Do investors regard listed real estate as part of the real estate allocation?
Initial findings from the EPRA Survey

Listed vs. unlisted
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- Liquidity
- Valuation
Introduction

As all markets do, the real estate capital markets are continually evolving. Real estate debt is now an investable sector in Europe; derivative funds are up and running; and secondary trading in unlisted funds has shone a bright light on comparative pricing across public and private real estate markets. What can we learn from comparing these sub-markets?

This is the first of what we intend to be a regular series of publications looking at current trends in the public and private real estate capital markets in the UK and worldwide. In this issue, we focus on the listed and unlisted real estate equity markets and address three areas where consistent and meaningful data can be contrasted (relative performance, liquidity and valuation). By examining the shifts in these metrics we hope to provide a framework for informed decision-making across these and, in time, other quadrants of real estate investing.

In addition to regular metrics Across the Universe will feature topics of current interest and summaries of proprietary research. In this issue we show the findings of an initial pilot survey, commissioned by EPRA, on the use of listed real estate in the real estate asset allocation process.

Data and commentary are provided by Andrew Baum and Nick Colley of Property Funds Research, a research and consulting company specialising in private real estate investment, and Alex Moss of Consilia Capital, an advisory company specialising in public real estate. For details of advisory and bespoke research services please contact us. Our contact details are on the back page.

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This month’s article features the key findings from work that PFR, Consilia Capital and others undertook for EPRA: can listed real estate be managed as part of the real estate allocation?
Performance

Performance measures in the listed sector are usually expressed in a sub-sector neutral index form, with membership of the index based on the free float market capitalisation of the constituent companies. To be able to compare the listed real estate sector with the unlisted market, it would be useful to look below the index level at the popular sectors. To do this, we have grouped together UK companies with similar portfolios to replicate the specialisation common in the unlisted market. Our groupings are as follows:

- Retail: Hammerson; Capital Shopping; Town Centre; LXB; Metric; New River Retail
- Diversified: Land Securities, British Land
- London Office: Derwent London, Great Portland, Shaftesbury, Capital & Counties
- Industrial: Segro, Hansteen, Workspace, Mucklow

Figure 1 below shows the quarterly total returns of these groups to the end of Q3 2012.

Table 1: Quarterly total returns - UK listed sector groupings (%)

<table>
<thead>
<tr>
<th></th>
<th>Retail</th>
<th>Diversified</th>
<th>London office</th>
<th>Industrial</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q4 2009</td>
<td>7.41</td>
<td>6.62</td>
<td>9.21</td>
<td>-4.36</td>
</tr>
<tr>
<td>Q1 2010</td>
<td>-3.72</td>
<td>0.87</td>
<td>4.45</td>
<td>-2.44</td>
</tr>
<tr>
<td>Q2 2010</td>
<td>-11.87</td>
<td>-12.27</td>
<td>-6.62</td>
<td>-16.84</td>
</tr>
<tr>
<td>Q3 2010</td>
<td>14.74</td>
<td>12.17</td>
<td>19.88</td>
<td>8.19</td>
</tr>
<tr>
<td>Q4 2010</td>
<td>9.10</td>
<td>10.34</td>
<td>6.72</td>
<td>7.21</td>
</tr>
<tr>
<td>Q1 2011</td>
<td>1.39</td>
<td>8.84</td>
<td>7.36</td>
<td>10.31</td>
</tr>
<tr>
<td>Q2 2011</td>
<td>6.68</td>
<td>13.72</td>
<td>14.00</td>
<td>3.40</td>
</tr>
<tr>
<td>Q3 2011</td>
<td>-16.91</td>
<td>-22.31</td>
<td>-17.52</td>
<td>-22.37</td>
</tr>
<tr>
<td>Q4 2011</td>
<td>-4.47</td>
<td>-0.68</td>
<td>3.53</td>
<td>-1.81</td>
</tr>
<tr>
<td>Q1 2012</td>
<td>11.23</td>
<td>10.70</td>
<td>8.86</td>
<td>11.35</td>
</tr>
<tr>
<td>Q2 2012</td>
<td>1.71</td>
<td>4.81</td>
<td>8.35</td>
<td>-2.63</td>
</tr>
<tr>
<td>Q3 2012</td>
<td>3.40</td>
<td>3.83</td>
<td>6.97</td>
<td>6.78</td>
</tr>
</tbody>
</table>

Average annualised returns over this period have been quite strong for some property types, but poor for others. Our London office sample produced an average annualised return of over 17%, pushing the diversified sample (the average of Land Securities and British Land, both of which include healthy allocations to London offices) to over 12%. Meanwhile retail plodded along at just over 6%, and industrial returns were negative at less than minus one per cent. The diversified 12% return achieved by is well above the long term average annual return delivered by the property sector.

The London office group was particularly strong, delivering a quarterly return of just over 4.25%, ahead of the diversified sample of just over 3%. Lagging behind were retail, at 1.5% return per quarter, and industrial, which delivered negative quarterly returns of less than 0.25%.

There was less disparity in returns over the second half of this period, during which London office returns were running at an annualised rate in excess of 25% while industrial returns were close to zero.
As can be seen by comparing figures 1 and 2 (below) the scale of monthly volatility is in sharp contrast to the smooth, linear progression of the representative IPD sector indices, but a very clear pattern emerges in both figures: offices, dominated by Central London, have clearly outperformed other sectors at the asset level. This is reflected at the securitised sector level: stocks with > 65% Central London exposure were the best performing sector in 9 out of the 12 quarters, with two quarters of negative returns (Q2 2010 and Q3 2011) when the sector as a whole was under pressure. Similarly the worst performing sector at the asset level (industrial) was also the worst performing sector at the securitised level.

Figure 1: UK listed performance – quarterly total return

The chart shows that, following the rebound in performance driven predominantly by yield compression, fund performance has fallen in all sectors, with funds investing in the London office market out-performing all other sectors since Q1 2011 and, again, industrial funds faring the least well.

Figure 2: IPD sector performance – quarterly total returns (%)

The graph shows the familiar smooth return delivery typical of the IPD monthly index and direct real estate in general, albeit falling from the enormous returns delivered in the rebound of 2009. Meanwhile, we see the equally familiar relative volatility of the listed sector, and the reason why many would suggest that these are uncorrelated, very different, investment classes. However, the secondary market for unlisted funds appears to link the two series – not as volatile as the listed sector, but certainly not as smooth as the direct market, and possibly slightly lagged behind the listed market.

Figure 3: Unlisted fund performance – quarterly total returns

Source: PFR/AREF, 2012

Figure 4 compares the quarterly return series for the IPD monthly index, the JLL unlisted fund series (based on secondary trading prices) and the EPRA listed property index. We have selected the retail sector as the basis of this comparison, although diversified, office and industrial paint a similar picture.

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Figure 4: Retail performance – direct, listed, unlisted

Source: Consilia Capital; Bloomberg; PFR; JLL

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Figure 1: UK listed performance – quarterly total return

Source: Consilia Capital, Bloomberg

Figure 2: IPD sector performance – quarterly total returns (%)

Source: IPD

Figure 3 shows the mean quarterly total return for a basket of unlisted funds grouped by investment sector. Total return is calculated on a NAV to NAV basis and net of fund expenses.
Liquidity

Liquidity is often cited as one of the listed sector’s key advantages. While this remains true, even in current markets, it is worth examining more precisely the nature of this liquidity, and how it has varied over time. Figure 5 below shows the aggregate monthly trading volumes of the 21 members of the UK FTSE 350 Real Estate Index. The scale is in £ms, so in September 2002 the monthly volume was just under £2,000m (£2bn). A peak of £9.8bn was reached in June 2007. Since then the sector’s decline has resulted in significantly lower volumes, under £1bn in December 2011. Current volumes are around 12% of peak volumes. This contrasts with an equivalent figure of around 20% in North America.

We shall be looking at liquidity in greater detail in future issues, but one point must be borne in mind when comparing figures from the unlisted (matched bargain) secondary market and the listed market. The figures for the unlisted market relate only to end investors. Therefore the figures are an accurate indication of transacted investor volumes. For the listed sector a number of adjustments are commonly made to the gross figures to arrive at “investor liquidity”. The first adjustment recognises that in a continuously traded market a fair proportion of trades (volumes) will be undertaken by market makers/participants, not end investors.

To arrive at an estimate of investor level volumes, the gross figure is commonly halved. Therefore, going forward, when we speak of investor volumes we will be talking of this lower figure. The next adjustment that is made by funds when looking at the liquidity of individual stocks is to take a proportion of the net investor volumes figure to represent the amount that could be traded without affecting the price. This is often taken as 20% of the net investor figure. We regard this as the true level of investor liquidity at the stock level. Given the risk aversion and herding towards more liquid stocks this metric has gained increasing importance for fund managers measuring the risk in their portfolios over the last five years.

Figure 6: UK unlisted fund secondary trade volumes – all funds

Overall, H1 2012 transactions totalled £342m, representing a healthy growth rate of 18% on H1 2011 and highlighting the growing level of liquidity in the UK’s unlisted market, but still only 5% or so of the liquidity in the listed market.

Source: Consilia Capital, Bloomberg
Valuation

Given the value of the assets held by the underlying vehicle, be it listed or unlisted, how do secondary market trading prices reflect the popularity or otherwise of the structure? There are a number of models used for parallel asset pricing such as implied yields and earnings yields (the reciprocal of AFFO multiples), but the discount / premium to NAV methodology is still most commonly sourced as an indication of relative valuation.

Figure 7: UK REITs discount to NAV since January 2007

Source: FTSE EPRA/NAREIT Indices, September 2012

We show above UK discounts since the initial group of UK companies converted to REIT status in January 2007. UK REITs are currently trading close to their long run average, an 18% discount to published NAV. The peak discount was in January 2009, and the peak premium was in the summer of that year.

In figure 8, we have used Jones Lang LaSalle unlisted fund secondary pricing data to calculate a monthly average discount or premium to fund NAV.

Figure 8: UK unlisted discount/premium NAV – all funds

Source: PFR/Jones Lang LaSalle, 2012

Valuation metrics

On a global basis there are three commonly used valuation metrics for listed real estate.

Discount / premium to NAV – most commonly used in the UK and Europe. This metric enables a valid comparison with the underlying real estate market, but is less valid in regions where assets are not marked to market for example the US.

Dividend yield – either via a dividend growth model or relative to benchmark risk free rates and yields available in the direct market – most commonly used in the Asian REIT market.

Multiple of funds from operations – most commonly used in the US where the emphasis is on ongoing cash flow generation and momentum rather than unrealised valuation movements.
Over the short time series (September 2006 – October 2012) the average pricing for UK funds is a discount of around 7%, with current pricing around this level. In the unlisted sector the peak discount of -31% occurred in February 2009 (one month later than the REIT premium peak) with the sector experiencing a peak premium of 4% in December 2011. Since this peak rising valuations from 2010 until the summer of 2011 reflect the more positive outlook adopted by investors at the time, before the resurgence of the Eurozone debt crisis towards the end of 2011 drove pricing levels back down towards the average.

Recently, unlisted and listed markets have become more integrated. Discounts remain bigger in the listed sector, but pricing relative to long run average discounts has looked similar recently, albeit with some evidence of the listed sector leading the unlisted market.

Figure 9: Dividend yields 2010-2012

![Figure 9: Dividend yields 2010-2012](image)

Source: FTSE EPRA/NAREIT Indices, September 2012

Increasingly, dividend yields and dividend growth are used as valuation tools. In figure 9 we have put together a small sample of UK (Land Securities, British Land and Hammerson), and Eurozone (Unibail, Klepierre and Corio) REITs and looked at their equally-weighted yields relative to the wider European equity market. In order to attract generalist investors, a higher than average yield over equities (and normally bonds) is a positive sign for REITs. As can be seen from figure 9, the UK REITs yield advantage has now been eroded, while high quality European stocks retain a significant (c. 200 bps) premium.

The long run REIT average discount of 18% is higher than for European counterparts. This is believed to be primarily a function of greater volatility in the UK market, exacerbated by greater leverage. Discounts in Europe remain wider than in the UK as the uncertainty over the future of the Euro continues to have an impact on investor sentiment towards Euro REITs.
Come together: can listed real estate stocks be managed as part of the real estate allocation?

Europe is underweight listed real estate

Europe as region holds a smaller percentage of its investable real estate through listed companies than is the case in either North America or developed Asia (see below). At the same time, private real estate vehicles are relatively over-represented. Understanding why this is the case is important for EPRA as it pursues its mission to promote, develop and represent the European public real estate sector.

<table>
<thead>
<tr>
<th></th>
<th>Europe</th>
<th>Asia</th>
<th>Emerging</th>
<th>North America</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unlisted market</td>
<td>6,353,676</td>
<td>3,440,101</td>
<td>4,452,212</td>
<td>5,672,705</td>
<td>16,151,694</td>
</tr>
<tr>
<td>Listed market size</td>
<td>658,463</td>
<td>904,665</td>
<td>1,188,379</td>
<td>746,896</td>
<td>2,508,402</td>
</tr>
<tr>
<td>Listed market %</td>
<td>10%</td>
<td>25%</td>
<td>41%</td>
<td>13%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: Baum and Hartzell, 2012, Global Property Investment

An under-representation of listed real estate in Europe may be the result of performance (risk and return characteristics relative to equities, bonds and other assets): this has been the subject of considerable, often supportive, work; it may be to do with regulatory differences; or it may be to do with historic organisational (or ‘institutional’) issues. We know very little about the latter influence. To begin to redress this, EPRA has an ambition to undertake significant research designed to capture the organisational processes that determine whether European investors typically include listed real estate in their real estate portfolios. If not, we would like to know why not; if they do, we would like to do what (if anything) limits the weight they place on listed real estate.

Research objectives and method

As a precursor to any such significant study, the EPRA research committee designed a pilot survey to identify potential organisational issues limiting the exposure of European institutions to listed forms of real estate and to support the design of a comprehensive research study of this issue.

The case against

Views expressed by more than one of those investors that do not manage listed real estate as part of the real estate allocation were to the effect that property companies and REITs are securities. They do not come within the real estate team’s remit, and sit very firmly within the equity team. Listed property analysts may be close to the direct real estate team, exchanging notes on markets, but the investments are fundamentally different. Real estate securities and private real estate should be separate because (a) they are essentially different animals, with different correlations and different volatilities and (b) the skills sets for investing are different.

"(Listed) is currently not within the mandate or IMA (investment management agreement). The client deals with real estate equities within the equity allocation. Real estate equities are not part of the real estate allocation. The client’s view is that they are more ‘equities’ than ‘real estate’."

Others feel that they lack the required expertise: "we are a specialist real estate company investing in direct property, so (listed) would sit uneasily within the framework of our business. Our philosophy is to drive performance through superior asset selection and management ....ceding control to another company would be inconsistent with this approach".

At present there appears to be little or no perceived pressure from client investors for change, although new product development (for defined contribution pension schemes, for example) may lead to some demand to include listed real estate in the property portfolio.

But the case for predominates...

The majority of investors and managers interviewed said they managed both public and private real estate within the real estate allocation or mandate. Of these, most used a dedicated REIT team sitting outside the real estate group, sharing research only to a limited extent. One investor/manager suggested that as the allocation grows they may outsource to an external manager. One manager that uses listed securities believes that the listed sector should not form part of the real estate portfolio in future. All of the others believe that it should, one for liquidity purposes only. Several of the rest believe the allocation will probably stay stable in the future, while another significant group believe it will grow, with the growth of defined contribution schemes being seen as a driver. Importantly, only one suggested the allocation will fall. One investor/manager specifically stated that they would like to develop more integrated products using listed and private real estate together.
...despite execution difficulties

Several interviewees mentioned the volatility of the listed sector as causing them a significant problem. Another said this was more about perception than reality, and this issue required education for users and clients. High correlation with general equities was quoted as an issue for a few investors, expressed more fashionably by one as ‘the standard issue of real estate beta being different from equity market beta’. This could also be expressed as a focus on relative performance objectives and benchmarking by many European investors, especially in the UK and Netherlands, with special attention being paid to year-end valuations of private real estate and their consequent impact on returns, solvency and funding models. When NAV (net asset value) estimates are taken very seriously, REITs cause problems.

Several mentioned the operational difficulties involved in exploiting the arbitrage opportunities that should exist between public and private real estate. There is a clear failure to separate the active tactical decisions commonly used in managing REITs from the decision to use REITs as part of a strategic real estate allocation. Hence listed real estate is ‘seen by as clients as equities rather than real estate, used as a cash pot, and holdings are tactical rather than strategic’.

The next steps

We believe we may have uncovered some interesting issue for further examination. Within the sub-set of those for whom listed real estate forms part of the real estate allocation, some have an integrated approach to public and private real estate; but more do not, sub-contracting public real estate to a dedicated team, the equity desk, or even to an external manager. It appears that this goes some way to defeating the object of a combined mandate.

This pilot survey suggested that to some extent this results from a unique focus on (and faith in) net asset values, more predominant in Europe than elsewhere. But to what extent has the recent crisis eroded or cemented this faith and strengthened or weakened the case for listed real estate within the real estate allocation?

There is equal evidence in the survey to suggest that asset managers (with their greater experience of execution as well as a propensity for business unit separation) may not have developed a satisfactory integrated investment process. As asset managers adjust and develop their product ranges to meet what might be a gently rising demand, they also need to solve the investment process problems of integrating listed and private real estate within one business and one portfolio, a facility which currently seems either elusive or absent. They also need to be able to show that the listed portfolio is being managed with an eye on the strategic objectives of the real estate allocation, and not on a standard solution that suits the objectives of the listed real estate team.

We need to know more about the relative weight and distribution of these positions among the pure investor community (pension funds) and the consultants, as managers are generally in business to respond to their needs. To what extent do investors want to use listed securities? Are they being disappointed by the industry response, and if so what weight of capital is being frustrated? How much money would be allocated to the listed sector if managers had the appropriate investment solutions in place? Is there any difference in attitude between those managers with captive capital (where it would be expected that a rational solution could be developed and delivered in the client/owner’s interest) and the independent managers?

‘The REIT allocation is actively managed against an EPRA benchmark, comprising 7.5% of the fund, but it is there to create a real estate linked liquidity buffer, so why trade it? This is a problem to do with the culture of equity managers. In addition, the fund is a UK product, but our REIT team uses European REITs because that gives them more tactical choice and liquidity!’

‘There is no way of reducing our unlisted allocation when listed is cheap, so the allocations remain separate; and short term volatility has affected the returns badly. Our REIT manager aims to out-perform his REIT benchmark on a 6-12 month basis but this has little to do with our overall objective.’

Andrew Baum, Property Funds Research

with thanks to Karen Sieracki, Kaspar Associates, and Alex Moss, Consilia Capital