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**UNIVERSITY OF KRAGUJEVAC
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REAL ESTATE INVESTMENT TRUSTS SPECIALIZED FOR INVESTING IN HOTELS

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Abstract

The chance for the development of Serbian hotel industry and tourism in general should be sought in the investment of real estate investment trusts specialized for investing in hotels. Regarding this, the objective of this paper is acquainting investment public in Serbia with the basic characteristics of real estate investment trusts and the importance of real estate investment trusts specialized for investing in hotels. The development of the hotel sector of Serbia will be accelerated and significant contribution to increasing the capacity of domestic hotel in the future can be provided by the establishment of these funds. Therefore, the way of Serbian hotel sector development should be focused on attracting funds of foreign hotel real estate investment trusts and the establishment of national hotel real estate investment trusts.

Keywords: *real estate investment trusts, hotel or lodging REITs, hotel industry, investment funds*

JEL classification: *G23, Z32, L85*

Introduction

The development of the investment funds industry of a country directly corresponds to its economic development. It is not surprising that Serbia lags significantly behind high developed countries, when the development of the investment fund sector is taken into consideration (Jakšić et al., 2015, 49). In spite of that, the chance for the development of Serbian hotel industry and tourism in general should be sought in the investment of investment funds (Krstić et al., 2016). It is particularly important to

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attract financial resources of special type of investment funds which invest in real estate (real estate investment trusts – REITs) (Gnjatović & Leković, 2016, 64).

Bearing in mind the above mentioned, the aim of the paper is to show the basic characteristics of REITs to the investment public in Serbia, with a special focus on REITs specialized for investing in hotels (hotel or lodging REITs). The intention is to emphasize, on the case of the most developed investment fund industry in the world – the United States (US) investment fund industry, the importance of hotel REITs and REITs in general.

The importance of hotel REITs is reflected in the fact that the establishment of these funds can be an important generator of development of Serbian hotel industry in the future (Krstić & Stanišić, 2015). The exchange of good practices with the world, the establishment of hotel REITs in Serbia and attract foreign hotel REITs, paving the way for development of the hotel sector in Serbia and promising positive effects on the national economy.

The concept and the formation of REITs

REITs are financial intermediaries who carry out capital aggregation of individual and institutional investors, and invest thus associated funds in real estate, mortgage credits and mortgage-backed securities. According to Krewson-Kelly & Thomas (2016), REIT is an entity that receives revenue through owning or financing income-producing property. The formation and business of these funds in the US were enabled by American Real Estate Investment Trust Act from 1960. Legislation regulating the business of REITs like the US, is brought about ten years later in New Zealand, the Netherlands and Australia, while the introduction of these funds in other parts of the world was conducted in the nineties of the 20th century and at the beginning of the new millennium.

While REITs were introduced in the United States in 1960, the next 30 years saw very few other countries adopt the structure. Some markets introduced a REIT type vehicle in the 1990s, such as Belgium (1995), Brazil (1993), Canada (1994) and Spain (1994). However the major period of growth took place post 2000. The major Asian markets such as Japan (2000), Hong Kong (2003) and Singapore (2002) all introduced

REITs just after the turn of the millennium, whilst France was the first major European market to launch a REIT vehicle in 2003. Markets such as the UK and Germany launched later in 2007 (Stevenson, 2013, 18).

One of the key reasons delayed the introduction of REITs in many economically powerful countries of the world lies in the estimated possibility of tax evasion and related abuses. For example, if a foreign investor invests money in a REIT, the country where REIT is registered will not make a tax revenue because of the REIT is exempt from income tax, while foreign investor pays tax to the country whose citizen he is or in which is registered as a legal entity.

The basic advantages of investing funds in REITs in terms of investors are liquidity, security and return on investment. Liquidity of investments arises from the possibility of a relatively quick sale of the shares of these funds on the stock market, as opposed to real estate, whose sale requires time.³ Security has always been a feature of investing in real estate, which is through diversification of investments (investments in different types of geographically distant estate) and the required investment transparency additional increased for investors who entrust their funds to real estate funds. Purchase of shares of REITs represents the cheapest way to diversify investments in the real estate market, and diversification of investments is the best guarantee of security of fund assets. Finally, provision that these funds during the year must pay at least 90% of taxable income to its shareholders speaks in support of investment profitability. Real estate funds are entitled to exemption from income tax by fulfilling these provisions. By exemption from taxation at the level of the fund, the tax costs between direct and indirect investment in real estate are equated in terms of investors (Jagodić, 2012). In this way, the economic logic and motivation for investing in REITs are provided. However, the obligation of a REIT to pay at least 90% of its profit significantly reduces the potential for growth, which would be financed from its own funds, because a small percentage of the amount of profit that can be reinvested remains available (Mašić, 2009, 146).

The additional requirements that must be met in order to classify a particular fund as a REIT are (NAREIT, 2016): 1) the fund is managed by directors or trustees, and its shares are transferable, 2) the minimum

3 The stated advantage does not apply to a relatively small group of REITs whose shares are not publicly traded on a stock exchange.

number of shareholders is hundred, that the five largest shareholders may own a maximum of 50% of the fund's shares ⁴, 3) at least 75% of the total revenues of the fund must come from renting and selling real estate, as well as from interest income on mortgage loans, 4) at least 75% of total assets must be invested in real estate and 5) the fund may not own more than 10% of the voting shares of a company.

In addition, it should be noted that REITs are an effective hedge against inflation, because their dividends generally increase faster than inflation. Also, by investing in REITs, individual investors achieve benefits such as easy and cheap access to the real estate market, professional asset management, reduction of transaction costs by achieving economies of scale. The establishment of REITs enables participation in the real estate market to small investors with a modest amount of free funds.

It is important to point out the fact that, due to the unique regulatory framework of REITs and the characteristics of real estate as an asset, REITs act in parallel markets. "Parallel" means that REITs are active in the stock market on the one hand and in the private property market on the other hand. The parallel market setting is a unique feature that distinguishes REITs from most other non-real estate firms that are listed on the stock market (Pfeffer, 2009, 38).

Types of REITs and REIT structure

The usual classification of REITs is the following: *equity REITs*, *mortgage REITs* and *hybrid REITs*. Equity REITs are direct owners of real estate. They manage real estates as part of their portfolio, and real estate bring income to them. On the other hand, mortgage REITs do not own or manage real estate, but finance real estate owners through mortgage loans. An important characteristic of these funds is the high level of indebtedness, or high financial leverage. Finally, hybrid REITs are generated by a combination of characteristics and investment strategies of equity and mortgage REITs.

Among the aforementioned types of funds, equity REITs are the most numerous with the largest market capitalization. American National Association of Real Estate Investment Trusts (NAREIT) performs further classification of equity REITs, starting from the type of assets in which

4 In order to meet the above mentioned conditions, many REITs do not allow to individual shareholders to own more than 9.8% of the fund's shares.

the fund invests money. In that sense, there are equity REITs specialized in the purchase and management of:

- business facilities (*office REITs*),
- industrial facilities (*industrial REITs*),
- retail stores (*retail REITs*),
- hotel facilities (*hotel or lodging REITs*),
- residential facilities (*residential REITs*),
- forest wealth (*timberland REITs*),
- institutions for providing health care (*health care REITs*),
- warehouses and storage areas (*self-storage REITs*),
- industrial infrastructure (*infrastructure REITs*),
- combination of the above mentioned institutions, facilities, areas (*diversified REITs*).

Another important classification of REITs is classification on REITs whose shares are publicly traded (*publicly traded REITs*) and REITs whose shares are not publicly traded (*non-traded REITs*). Most REITs belong to the first group, and as important shortcomings of non-traded REITs stand out (SEC, 2011):

- Lower liquidity - shares of these funds cannot be cashed by fast selling on the market. Although there is a share buyback program, investors are often forced to wait for the inflow of money for ten years, until the company decides to include their shares on the stock exchange listing or to liquidate its assets. This decision is a discretionary right of the fund.
- Non-transparent value of shares - as opposed to always available the market price of shares of funds whose shares are publicly traded on the stock exchange, the second group of funds assesses the value of its shares eighteen months after completion of shares offering. Seen from the perspective of investors who have bought shares among the first, it can take years until they find out the value of shares in their possession.
- Potential conflicts of interest - funds whose shares are not publicly traded do not have their own employees and the management of these funds is entrusted to a third party (external manager). In this way, the probability of a conflict of interest is increased, because the external manager can simultaneously manage competitive funds or act contrary to the interests of shareholders. For example, the external manager may make an acquisition of fund that not operates well in order to earn higher commissions as a percentage of total managing assets.

In addition, most non-traded REITs start out as blind pool REITs. A blind pool REIT is a REIT that does not tell investors what specific real properties will be acquired when raising capital from the public. On the other hand, non-traded REITs offer certain advantages to its investors as a relatively higher income in the form of dividends and the fact that, as opposed to publicly traded REITs, are not exposed to market volatility. These advantages ensure the survival and justify the existence of these types of funds.

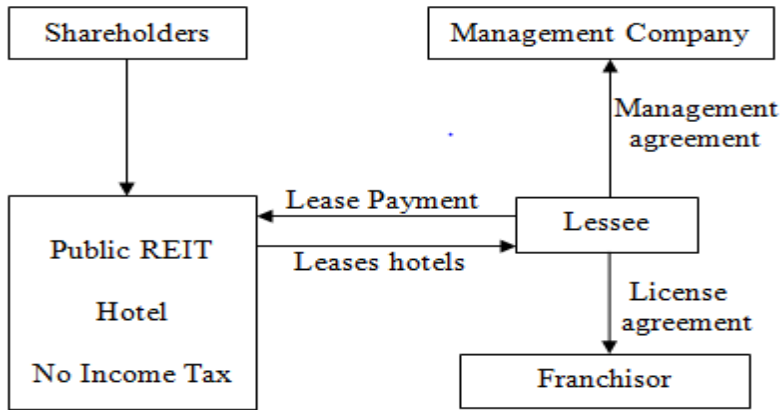
The third classification of REITs is classification on REITs with limited lifetime (*finite-life REITs*) and REITs with unlimited lifetime (*infinite-life REITs*). Finite-life REITs are generated as a response to investor criticism that the stock prices of REITs are determined more by their current and expected income (capitalization of expected dividends), than by the value of real estate held by the fund. After the expiration of the predefined durability, the assets of these funds are liquidated and distributed to shareholders. However, most of today's REITs are infinite-life REITs.

A less common but nonetheless important way of classifying REITs is according to the tactics they use to grow earnings and cash flow. Every REIT can be broken down into three activities that support their financial results (Krewson-Kelly & Thomas, 2016, 12):

- Internal growth generated by managing assets the REIT already owns; also sometimes called „organic“ growth;
- External growth generated by acquiring or developing properties;
- Financing that growth through issuing new debt or equity, and/or by selling properties.

In addition to different types of REITs, different forms of REIT structures are distinguished in the finance literature and economic practice. There are typically three forms of REIT structures: 1) traditional REIT structure, 2) paired-share REIT structure and 3) paper-clip REIT structure. In the traditional structure, the REIT owns the real estate (hotels, apartments, and office buildings), and these are then leased to a lessee, who arranges management and franchise agreements with third parties (Figure 1) (Beals & Singh, 2002, 19).

Figure 1: *Traditional REIT structure*

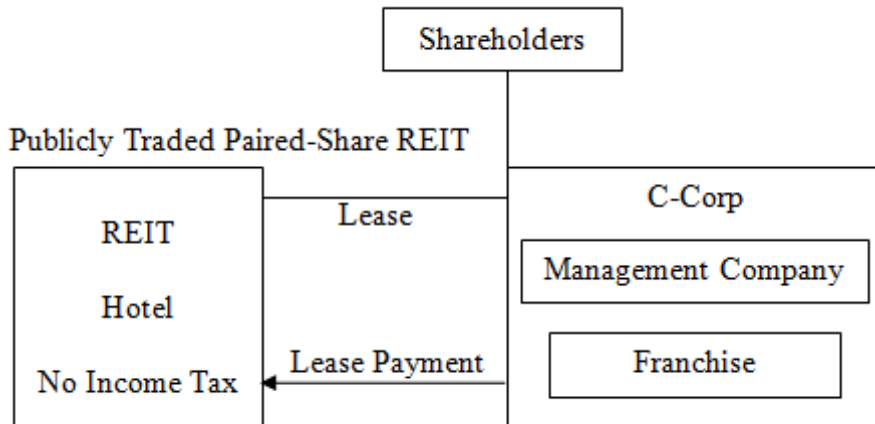


Source: *Beals & Singh, 2002, 20*

In this structure the REIT earns its income through the lease payments. The key disadvantage of traditional REIT structure is „leakage“– this term refers to the loss of investment returns to a REIT that is caused by expenses paid to a service provider or lessee. It should be understood that leakage is a true economic loss if the property owner could provide a similar service at or below the cost of the outside service provider (Imperiale, 2002).

On the other hand, a paired-share REIT pairs a REIT with a C-Corp (Figure 2). The shares of the REIT and its affiliate are combined and traded as a unit in equal allotments under one ticker symbol. This integrated structure is advantageous to investors because the REIT leases the hotel properties to the C-Corp, which then is the operating company and, in some cases, the franchisor. This structure successfully resolved the problem of lack of control over real properties owned by a REIT. Also, this structure avoids what is inelegantly termed in the industry "leakage." In a paired-share REIT, the „leakage“ occurs but is recaptured by the C-Corp. Since paired share shareholders own an equal stake in both the REIT and the C-Corp, the profits forgone by the REIT flow back to the security holder via the C-Corp (Beals & Singh, 2002, 20).

Figure 2: *Integrated paired-share REIT structure*



Source: *Beals & Singh, 2002, 21*

The paired-share structure also promoted tax sheltering by corporations engaged in real estate operations. The corporations shelter a portion of their income by placing their real estate in a REIT and render nontaxable the share of its income paid as "lease payments" to the REIT. The US Congress quickly recognized the potential for abuse under this structure and revised the law in 1984, adopting Section 269B of the Internal Revenue Code. Out of fairness to existing REITs, the legislation "grandfathered" paired-share REITs established prior to June 30, 1983. Ironically, the four companies that qualified under this rule have used their exemption to engage in the very practices Congress sought to end (Hubbell, 1998).

Another REIT, similar to a paired-share REIT, is known as a paper-clip REIT. The principal difference between the two is that paired-share REITs trade the shares in the REIT and the C-Corp as one integrated share, while paper-clip REIT trades shares in the REIT and the C-Corp separately (Beals & Singh, 2002, 21). The REIT has an intercompany agreement with an operating company, which allows each entity to participate in certain transactions and investments of the other entity. In addition, the two companies may have the same senior managers and board directors. Although the shares of the two companies are not paired or traded as a unit, investors may purchase the shares of the two companies and "paper-clip" them to capture the symbiotic relationship between the two companies (Frequently Asked Questions about Real Estate Investment Trusts).

Development of US REITs

The first two decades of operations of US REITs were characterized by the gradual development that was strongly shaken in 1973, when there was a collapse of the office real estate market. Oversupply of office space has led to a decline in the rate of availability of space, which for mortgage REITs means a high increase in non-performing loan arrangements. Consequently, there has been a dramatic fall in the value of shares of mortgage REITs and a rapid reduction in their number (Jagodić, 2012, 47). The value of the assets of US REITs decreased from US\$1,880.9 million in 1972 to US\$712.4 million in 1974 (Table 1). Then the recovery of this sector came accompanied by growth in the number of REITs and the value of their property. Development of REITs industry was intensified in the nineties of the 20th century and at the beginning of the new millennium. Only in 2006 the value of assets of REITs increased to US\$107,379.8 million and reached the amount of US\$438,071.1 million.

The global financial and economic crisis started in the US mortgage market in late 2007 has set the second powerful blow to REIT industry. The value of the assets of US REITs decreased from US\$438,071.1 million in 2006 to US\$191,651.0 million in 2008, while the number of REITs in the same period decreased from 183 to 136. However, the US REIT sector has once again shown its resilience and vitality, which is with the subsiding crisis manifested in an even faster growth in the value of assets in the sector. The market capitalization of US REITs already in 2011 reached the amount of 2006, and doubled in the following three-year period and reached the amount of US\$907,427.5 million (Table 1). The US REIT industry has reached the value of assets of more than US\$1 trillion in 2016, accounting for 66% of the assets of the all REITs in the world, which amounts to US\$1.7 trillion.

REITs have become an increasingly popular vehicle for real estate ownership. Global market capitalization now stands at approximately US\$1.7 trillion, up from US\$734 billion in 2010. Since 2010, the US REIT market has grown by almost 150%, while the market capitalization of non-US REITs has more than doubled in United States dollars terms. The two fastest-growing markets in the last five years have been Australia and Japan, both of which have now overtaken France and the UK to be the second- and third-largest global REIT markets, respectively (EY, 2016).

Table 1: *US REIT industry equity market capitalization*

Year	All REITs		Equity			Mortgage			Hybrid*		
	Number of REITs	Market capitalization	Number of REITs	Market capitalization	% of all REITs	Number of REITs	Market capitalization	% of all REITs	Number of REITs	Market capitalization	% of all REITs
1971	34	1,494.3	12	332.0	22.2	12	570.8	38.2	10	591.6	39.6
1972	46	1,880.9	17	377.3	20.1	18	774.7	41.2	11	728.9	38.8
1973	53	1,393.5	20	336.0	24.1	22	517.3	37.1	11	540.2	38.8
1974	53	712.4	19	241.9	34.0	22	238.8	33.5	12	231.7	32.5
1975	46	899.7	12	275.7	30.6	22	312.0	34.7	12	312.0	34.7
1976	62	1,308.0	27	409.6	31.3	22	415.6	31.8	13	482.8	36.9
1977	69	1,528.1	32	538.1	35.2	19	398.3	26.1	18	591.6	38.7
1978	71	1,412.4	33	575.7	40.8	19	340.3	24.1	19	496.4	35.1
1979	71	1,754.0	32	743.6	42.4	19	377.1	21.5	20	633.3	36.1
1980	75	2,298.6	35	942.2	41.0	21	509.5	22.2	19	846.8	36.8
1981	76	2,438.9	36	977.5	40.1	21	541.3	22.2	19	920.1	37.7
1982	66	3,298.6	30	1,071.4	32.5	20	1,133.4	34.4	16	1,093.8	33.2
1983	59	4,257.2	26	1,468.6	34.5	19	1,460.0	34.3	14	1,328.7	31.2
1984	59	5,085.3	25	1,794.5	35.3	20	1,801.3	35.4	14	1,489.4	29.3
1985	82	7,674.0	37	3,270.3	42.6	32	3,162.4	41.2	13	1,241.2	16.2
1986	96	9,923.6	45	4,336.1	43.7	35	3,625.8	36.5	16	1,961.7	19.8
1987	110	9,702.4	53	4,758.5	49.0	38	3,161.4	32.6	19	1,782.4	18.4
1988	117	11,435.2	56	6,141.7	53.7	40	3,620.8	31.7	21	1,672.6	14.6
1989	120	11,662.2	56	6,769.6	58.0	43	3,536.3	30.3	21	1,356.3	11.6
1990	119	8,737.1	58	5,551.6	63.5	43	2,549.2	29.2	18	636.3	7.3
1991	138	12,968.2	86	8,785.5	67.7	28	2,586.3	19.9	24	1,596.4	12.3
1992	142	15,912.0	89	11,171.1	70.2	30	2,772.8	17.4	23	1,968.1	12.4
1993	189	32,158.7	135	26,081.9	81.1	32	3,398.5	10.6	22	2,678.2	8.3
1994	226	44,306.0	175	38,812.0	87.6	29	2,502.7	5.6	22	2,991.3	6.8
1995	219	57,541.3	178	49,913.0	86.7	24	3,395.4	5.9	17	4,232.9	7.4
1996	199	88,776.3	166	78,302.0	88.2	20	4,778.6	5.4	13	5,695.8	6.4
1997	211	140,533.8	176	127,825.3	91.0	26	7,370.3	5.2	9	5,338.2	3.8
1998	210	138,301.4	173	126,904.5	91.8	28	4,916.2	3.6	9	6,480.7	4.7
1999	203	124,261.9	167	118,232.7	95.1	26	4,441.7	3.6	10	1,587.5	1.3
2000	189	138,715.4	158	134,431.0	96.9	22	2,652.4	1.9	9	1,632.0	1.2
2001	182	154,898.6	151	147,092.1	95.0	22	3,990.5	2.6	9	3,816.0	2.5
2002	176	161,937.3	149	151,271.5	93.4	20	7,146.4	4.4	7	3,519.4	2.2
2003	171	224,211.9	144	204,800.4	91.3	20	14,186.5	6.3	7	5,225.0	2.3
2004	190	305,025.1	150	273,629.0	89.7	33	24,774.1	8.1	7	6,622.0	2.2
2005	197	330,691.3	152	301,491.0	91.2	37	23,393.7	7.1	8	5,806.6	1.8
2006	183	438,071.1	138	400,741.4	91.5	38	29,195.3	6.7	7	8,134.3	1.9
2007	152	312,009.0	118	288,694.6	92.5	29	19,054.1	6.1	5	4,260.3	1.4
2008	136	191,651.0	113	176,237.7	92.0	20	14,280.5	7.5	3	1,132.9	0.6
2009	142	271,199.1	115	248,355.1	91.6	23	22,103.2	8.2	4	740.8	0.3
2010	153	389,295.4	126	358,908.2	92.2	27	30,387.2	7.8	--	--	--
2011	160	450,500.6	130	407,528.9	90.5	30	42,971.7	9.5	--	--	--
2012	172	603,415.3	139	544,414.9	90.2	33	59,000.3	9.8	--	--	--
2013	202	670,334.1	161	608,276.6	90.7	41	62,057.4	9.3	--	--	--
2014	216	907,427.5	177	846,410.3	93.3	39	61,017.2	6.7	--	--	--
2015	223	938,852.0	182	886,487.5	94.4	41	52,364.6	5.6	--	--	--

2016	224	1,018,729.9	184	960,192.8	94.3	40	58,537.1	5.7	--	--	--
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Note: Market capitalization is expressed in millions of dollars.

* The FTSE NAREIT Hybrid REIT Index was discontinued on December 17, 2010.

Source: *NAREIT (2017)*

Based on the above table, it can be concluded that all three types of REITs (equity, mortgage and hybrid REITs) were about equally represented in the structure of all REITs to the end of the eighties of the 20th century, after that equity REITs have become dominant. In 1988, equity REITs realized share exceeding 50% for the first time, which amounted to even 91.8% ten years later. At the end of 2016, the value of the assets of US REITs reached a record amount of US\$1.018 trillion, while the share of equity REITs was even 94.3%, the share of mortgage REITs was 5.7%, while hybrid REITs did not take part in the structure of all REITs since 2010.

US Hotel or lodging REITs

Hotel or lodging REITs are real estate investment trusts specialize in investing in hotels. Hotel REITs invest in hotel capacity, then they usually are left to manage by large hotel corporations, through management contracts, or lease for a certain period. The focus of investment is on financing the construction and acquisition of hotel facilities. Joint ventures of REIT and global or regional hotel operators are also not unknown. There were cases that hotel operators build a hotel facility and then sell part or whole to REIT, with the condition of the conclusion of the contract for continuation of facility management. This indicates a clear tendency to separate the ownership of hotels from managing (Mašić, 2009, 148).

Hotel properties have often been excluded from “traditional” real estate sectors because they differ from typical real estate investment criteria in some ways. For example, hotel properties are often highly leveraged operationally because of their high maintenance and staffing needs. Moreover, the volatility of the lodging industry reflected in unsteady income streams even for high-profile city locations with established brand names. These factors have kept some real estate investors away from hotel REITs (Pfeffer, 2009, 48).

Hotel REITs achieved significant development from their introduction in 1993, despite the fact that they are characterized by high non-systemic

risk, which, according to research carried out by Kim et al. (2002) on the case of 19 US hotel REITs, makes up to 84% of the total risk of hotel REITs stocks. The number of US hotel REITs has increased from 2 in 1993 to 15 in 2000, while market capitalization increased from US\$100 million in 1993 to US\$7.5 billion in 2000.

Key factors that contributed to the development of hotel REITs in the last decade of the 20th century are (Gu & Kim, 2003, 167-168):

- Tax legislation included in the Revenue Reconciliation Act of 1993 removed a major tax barrier to make large-scale investments in equity REITs more attractive to institutional investors;
- During the economic recession of 1990 to 1991, many hotels suffered losses due to low occupancy resulting from overbuilding in the late 1980s. The recovery of the industry in the early and mid-1990s, featured by higher occupancy rate, rising average daily rate, and improved operation profits, could have encouraged investors to inject sizable new equity capital into the hotel industry through the ownership of hotel REITs;
- Hotel investors considered REITs as a mechanism for pooling financial resources, and in the process to obtain the economic benefits of commercial real estate investments, they also contributed to the hotel REITs boom in the mid-1990s;
- The hotel REITs boom in the 1990s was also attributable to investors' perception that ownership of REITs could provide them with inflation-hedging ability.

Development of US hotel REITs is continued in the new millennium, as evidenced by data from the following table.

Table 2: *Number and market capitalization of US hotel REITs*

Year	Number of hotel REITs	Market capitalization (y 000 \$)	Percent of total market capitalization of all REITs
2000	15	7,524,610	5.42
2001	15	6,896,702	4.45
2002	16	7,789,033	4.81
2003	15	9,173,345	4.09
2004	17	14,510,924	4.76
2005	19	18,208,922	5.51
2006	14	28,905,770	6.60

2007	10	19,343,990	6.20
2008	8	6,937,773	3.62
2009	9	14,229,944	5.25
2010	11	23,341,026	6.00
2011	14	24,279,627	5.39
2012	14	28,077,843	4.65
2013	16	41,094,548	6.13
2014	16	55,210,232	6.08
2015	17	41,918,460	4.46
2016	17	50,138,414	4.92

Source: *The authors, based on NAREIT (2000-2017)*

In the period from 2000 to 2016, the number of hotel REITs increased slightly (from 15 to 17), while market capitalization increased to US\$42.6 billion and reached a record amount of US\$50.1 billion. Despite the growth in the value of assets of hotel REITs, their share in the market capitalization of all REITs decreased from 5.42% in 2000 to 4.92% in 2016, indicating slower growth in the market capitalization of hotel REITs in comparing the growth in the value of assets of all REITs. The average share of hotel REITs in the market capitalization of all REITs amounted 5.2% in the period from 2000 to 2016 (Table 2).

The observed period was marked by two crisis events: the terrorist attack in New York, which took place on 11 September 2001 and the global financial and economic crisis started at the end of 2007. These events had a negative impact on the demand for hospitality services, and since the performance of hotel REITs are positively correlated with the performance of the hotel, this resulted in a significant decline in performance and asset value of hotel REITs. The market capitalization of US hotel REITs decreased by US\$627.9 million as a result of the terrorist attacks from 2001, while the global financial and economic crisis led to a reduction in the value of the assets of US hotel REITs from US\$28.9 billion in 2006 to US\$6.9 billion in 2008, representing a decrease of US\$22 billion. The share of hotel REITs in the market capitalization of all REITs reached the lowest level of 3.62% in 2008. This suggests to the fact that the hotel REITs are the most sensitive segment of the REIT industry in relation to other types of REITs, which is not surprising given the sensitivity of the demand for hospitality services and positive correlation between performance of the hotel and performance of the hotel REITs.

Hotel REITs have historically proven to be highly cyclical as the extremely short-term nature of their leases (nightly) can lead to highly volatile room rates and occupancy levels. Many operating expenses cannot be easily pared back, which can lead to volatile earnings cycles (Bank of America Merrill Lynch, 2013). The seasonal component of hotel space markets and the refurbishment and replacement cycle differentiates hotel REITs from the other four REIT property sectors (Pfeffer, 2009, 282). Hotel REITs differ structurally from other equity REITs in that, according to REIT rules, hotel owners are not permitted to directly operate the properties they own. This is because earning profit from operating hotels is active and differs from the more passive business of collecting rent on hotels leased to third-party operators. As a result, hotel REITs must retain a third-party hotel manager to operate its hotel (Krewson-Kelly & Thomas, 2016, 64).

Therefore, hotel REITs are not able to receive income directly from hotel operations, nor operate directly owned hotels. Instead, the hotel REITs have set up taxable REIT subsidiaries (TRS)⁵ that generate income from the hotels, and the TRS in turn pays the REIT. When the hotel REITs report earnings, they show the actual room revenue and food/beverage revenue. However, the income from hotel operations is not received by the REIT directly. A TRS, which is taxed at the corporate level, can engage in non-rental, ancillary business activities, such as property management, leasing, or merchant development. All of these activities contribute to a REIT's earnings. A REIT can own 100% of the stock of a TRS (Bank of America Merrill Lynch, 2013)

It should be pointed out that hotel REITs are subject to particular business risks (Pfeffer, 2009, 284):

- *Terrorist attacks:* Future terrorist attacks would adversely affect hotel REITs immediately. Even a change in the terrorist alert system can affect the performance of REITs, both the income and the pricing component of REIT returns.
- *Unionization:* Unionization of the labor force is a factor that can adversely affect the revenue of hotel REITs. Since hotel REITs have to employ more people than, for example, industrial REITs, this factor is of greater importance for hotel REITs.

⁵ The formation of TRS was allowed by the REIT Modernization Act, which went into effect in 2001.

- *Relative attractiveness of properties*: Since hotel REITs have to renew their properties approximately every seven years, changing consumer preferences and the state-of-the-art of the buildings is crucial for the success of hotel REITs.
- *Manager dependence*: Hotel REITs depend on the quality of their managers. Opportunistic behavior or insolvency of a manager can seriously affect the competitiveness of a hotel REIT.
- *Expense increase versus revenue decrease*: Many expenses associated with the operating of a hotel are relatively fixed such as employee wages and insurance, and may exceed inflation in tandem with decreasing room rates.
- *Economic climate and travel patterns*: More than other REIT property types, hotel REITs are affected immediately and drastically by changes in national, regional, and local economies as well as changes in business and leisure travel.

One of the characteristics of the US hotel REITs sector is the relatively high degree of concentration, as evidenced by the data in Table 3. Concerning the participation of individual funds in the structure of total assets of this sector, the existence of large disparities is noted. For example, an investment fund Host Hotels & Resorts, Inc. participates with US\$14.08 billion or 28.01% in the structure of total assets of hotel REITs sector, while investment fund Condor Hospitality Trust, Inc. achieves a share of only US\$9.9 million, or 0.02%.

Table 3: *Hotel REITs in USA (December 31, 2016)*

	Hotel REIT	Market	%
1.	Host Hotels & Resorts, Inc.	14,079.4	28.0
2.	Hospitality Properties Trust	5,213.9	10.3
3.	Apple Hospitality REIT Inc.	4,462.8	8.88
4.	LaSalle Hotel Properties	3,437.3	6.84
5.	Sunstone Hotel Investors, Inc.	3,302.3	6.57
6.	Ryman Hospitality Properties, Inc.	3,229.5	6.42
7.	RLJ Lodging Trust	3,044.1	6.06
8.	Diamond Rock Hospitality Company	2,314.2	4.60
9.	Pebble brook Hotel Trust	2,137.7	4.25
10.	Xenia Hotels & Resorts, Inc.	2,096.5	4.17
11.	Chesapeake Lodging Trust	1,542.6	3.07
12.	Summit Hotel Properties, Inc.,	1,388.1	2.76
13.	Falco Lodging Trust Incorporated	1,113.5	2.21
14.	Hersha Hospitality Trust Class A	899.6	1.79

15.	Chatham Lodging Trust	786.2	1.56
16.	Ashford Hospitality Trust, Inc.	740.9	1.47
17.	Ashford Hospitality Prime, Inc.	350.0	0.70
18.	Sotherly Hotels Inc.	101.5	0.20
19.	Inn Suites Hospitality	21.0	0.04
20.	Condor Hospitality Trust,	9.9	0.02
	Sector Totals	50,270.9	100

Note: Market capitalization is expressed in millions of dollars.

Source: *NAREIT (2017)*

On 31 December 2016, four hotel REITs (Host Hotels & Resorts, Inc., Hospitality Properties Trust, Apple Hospitality REIT Inc. and LaSalle Hotel Properties) participated in the total value of assets of this sector with 54.1%. Thus, 20% of hotel REITs achieved share exceeding 50%, which confirms previous statement about the high level of concentration of this sector.

Conclusion

Opinion that more than half a century old REITs industry will continue to grow and play an important role in the global real estate market is widespread in the finance literature. Therefore, it is important to recognize the potential benefits that would bring the establishment of these funds in Serbia, which are reflected primarily in attracting domestic and foreign investment. Real estate investment trusts are aimed at the effective mobilization and then the optimal allocation of long-term funds in the direction of the real estate market. The establishment of REITs would increase the liquidity and transparency of the real estate market in Serbia.

Given the above mentioned, it is necessary to provide adequate regulatory conditions for the establishment of these funds, and key prerequisite of REITs operating in Serbia is amending tax legislation in terms of eliminating double taxation. When there is double taxation (taxation at the level of the fund and taxation at the level of the individual investor), direct investments in real estate will be more attractive than investing through REITs. The presence of double taxation implies a lack of economic logic and economic motives for investing in real estate funds. On the other hand, it is equally important to prevent misuse in the form of tax evasion by the legal provisions.

From the standpoint of the development of Serbian hotel industry and tourism in general, it is particularly important to the establishment of hotel REITs. The establishment of hotel REITs as subtypes of REITs, would provide a significant contribution to increasing the local hotel capacity, which would result in improving the hotel and overall tourist offer of Serbia.

It is reasonable to expect progress of the Serbian sector of investment funds and appearance of REITs in the future due to the increase in overall investment culture and the fact that there are significant funds deposited in banks in the country without greater opportunities for alternative investments. The long-term development of this sector can be almost certainly ensured by the full membership of Serbia in the European Union, which can give chance to develop much faster to the overall industry. The entry of Serbia into the European family of countries would be a signal to foreign investors that the macroeconomic, legal and political stability, as the basic precondition for investing in the Serbian capital market and the Serbian investment funds industry, is achieved.

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