The public-private disconnect

Valuations for public and private real estate have diverged, and so has market sentiment

by Loretta Clodfelter

Public equity markets have been volatile recently, with a lot of downward movement. But even as stock markets have declined — including public real estate equities — private real estate values have appeared to hold steady.

Since early 2015, valuations for public and private real estate have diverged, especially in the U.S. markets, where, according to Peter Zabierek, CEO of Presima, "the divergence is the most striking and has been for a while." And any time such a disconnect becomes apparent, investors are sure to ask: What does it mean?

And, much as the hoary joke that if you ask two economists about the market, you'll get three opinions, plenty of disagreement surrounds the current public-private disconnect.

"It's a very interesting signal that there are different opinions and strongly suggests it's time to be cautious for the long-term investor," says Andrew Allen, head of global property research and strategy at Aberdeen Asset Management.

Gap year

The past year was not a great one for U.S. REITs. The FTSE NAREIT All Equity REITs Index had a total return in 2015 of 2.8 percent, while the FTSE NAREIT Equity REITs Index had a total return of 3.2 percent. (In 2014, those indices' total returns were 28.0 percent and 30.1 percent, respectively.) Those 2015 returns for public REITs are actually pretty good when you compare them with the broader equity market, however; the large-cap S&P 500 Index returned 1.4 percent in 2015, for example, and the small-cap Russell 2000 Index had a return of –4.4 percent. By contrast, private real estate had a total return of 13.3 percent in 2015, according to the NCREIF Property Index.

While public real estate stocks had a volatile year, without much increase in prices, the underlying real estate assets of those publicly traded companies showed significant appreciation. That has led to a divergence between REIT stocks and their asset values.

According to Jason Moore, senior analyst – real estate analytics with real estate research firm Green Street Advisors, the observed discount on an NAV basis is approximately 12 percent to 15 percent. Moore recommends looking at premium/discount to asset value, which removes the effects of leverage; on that basis, REITs are trading at a discount of 8 percent to 10 percent.

The biggest discounts are for lodging, industrial, office and regional malls, notes Zabierek. (See graph, page 30.)

"The lodging REIT sector has been pummeled," agrees Moore. He notes hotel REITs are trading at a 15 percent discount on an asset value basis and a 25 percent discount to NAV. But other property sectors are not experiencing those deep discounts. "Self-storage is still trading at a premium of 30 percent," says Moore.

"The strongest sectors will be those with secular tailwinds and cyclical resistance — for example, data centers, apartments, storage, net-lease retail," says Scott Crowe, chief investment strategist at CenterSquare Investment Management. "In general, we expect core real estate with low leverage to outperform," he adds.

One thing to keep in mind: "REITs have been white-hot," says Mark Grinis, senior partner and head of global real estate investment fund services at EY, referring to the sector's strong performance in the years prior to 2015. To a certain extent, the 2015 market move is a sector rotation, as equity investors take money off the table after the strong performance of 2014.

"We're getting so many questions about the cycle now," says Melissa Reagen, head of real estate and agriculture research and strategy at MetLife Investment Management. But while investors are concerned about where we are in the real estate cycle, property fundamentals still look good. "Vacancy is down, rents are up, supply is in check," says Reagen.

The appraisal lag

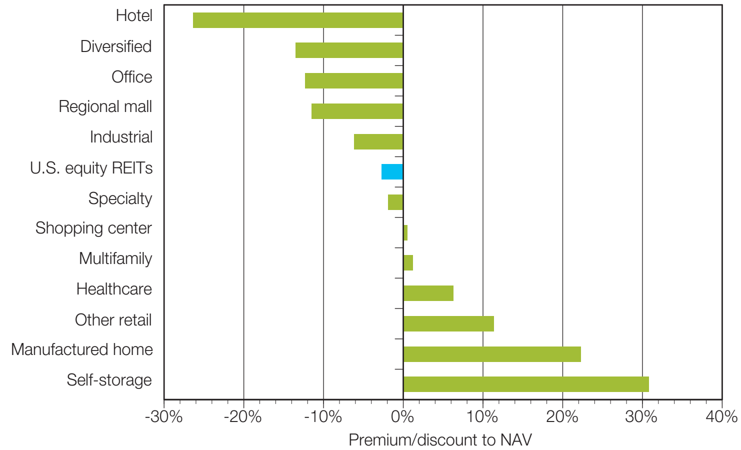
The public-private spread may be due to delays in valuations, as the evidence from appraisals and property transactions is much slower to register than the immediacy of the stock market.

"We expect market volatility around the REIT sector," says John Papadoulias, a partner with Rocaton Investment Advisors. "We think this is part of the public wrapper."

"The public market has historically led the private market" because of the appraisal lag, says John Vojticek, managing director and CIO of real estate and infrastructure securities with Deutsche Asset & Wealth Management.

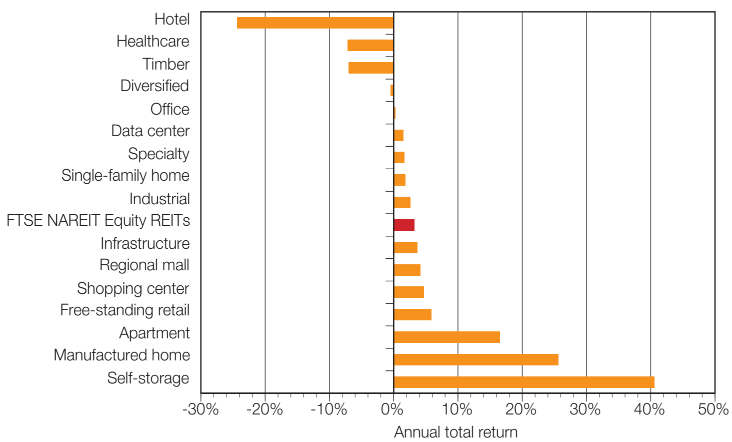
"It's easy to say private markets lag public markets," says Papadoulias. As everyone is quick to remember, REIT stocks dipped in 2008 and, shortly thereafter, the private market plummeted. But in 2011, Papadoulias points out, REIT stocks

U.S. equity REIT sector, weighted average premiums/ discounts to NAV estimate



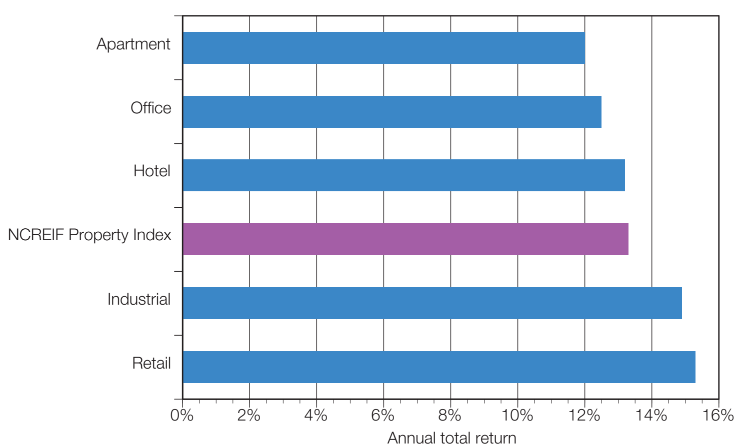
Note: As of Dec. 31, 2015
Source: SNL Financial

U.S. REIT investment performance by property sector, 2015



Note: As of Dec. 31, 2015
Source: FTSE NAREIT Equity REIT Index

U.S. private real estate investment performance by property sector, 2015



Note: As of Dec. 31, 2015
Source: NCREIF

fell but then rallied. So which will it be this time? "It's hard to tell," he says.

The public markets price instantly, says Grinis, which means the public real estate market can move immediately to react to changing industry conditions, such as interest rate increases. "That's just the simple dynamics," he says.

As an example of the liquidity of public real estate, Zabierek explains: "You can buy $100 million of U.S. REITs on a Friday and sell $100 million on a Monday."

Private real estate is able to have a little bit of a longer view, says Grinis. "You look at a portfolio of a lot of different investors mandated to invest in real estate, you're not looking at six-month exits." He says private equity real estate is such a different animal, it is hard to compare against REITs and points to the short-term thinking that goes with equities.

"Real estate is a great asset for long-term investment," agrees Allen. He says the public market can be too volatile for those investors attracted to such a slow-moving, income-oriented asset class such as real estate.

Another factor in the disconnect is the different goals of investors in public and private real estate. Investors in trophy properties are looking for a safe place to park their money, says Brad Case, senior vice president – research and industry information with the National Association for Real Estate Investment Trusts; they are not maximizing their expected total returns.

In early 2015, REITs were trading at a premium to asset values. The decline since then is partly "a symptom of the overall market," says Moore. He suggests the reasons for the spread are twofold: "The liquidity that REITs provide enables investors to sell off REITs faster." So investors holding both public and private real estate can exit the REIT portion much quicker if they decide real estate has become less attractive. For that reason, "we do believe the public market leads the private" when it comes to pricing, says Moore. As to what is leading to the sell-off, Moore points to higher corporate-bond yields. Spreads have been widening in the corporate bond world since the summer of 2014 and particularly since May 2015.

Like Moore, Vojticek points to the widening spreads against Baa bond yields but also to "the anticipation of a rate increase in 2015 — we had a big drawdown."

But although REITs may have fallen in advance of rising interest rates, that may not reflect a fundamental interest-rate sensitivity. Case says REITs will not necessarily underperform in a rising interest-rate environment. "Interest rates are going up because the economy is improving," says Case. He notes improvements in the macroeconomy mean

increased rents. "With REITs, when interest rates go up, it's under the same conditions that occupancy rates go up and rent rates go up," adds Case.

Elephant hunters

When a divergence between public and private valuations exists, and persists, it creates opportunities to sell assets in that gap. The past year was marked by several high-profile REIT privatizations, three instigated by The Blackstone Group alone.

The biggest privatization in 2015 was Blackstone's agreement to acquire BioMed Realty Trust in a deal valued at $8.0 billion. Blackstone also has closed on a $6.0 billion acquisition of Strategic Hotels & Resorts and a $2.0 billion acquisition of Excel Trust. Another big real estate private equity player, Lone Star Funds, acquired Home Properties in a $7.6 billion deal.

Blackstone and Lone Star raised billions of dollars from investors in 2015, and that capital has to be put to work. Two major opportunity funds — Blackstone Real Estate Partners VIII, which raised $15.8 billion, and Lone Star Real Estate Fund IV, which raised $5.9 billion — closed last year. In addition, Blackstone's core-plus open-end fund, Blackstone Property Partners, continues to gather capital.

A pooled fund with billions of dollars in commitments is not going to reach its investment goals by buying single properties for $25 million a pop. Portfolio and platform deals are the only way to achieve the scale required to put those capital commitments to work.

"Real estate private equity has lots of capital and flexibility. These big funds are looking for elephants," says Grinis. In the current market, "you need elephants, and you need elephant hunters," he says, which leads to a consolidation of dollars in a few big players.

Everyone expects more public-to-private transactions in 2016. One elephant those hunters could be targeting is General Growth Properties. At press time, rumors were swirling of a privatization of the regional mall REIT, which had an equity market capitalization of $24 billion as of Dec. 31, 2015.

"There's been a long list of take-privates," says Zabierek. "Capital is still very cheap," he notes, "and it wouldn't surprise us to see this continue."

In addition to privatizations, REIT firms are actively engaging in stock buybacks, says Vojticek. "To do it leverage-neutral is important," he says. By which he means REITs need to sell property and use the proceeds to buy stock.

The current environment also may create opportunities for LPs looking for joint-venture partners. As one public pension investor recently noted, "Our capital might be attractive to them again."

LPs also may be looking at increasing their REIT holdings; a buying opportunity may be opening up. "REITs have probably discounted most, if not more, of the real estate market softening for 2016," says Crowe. "We believe that REITs now present an inexpensive way to enter the cycle."

Competing narratives

Although industry watchers agree on the existence of the disconnect, less agreement exists on the factors leading to the split — and the implications thereof. Not only is there a divergence of valuations, but there is also a divergence in how investors are approaching that spread.

For investors in private real estate, the question becomes, Is the public market sending an important signal as a leading indicator, or is the activity a reflection of broader equity volatility that is unrelated to activity in the property markets? And, following on, if volatility in equity markets is pushing down real estate securities, how could private investors take advantage of the pricing differential? Is there an opportunity to invest in REITs in 2016?

Are U.S. REITs underpriced, or is private real estate overpriced?

Moore says it is a combination of the two: "The public market is a decent predictor of the private market, which means private market prices will fall." He says values will "probably meet in the middle."

"To some extent, REITs are undervalued, but private real estate is overvalued," says Case.

Vojticek also predicts prices will meet "somewhere in the middle at the end of the day." That means "a 3 percent to 5 percent correction in real estate prices."

"The REIT market is overreacting, caught up in the turmoil of the stock market," says Moore.

Certainly an appraisal lag exists, but sentiment among U.S. private-property players has not indicated a sharp decline. Some industry watchers

Major REIT privatizations in 2015				
Buyer	**Target**	**Date announced**	**Property sector**	**Transaction value ($b)**
The Blackstone Group	BioMed Realty Trust	Oct. 8, 2015	Office	$8.0
Lone Star Funds	Home Properties	June 22, 2015	Apartment	$7.6
The Blackstone Group	Strategic Hotels & Resorts	Sept. 8, 2015	Hotel	$6.0
Brookfield Asset Management	Associated Estates Realty Corp.	April 22, 2015	Apartment	$2.5
DRA Advisors	Inland Real Estate Corp.	Dec. 14, 2015	Shopping centers	$2.3
The Blackstone Group	Excel Trust	April 10, 2015	Shopping centers	$2.0
Harrison Street Real Estate Capital	Campus Crest Communities	Oct. 16, 2015	Student housing	$1.9

Source: SNL Financial

are confident private real estate values are a good indication of underlying fundamentals.

"These markets have changed from what they were historically," says Reagen. "We're in this period where the federal funds rate has been at zero since 2008, 2009. Risk has been repriced."

Regarding the Fed's actions, "we have never been here before," agrees Grinis.

While, historically, public markets were a pretty good indicator of where private markets are going, "this time it's different," says Zabierek. "I feel pretty comfortable that, in most sectors, the private market has it right," he adds, noting private investors make up 90 percent of the market. "Smart investors are buying real estate right now," says Zabierek.

"There's a good argument [for] flows into real estate remaining stable," says Reagen. "Even in a recession, U.S. real estate looks good from a relative value perspective." Reagen also suggests there could be a continuing disconnect between public and private real estate pricing.

"It could persist for a while," agrees Zabierek.

But the chance remains the spread will close with a fall in private real estate valuations. "During 2016, we will see a marked softening of private real estate values," forecasts Case.

"The private market will probably move toward public valuations, but we believe that as the slowdown is digested and the cycle continues, REITs will ultimately climb back up," says Crowe. He says it is important to note, in contrast to the previous cycle, REITs are well-positioned this cycle to deliver on their defensive mandate with low leverage, ample liquidity, low levels of development and a significant cap rate spread to Treasuries.

Crowe adds, "We believe 2016 will be a mid-cycle slowdown or pause, with some years to go before an ultimate cycle end."

Perhaps, as some suggested, the answer is both private and public real estate are overvalued at present. "It's hard to draw a conclusion," says Papadoulias. "We still see REITs as relatively expensive versus other asset classes. We don't find REITs to be an incredible buying opportunity. We're not that excited for the prospects of U.S. core real estate. Valuations in private markets seem quite high. We worry a little more about the absolute values of real estate."

"Property prices have doubled in the past six years," says Grinis. "That's a staggering statistic." When looking at real estate markets today, "it feels expensive," adds Grinis. But right now, he continues, "all asset classes are expensive."

"Post-GFC, it's rare that you would find something to be considered cheap," agrees Allen.

Crowe sees a silver lining in the present pullback: The development cycle has been pushed out further. "Lower bond yields and less development ultimately reinforce the cycle and will continue to elongate it," he adds.

The bottom line

Investors will need to make their own determinations about what is happening in REIT markets and what it means for private real estate. U.S. real estate fundamentals appear strong, and global capital flows are set to continue to private real estate.

Volatility in the equity markets, along with widening spreads for corporate bond yields, may have pushed REIT prices below asset values and created opportunities along a number of angles. Real estate private equity funds are likely to target a few more REITs for privatization activity — possibly bringing down some larger game than was seen in 2015. REITs also can take advantage of the strong values for their underlying real estate assets, raising capital and buying back stock. They also may find they need additional capital partners, and LPs may be able to find attractive co-investment opportunities.

On the other hand, real estate investors should be mindful of the signals the public market is sending. If REITs are acting as a leading indicator, private real estate investors should remain disciplined and be prepared for possible downsides. ❖

Loretta Clodfelter is editor of *Institutional Real Estate Americas*.