REITs on the rise

Asian REITs to stand tall in global capital markets

by Benjamin Cole

The words "real estate investment trust" may yet summon images of dividend-clipping, risk-averse investors in the United States, but for institutional investors seeking exposure to the world's largest property market — Asia — the otherwise-prosaic listed REIT offers easy access and liquidity.

Over longer horizons, listed REITs generally match even direct institutional real estate ownership for total returns, but without the intensive management obligations, the risks and the need for scale — that is, a large, discrete chunk of capital that can be allocated to one or a few projects.

Although investors of all sizes can deploy capital to Asian REITs to balance portfolios or test waters in new markets, smaller institutional investors may find REITs offer the best, most prudent way to play the Asian property game. "A well-diversified portfolio of Asian REITs can gain exposure to sectors, formats and locations not always accessible by direct investment," suggests Jana Sehnalova, Singapore-based managing director and CEO/CIO at La Francaise Forum Securities.

Also, Asian REITs often own the highest-quality assets. "For investors looking specifically for top assets, investing in a listed portfolio can be the only option," says Victor Yeung, CIO at Hong Kong–based property investor Admiral Investment.

Perhaps most important, many Asian REITs are trading below net asset value, while untold hundreds of billions sit on capital sidelines. It does not take much imagination to foresee a wave of

pension fund money and global capital heading toward Asian REITs in the next several years, if the global economic picture stays on a growth path.

Private real estate equity funds alone have US$230 billion of dry powder, notes Kwok Wing Cheong, global real estate securities portfolio manager, PGIM Real Estate, citing industry data. "Asian listed real estate, including REITs, currently trades at a discount and, thus, offers investors a leveraged and superior risk-adjusted exposure into the Asian real estate growth dynamic," he says.

Several proxies for the Asian REIT market are trending up. As at mid-March, for example, the iShares II plc FTSE EPRA/NAREIT Asia Property Yield Fund (IASP) was up 23.0 percent in the past year. The Claymore/AlphaShares China Real Estate ETF (TAO) was up 20.7 percent in mid-March, from 12 months earlier.

In contrast, Japanese REITs were generally off in the past year, such as shares in Japan Hotel REIT Investment Corp, which were down roughly 25 percent in the past 12 months, despite a long-term robust outlook for the Asian travel industry. Uncertain regional economies and a fluctuating yen undercut all securities in Japan in 2016, and listed Japanese real estate securities in general peaked a year ago.

A longer view reveals a brighter picture for listed Nippon property issues. The Listed Index Fund J-REIT (TSE REIT Index), for example, a fund made up of listed Japan REITs, is up more than 80 percent for the five-year period ended in mid-March, and currently pays a 3.3 percent dividend.

If there is a drawback to listed REITs for some investors, it is that values change every business day. For institutions that need to report stable values, the daily marking-to-market of listed REITs can be a caution, say advisers. "While private real estate values are typically reassessed every six or 12 months, listed real estate values fluctuate every business day. For investors sensitive to volatility, less-liquid private real estate might still appear as a smoother approach," says Marc-André Flageole, portfolio manager, Presima.

But which REITs?

As money managers of all stripes know, making a decision to buy Asian REITs is easier than the actual nuts and bolts of allocating.

Listed securities markets are often exemplary of the "efficient market hypothesis". That is, investors relentlessly sniff out bargains or prospects of superior returns, effectively flattening risk-adjusted returns of all investments in listed securities markets to level, like water.

Indeed, in a sentiment that perhaps reflects efficient markets, "All four major Asia Pacific REIT markets — Australia, Japan, Hong Kong and Singapore — have a promising outlook, given the depth and liquidity of the markets," notes Patrick Ma, research director at Admiral Investment.

Still, countries' REIT markets vary in ways that may appeal to different sets of institutional investors. The three largest Asia Pacific REIT markets, in terms of capitalisation, are Japan, Australia and Singapore.

The J-REIT market

As the world's second-largest REIT market, Japan offers variety, liquidity, sector concentration, and 57 listed issues as at late 2016.

But J-REITs have limitations, most particularly that under Japanese law they are limited to passive income and are not allowed to develop or operate properties, reported financial accounting and advisory service EY in its *Global perspectives: 2016 REIT report*.

In general, Japanese REITs rely on external management (consistent with most Asian REITs), which at times can raise questions about allocation of income or conflicts of interest.

Thus, the potential for large development gains in J-REITs is limited, and it can be unclear if aggressive management of properties will reward operators as much as the passive property owners (the listed unit-holders), in a J-REIT structure. "Singapore, Japanese and Hong Kong REIT managers are 100 percent–owned by the original REIT sponsor, which maintains an equity stake in that REIT and provides a source of assets for external growth. It is less clear whether those management teams are working for the benefit of ordinary unit-holders or for the sponsor," observes Cheong.

For now, the ability to borrow money for extraordinarily-low interest rates is playing into J-REIT hands.

"The inherent conflict of interest is not prevented," sums up Sehnalova, in describing the management-ownership structure of many Asian REITs.

Another potential risk is Japan's central bank, the Bank of Japan, has been buying listed Japanese securities as part of its quantitative easing programme, and this may have artificially boosted J-REIT values.

"Japanese REITs continue to trade at elevated levels, boosted by the Bank of Japan's purchases. With interest rates at effectively zero, we think the risk for J-REITs is an eventual unwinding of the BOJ's balance sheet. It may not happen now, but it will eventually," warns Cheong.

The BOJ's QE programme also coincides with record-low interest rates, which presently are set by BOJ targets, such as zero percent interest on 10-year Japanese government bonds. It is controversial whether BOJ monetary policy is causing artificially-low interest rates or preventing a deflationary recession and even-lower interest rates. But should interest rates rise in 2017, J-REIT unit-holders, like real estate owners anywhere, would feel some ramifications.

For now, however, the ability to borrow money for extraordinarily-low interest rates is playing into J-REIT hands. "REITs in markets such as Japan can have low internal growth but could achieve better earnings acquiring new assets financed with a very low cost of capital," notes Flageole.

While Japan is often thought of as a nation with a shrinking population, Tokyo is still growing. And for now, REITs can borrow and buy prime property in Tokyo, a world-class business city and tourist destination, for the lowest interest rates in memory. Some investors may think such a constellation of opportunities should not be passed over.

REITs Down Under

A perennial favourite among global institutional real estate investors has been Australia because of its excellent system of property law and government, and a domestic economy with a solid track record of growth in recent years.

In the past year, however, the Australian property market has somewhat cooled; a proxy for real estate Down Under, Vanguard Australian Property Securities Index ETF, is about flat in the past 12 months through mid-March, though up about 64 percent over the past five years.

Unlike their brethren in Singapore and Japan, some Australian REITs are involved in larger real estate development and, thus, offer some appeal for investors seeking not only yield, but also long-term capital appreciation, suggests Flageole. But as with their peers in Asia and around the globe, A-REITs are now the beneficiaries of historically-low interest rates.

For investors, there are prospects for positive A-REIT mergers in coming years, posited EY. First, the acquired REIT shares generally will get a boost on sale. And second, going forward, the merged REITs should benefit from economies of scale, access to capital markets, and lower operating costs.

The cooling off of Australian property values in the past year may be a chance to buy in. "We like Australian office REITs for their robust fundamentals and attractive valuations since the pullback last year," says PGIM Real Estate's Cheong. "Rents are rising in the major cities, reducing the risk of lower asset values, even with higher interest rates."

Investors pondering Australian property will have to keep a wary eye on the central bank, the Reserve Bank of Australia. The RBA has hinted it will not raise rates this year, but the nation's housing markets are hot enough to warrant concern and may force the RBA's hand higher.

A look at Singapore

Singapore REITs are well regarded for good governance and for operating within the positive tax and regulatory climate of the pro-business and progressive famed city-state. With such advantages, Singapore has become the third-largest REIT market in Asia Pacific, after Japan and Australia.

Yet an oddity about S-REITs remains — they tend to invest internationally. The main reason for the outward focus is prosperous Singapore is small, with a population estimated at 5.6 million in 2016.

So buying an S-REIT, unless it is one limited to the city-state, is often a bet on the skills of the REIT management, and whatever regional or global markets it targets. Another concern for investors is S-REITs tend to be structured so managers are paid, in part, by the size of the portfolio under management. Ergo, "empire building" pays off for the S-REIT manager, and with interest rates so low, empires could be built. "REITs in markets such as Singapore and Hong Kong have ventured outside of their home countries to sustain growth," notes Presima's Flageole.

S-REITs sometimes manifest other potential conflicts of interest between manager and unitholder, such as management fees earned for buying and selling of property, between 0.5 percent and 1.0 percent of transaction value, reported EY.

Of course, as heard in many a Wall Street huddle, when it comes to management fees at S-REITs or any publicly-traded company, "the markets have discounted that." That is, listed S-REIT trading prices already reflect the market's anticipation of management's pound of flesh.

So, S-REITs are certainly worth a look, note experts. "Singapore office REITs have been trading at a substantial discount to their underlying physical asset values," states Cheong.

Buying grade A property at a discount in the Far East, and especially pro-business Singapore, is not an option to be dismissed lightly.

Slicing by sector

Asia's hospitality sector, in particular, has been affected by tourism trends.

Chinese tourist volume beyond the Macau and Hong Kong markets will more than double between 2015 and 2025, projects Goldman Sachs. That Asian tourism is in an epic boom that may last another generation is old news — so old, industry watchers say the hospitality sector is getting crowded.

Still, Asian hospitality REITs are often positioned to exploit the ballooning numbers of Asian tourists, though simply opening doors may not be enough. To appeal to mainland Chinese tourists may take special efforts.

"Mainland Chinese tourists exhibit preferences different from other major customer groups, so hotel REITs with property types or business strategies that are well-positioned toward such preferences should benefit from the growing mainland Chinese tourism trends," says Admiral Investment's Ma.

While Chinese tourists and travellers will be mainstays of the travel industry for decades to come, other groups are not to be overlooked. "We are seeing ex-China Asian tourists becoming a bigger growth driver than Chinese tourists," notes Yeung. "Taiwan's 2016 tourist arrivals, for example, recorded positive growth despite a fall in Chinese tourists. Japanese and Korean tourists to Hong Kong have also grown by more than 30 percent in 2016."

The most daunting aspect of the hospitality industry is competition, with limited-service hotels gaining traction in the Asian market in recent years. Singapore-based Far East Hospitality Trust, for example, generally has traded down for the past five years, and share prices have been cut in half in that time frame, as at mid-March. The S-REIT does offer an enticing 7.6 percent dividend, but late last year Moody's Investors Service placed the REIT on a negative ratings outlook because of climbing debt, and noted in Singapore "the supply of hotel rooms has continued to grow."

Investors have had better luck with Ascendas Hospitality Trust, which has traded flat for the past five years and offers a 7.06 percent dividend. Ascendas has more than 4,000 rooms across Australia, China, Japan and Singapore.

For some investors, it may be the stout REIT dividend yields that clinch the deal. Many pension funds in the United States and Europe have obligations extending out decades and can be thought of as permanent investors with horizon-less liabilities.

Pension funds could find long-term ownership a good fit. "Asian REITs could satisfy the growing demand for yield from global pension funds, which continue to need to fund their liabilities," says Flageole.

Moreover, with bond rates near record lows, Asian REITs provide higher current dividend yields, as well as prospects for dividend growth from rent increases or accretive new property acquisition or redevelopment, adds Flageole.

If the global economy grows, Asian REITs appear able to deliver both appreciation and yield to discerning investors.

The bottom line

In terms of governance, listed Asian REITs have matured in recent years to a level acceptable to most institutional investors, although improvements in corporate disclosure and management practices are always welcome, whether in the East or the West.

In 2017, bond yields have some prospects for rising, perhaps for the first time since the global financial crisis of 2008. If interest rates rise, that would in general depress property-industry profits, and also increase the relative attractiveness of bonds to real estate. Listed property-issue investors would likely feel results.

Still, few are predicting much of an interest-rate run-up this year, and the secular trend in global interest rates since the 1980s has been down, not up.

Pension systems and private equity real estate funds, as well as sovereign wealth funds and other investors, are bulging with capital in need of a home. For pension funds in particular, Asian REITs, with their yields and prospects for long-term capital appreciation, seem well matched.

If the global economy grows, Asian REITs appear able to deliver both appreciation and yield to discerning investors. ❖

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