by Marc-André Flageole and Vincent Felteau

Profiting from Sustainable Growth

A Review of 2009 Global REIT Performance and Expectations for 2010

At the start of 2009, very few investors could have predicted the strength of the recovery of listed real estate securities. Developers, particularly in China, Hong Kong and Brazil, were among the first to recover on the back of a rapid improvement of the housing environment and, in some cases, distressed valuation levels. While the latter half of 2009 saw a definite continuity of the recovery, it proved to be quite different in terms of its leadership. Not only did we see a regional shift as real estate firms from North America, Europe and Australia generally outperformed those of Asia, but it also seemed that investors gradually looked for a combination of sustainable income, quality real estate and better corporate governance.

Following the spectacular returns of 2009, which were mostly driven by investor sentiment and momentum, an in-depth valuation analysis is crucial to differentiate companies and deliver superior performance this year.

Differentiation among companies will likely become even more important in 2010 as returns will vary significantly depending on various corporations' ability to deliver earnings according to expectations. REITs in most mature markets are definitely better positioned than a year ago as companies benefit from many positive attributes: (i) a recent pick-up in transaction activity is providing positive valuation evidence for both high-quality and well-located properties; (ii) listed companies, generally well capitalized compared to their private counterparts, should be able to execute value-added transactions as opportunities arise; (iii) a combination of pent-up demand, greater visibility and higher confidence levels is bringing an increasing demand for space; and (iv) a large amount of liquidity still has to be deployed.

Despite a gradual recovery in developed markets, which bodes well for REITs, it appears that fundamentals are partly supported by favorable government policies. Given that this stimulus will eventually dissipate and looking at valuation by factoring future growth, Asian and emerging markets real estate companies will likely continue their upward trend and outperformance.

SUSTAINABLE & STABLE INCOME

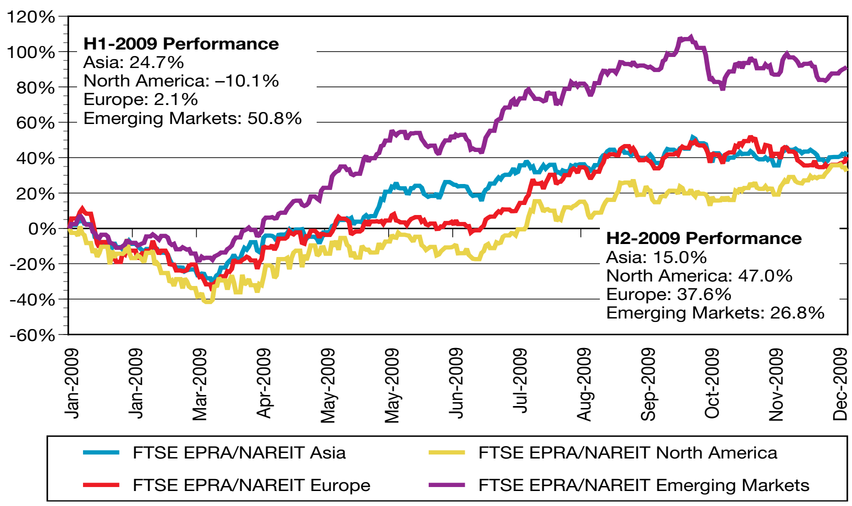
The Hong Kong, China and Brazil housing markets were among the first illustrations of the real estate recovery that took place from early March 2009. These markets quickly exhibited strong growth both in terms of sales volumes and housing prices. An extensive economic stimulus package put in place by the Chinese government, combined with potential pent-up demand for housing from the 2008 downturn, certainly contributed to a pick-up in confidence and an improvement of real estate fundamentals.

Notwithstanding the spectacular income growth of developers, it seems that some investors gradually questioned their long-term sustainability. It appears that the market moved away from the volatile income profile of developers and generally favored companies managing assets and collecting rents. Moreover, expectations of the stabilization, or even an upturn, in the value of physical real estate certainly benefited landlords. With reasonable valuation levels and implied capitalization rates significantly above their fair value, REITs owning office and retail spaces in the United States particularly performed well.

From the third quarter of 2009, investors showed interest in real estate companies with healthy distribution yields. As cash rates remained extremely low on a global basis, dividend-paying REITs appeared again to be an interesting investment proposition. This interest was exacerbated by the fact that a number of REITs scaled back their distribution to ensure they were covered by actual income and not financial engineering, hence potentially increasing their long-term sustainability. Broadly speaking, REITs from the United States, Singapore, Europe and Australia particularly benefited from this interest for yield.

In addition, more than US$30 billion of equity and debt were issued by U.S. and U.K. REITs in 2009, the majority of it during the second and

FTSE EPRA/NAREIT Index — 2009 Regional Performances (US$)



Sources: Bloomberg, EPRA/NAREIT Indices third quarters. Despite such a large amount, investors' appetite for most of the deals appeared very strong, which allowed companies to solidify their balance sheets and potentially pursue growth opportunities without significant hurdles. Towards the end of the year, the market was not as receptive for a good number of initial public offerings from Chinese real estate companies. In many cases, the pricing of equity had to be set toward the lower end of the range proposed by the issuers to ensure that the interest would be sufficient. Here again, it seemed that after their strong rebound in the second quarter of 2009, investors were more hesitant to put money at work with home builders showing a more uncertain and volatile income profile.

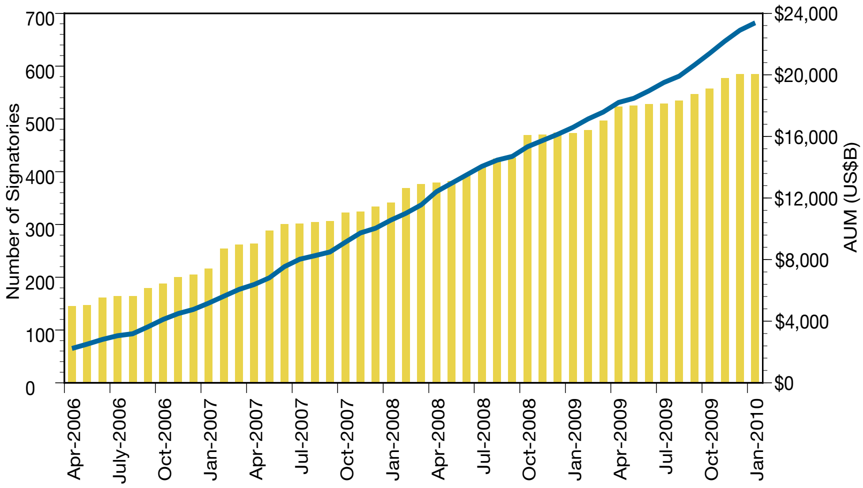
GLOBAL INVESTOR AWARENESS OF "ESG" ISSUES

The recent financial crisis and extreme volatility of listed real estate securities has raised questions, not only about the quality of income, but also about the sustainability of the business model itself. In that sense, there is a growing interest by real estate investors for companies that conduct themselves not only in the best interest of their shareholders, but also as good corporate citizens in regard to their environment and community.

This consciousness is being translated into the increasing number of signatories of the United Nations' Principles for Responsible Investment. As of January 2010, 675 signatories are now considering environmental, social and governance (ESG) issues in investment decision-making and ownership practices. Money managers that are UNPRI signatories are already managing more than US$18 trillion. This is a good representation of potential demand growth from global investors.

Despite all of this, only a limited number of companies seem to fully understand how critical ESG issues are. This situation will likely change as the performance of best-in-class and proactive companies deviates positively from others. Looking at several listed real estate companies that outperformed peers in the second half of 2009, the quality of their buildings and corporate governance were often superior. It appears investors considered these factors to be more important in their investment process. In 2010, these considerations will likely continue to have a significant impact.

Growth in PRI Signatories and AUM



Source: U.N. Principles for Responsible Investment

Money managers should be aware that there are reputational and financial risks of not addressing these issues, especially in an environment where policy headwinds are more likely. In that sense, several companies that have demonstrated a leadership role from Australia, Japan, Singapore and the United States look particularly attractive. In the emerging markets, incredible marginal gains could be on the horizon if collaborative efforts are made by global investors.

POLITICS DO MATTER

Government policies were important for real estate investors in 2009. Both in stimulating their economies and in terms of monetary policy, governments in the United States, United Kingdom and Europe remained largely supportive, which arguably provided liquidity and confidence to real estate investors of these regions.

In contrast, Asia Pacific saw the first signs of tightening in the second half of 2009. The Reserve Bank of Australia increased its cash target rate by 75 basis points to 3.75 percent from October to December. To counter the rapid housing price increase, the Chinese, Hong Kong and Singapore governments introduced a new series of austerity measures specifically targeted at residential real estate. The main objectives of these measures were largely to limit speculative demand and maintain the supply of affordable housing. While it might still be early to measure the concrete impact of these measures, it is reasonable to think that they might have affected adversely the performance of certain Asian companies in anticipation of their influence. This was particularly evident for Chinese developers, which significantly underperformed their global peers from June 2009 until year end.

Countries that demonstrated more resilience in the past crisis have already started putting in place tighter regulations as a mean of controlling speculation. As a result, more policies will likely be deployed during the course of 2010. Fears of bubble formation in certain residential markets, worrying currency trajectories and increasing inflation expectations might pressure politicians to remove easy money. In China, the supply of money extended to corporations, consumers and home buyers in 2009 far exceeded 1 trillion yuan (US$147 billion). In 2010, real estate investors should closely monitor the attitudes of China and other governments toward their respective banking system and regulatory framework.

Patience and timing will be essential for investors this year as monetary tightening and stricter regulations often correspond to temporary negative performance for real estate companies. While most countries maintained very loose monetary policy in 2009, strength of the economic recovery and employment situation might set a different tone in 2010. Despite improving fundamentals, valuations of U.S., U.K. and European real estate companies are partially justified by historically low interest rates and supportive policy. Hence, valuation levels in these regions might be at risk once this accommodative climate comes to an end.

JAPAN AS AN OUTLIER

Japanese REITs and real estate developers were noticeable underperformers in 2009. Both J-REITs and Japanese developers failed to attract the interest of local Japanese investors as well as international money. Japan's recovery seemed to disappoint based on a distant future for further improvements. Broadly speaking, real estate fundamentals, such as the Tokyo office vacancy rate that surpassed 8 percent for the first time since 2003, failed to show noticeable signs of stabilization so far in the cycle. In addition, J-REITs started to issue equity much later than most investors expected. This was probably another contributor to their lackluster performance in 2009.

Being an export-led economy, Japan is highly impacted by the strength of its currency. A strong yen increases deflationary pressures and hurts the profitability of Japanese exporters. As a result of the strong appreciation of its currency, the Bank of Japan's governor ordered on 1 December 2009 an emergency policy meeting in order to confront those issues. Even if the immediate tangible actions were considered negligible by analysts, providing ¥10 trillion (US$ billion) of additional liquidity likely demonstrated to the market that Japanese politicians will not let their economy suffer for another decade. Since the meeting, the performance of real estate companies surprised to the upside. Should Japan's economy start to recover on the back of better export figures, the value of real estate companies could move upward and catch up with their global counterparts as this market has been unpopular for so long.

VALUATIONS & FUNDAMENTALS

Following the spectacular returns of 2009, which were mostly driven by investor sentiment and momentum, an in-depth valuation analysis is crucial to differentiate companies and deliver superior performance this year. Looking at valuations over a long period, Asia and emerging markets are below historical averages and exhibit stronger fundamentals going forward. The more mature and developed markets of Continental Europe, the United Kingdom and North America are showing valuations much closer to long-term averages. Obviously, Japan still looks like an outlier on the cheap side.

Looking at Hong Kong and China, regardless of policy risk, there is still room for improvement of real estate fundamentals that could push valuations toward the upper end of the historical range. The situation is gradually improving in Singapore, particularly in the retail and residential sectors. Australian REITs now enjoy more solid balance sheets, evolve in a very favorable economic environment and are still trading at discounts to NAV.

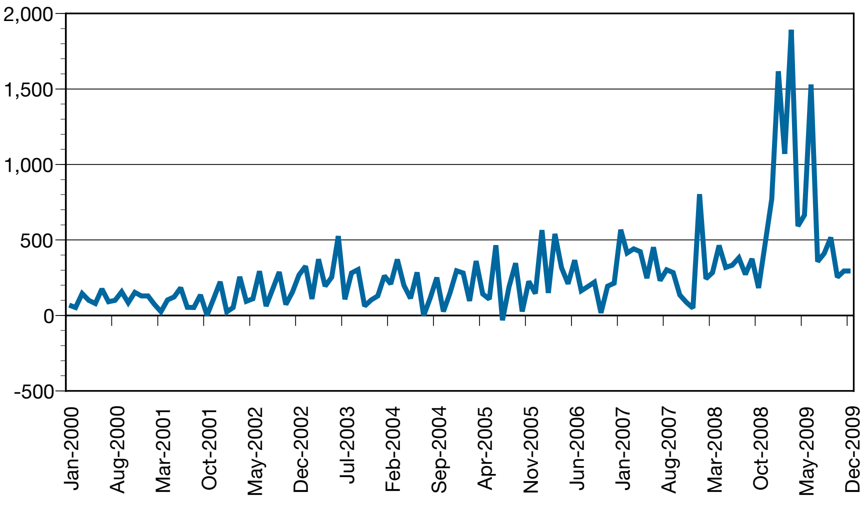
Despite the accommodative monetary environment in Continental Europe and the United Kingdom, the recent run-up in prices, combined with a few more difficult years on the direct real estate side, likely leaves limited potential upside for 2010. On average, share prices are above net asset values. As a result, allocating capital to companies that have niche markets and different business models is probably the best alternative for the region. The valuation of North American REITs seems fair according to most valuation metrics. These REITs are trading at a premium to NAV that is slightly above their historical averages. This premium reflects the potential for accretive acquisitions for REITs that have improving access to capital. Going forward, there will most probably be attractive opportunities for cash-rich companies as we get closer to the potential CMBS refinancing issue. However, investors should closely monitor default rates on commercial and residential mortgages as they might affect future financing spreads and, ultimately, REITs' valuation levels.

In light of their 2009 stellar performance, listed real estate companies of the emerging markets certainly deserve greater attention in 2010 and beyond. Broadly speaking, as population continues to expand rapidly and migrate toward city centers, well-located properties will increase in value. Moreover, favorable demographics and increasing consumption should continue to support rental growth for commercial assets. For instance, looking at the retail sector in Brazil, capitalization rates of listed companies compared with their direct counterparts, indicate further upside potential. In Mexico, as low-income housing developers benefit from a government-supported mortgage market and strong demographic factors, they should continue to deliver growth of 10 percent to 15 percent over the next few years.

VOLATILE FUTURE GROWTH

At the start of 2010, given that more restrictive monetary and real estate–specific policies are mostly confined to Australia, Brazil, China, India and Singapore, real estate owners in developed markets such as the United States, United Kingdom, Europe and Japan might outperform in the short term. However, it is crucial to understand that a combination of high asset prices, low interest rates and large economic stimulus packages is unsustainable. As governments and central banks start to implement their exit strategy, best-in-class real estate companies located in developed markets should continue to attract investors. However, in light of a gradual reduction of governments' supportive policies, firms with more reasonable valuation levels located in stronger growth Asia and emerging markets offer the most attractive long-term investment proposition; these domestic markets have much better prospects to sustain growth. ❖

All New Loans Face Value in Chinese Yuan (B)



Source: Bloomberg

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