not permitted to both own and operate such properties themselves. However, the TRS rules allow a REIT to lease such properties to a TRS, provided that the TRS engages a third party operator to manage such properties. The REIT receives REIT-eligible rent from the lease agreement with the TRS whereas the TRS receives income from managing the properties, a meaningful portion of which does not qualify as eligible REIT income.
- Financial reporting and accounting standards in the U.S. are promulgated by the Financial Accounting Standards Board (FASB). Those standards require that the financial statements of parent companies and their wholly-owned subsidiaries are consolidated for financial reporting purposes. Consequently, the consolidation of the financial statements of REITs and their TRS can obscure the data required to implement the EBITDA threshold. The rental income of the REIT (the index constituent) is sometimes no longer reported separately on the consolidated income statement whereas the income items received by the TRS (which is not an index constituent) are reported: the rent expense paid by the TRS and earned as income by the REIT is essentially netted out of the consolidated financial statement.

- Because authorization and use of a TRS is part of the REIT rules in the U.S. Internal Revenue Code, the conferral of REIT status by the IRS could be considered as evidence that at least 75% of their total assets consist of qualifying real estate assets and that at least 75% of the company's gross income is derived from certain real estate sources, including dividends from other REITs, interest on obligations secured by mortgages on real property, rents from real property, and gain from the sale of real property.

Eligible Real Estate Activities

Section 4.4

Relevant real estate activities are defined as the ownership, trading and development of income-producing real estate.

Section 4.7

The following are not considered relevant real estate activities:

- A. The financing of real estate.
- B. The provision of construction management, general contracting and project management services.
- C. The provision of property management, facilities management, brokerage, investment management funds and services.
- D. Holding companies are excluded from the index. Holding companies are defined as companies that have more than 50 percent of their net assets invested in the securities of other listed companies.
- E. Storage caverns/units for commodities such as oil & gas.
- F. Companies for which the ownership of real property is incidental to the primary revenue generating activities, including those companies in the gaming, theme park and other entertainment businesses.
- G. Infrastructure assets, including transportation assets (roads, bridges, tunnels, airports, etc.), energy and utilities assets (power generation, fuels, etc.), water and waste management assets and communication assets (line-based networks, air-based networks, etc.).

Data Center Issues

Data Center Improvements – which generally include electrical systems including generators and backup power systems, mechanical systems like HVAC, and fire protection and suppression systems – can account for a large portion of the value of a data center. Current practice includes these improvements as eligible real estate assets for the purpose of the requirement that at least 50% of total assets must be invested in eligible real estate (Rule 5.6.1.C). If improvements were not considered as eligible real estate, separating the value of the structure from the value of the improvements may be challenging because the distinction is not typically reported in audited financial statements.

Colocation Revenue - TechTarget.com defines Colocation (colo) as a data center facility in which a business can rent space for servers and other computing hardware. “Typically, a colo provides the building, cooling, power, bandwidth and physical security while the customer provides servers and storage.”

Colocation revenue can be a meaningful component of data center revenues. With no guidance from the ground rules, current practice has been to exclude colocation revenue from relevant real estate activities for purposes of the EBITDA screen because some data center firms use the term “colocation” to aggregate rental and service revenues in their financial statements while others provide granular details.

Size Thresholds and Market Classification

Size Thresholds

Additions to the Index Series

At the quarterly review, non-constituent securities that have an investable market capitalisation (after the application of investability weightings) equal to or greater than the following basis points of their respective regional index will be eligible for index inclusion:

Developed Markets

- a) Asian Stocks 0.30%
- b) EMEA Stocks 0.10%
- c) Americas Stocks 0.10%

Emerging Markets

- a) Asian Stocks 0.20%
- b) EMEA Stocks 0.30%
- c) Americas Stocks 0.30%

AIM Market

- a) AIM Stocks 1.50%

If a security being considered for addition to the FTSE EPRA/NAREIT Global Real Estate Index Series at the quarterly reviews in March, June, September or December failed the liquidity test at the previous semi annual review it shall be ineligible for addition until the next semi annual review.

Deletions from the Index Series

At the quarterly review, an existing constituent of the FTSE EPRA/NAREIT Global Real Estate Index Series is deleted from the Index Series if it has an investable market capitalisation (after the application of investability weightings) of less than the following basis points in their respective region:

Developed Markets

- a) Asian Stocks 0.15%
- b) EMEA Stocks 0.05%
- c) Americas Stocks 0.05%

Emerging Markets

- a) Asian Stocks 0.10%
- b) EMEA Stocks 0.15%
- c) Americas Stocks 0.15%

AIM Market

- a) AIM Stocks 0.75%

Market Classification

New constituents will be classified as Developed if greater than 75 percent of their total annual EBITDA has been derived from Developed Markets (as classified by the FTSE Country Classification Advisory Committee) for two consecutive years as evidenced from the company's annual reports.(1)

In the event that it is not possible to classify new constituents as Developed, the new constituents will be classified as Emerging if greater than 75 percent of their total annual EBITDA has been derived from Developed Markets and Emerging Markets combined (as classified by FTSE) for two consecutive years as evidenced from the company's annual reports. (2)

- 1) Non-constituents which became eligible in March 2012 upon the introduction of revised rules (v5.0) were included in the Global Index Series from March 2012.
- 2) The 'Red Chips' in the FTSE EPRA/NAREIT Global Real Estate Index Series, which remained in Hong Kong (Developed) in September 2009, moved to China (Emerging) in March 2012.

EBITDA derived from Frontier Markets (as classified by FTSE) and unclassified markets will be considered ineligible EBITDA.

Existing Developed series constituents will move to the Emerging series if their total annual EBITDA from Developed markets has decreased to less than 50 percent for two consecutive years as evidenced by the company's annual reports.²

Existing Emerging series constituents will move to the Developed series if their total annual EBITDA from Developed markets has increased to greater than 75 percent for two consecutive years as evidenced by the company's annual reports.

New constituents that have only one year of audited financial statements in their latest annual report (as defined by Rule 4.7A) or English IPO prospectus will be reviewed and classified based on the most recent available one year audited financial statements.

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