The glories of liquidity

Institutional investors can be in the REIT place at the REIT time

by Benjamin Cole

The real estate investment trust, or REIT, was until recently dismissed as the retail stock investor's friend, a relatively predictable vehicle to earn some steady dividends and own the kind of properties that non-billionaires cannot. But with trillions of capital pouring into the vaults of institutional property investors (you pick the currency, it doesn't seem to matter much), the prosaic REIT is getting a long second look from big-league real estate buyers — and is looking more royal with each passing day.

The primary reason for the increasing institutional investor attention to REITs is a "problem" that many would like to have: too much money. With large amounts of money comes the need to diversify. But diversification requires time-consuming due diligence, and investing in actual property requires due diligence in spades, often in connection with partnerships and deal-making.

Although the pockets of investors may appear bottomless, the time of institutional money managers is not. And so professional property investors who are strapped for time are appraising REITs. And the timing is just right for institutional property buyers: a European REIT boom is underway.

A wall of capital

The refrain "there is too much capital chasing too few deals" is almost becoming a cliché again in investment circles, property included. DTZ Research, an arm of the global real estate services giant, estimates that an additional $408 billion (€330 billion) entered global property markets in the first half of 2014, a 15 percent increase over the prior six months — indeed, DTZ Research has named its series of studies *The Great Wall of Money.*

As impressive as the DTZ stats are, they pale when compared to a report issued in 2012 by US consultancy Bain & Co, titled *A World Awash In Money.* If property investors are expecting less competition in coming years, they likely will be disappointed. From here through at least 2020, the globe will experience a "superabundance" of capital, predicts Bain. By 2020, a total of $900 trillion (€728 trillion) of capital will be invested in property, equity or bonds, up from $600 trillion (€485 trillion) in 2010, estimates Bain, using a broad definition of capital. A recent report from the IMF echoes the Bain findings, and predicts soggy interest rates for years as a result.

The preceding forecasts set up institutional property handsomely: with bond markets likely offering scant reward for a long stretch to come, it appears likely that plenty of new capital will seek a home in the perceived safety of, yet higher potential yields offered by, real estate. And what could be a safer or easier vehicle to invest in than a publicly-listed REIT?

Readily visible advantages

The advantages for institutional property investors of buying (and selling) REITs are plain: liquidity and ready diversity. While diversification should result in steadier returns over the long run, the desirable trait of liquidity is thought to crimp yields. It has long been assumed that private real estate delivers a "liquidity premium" relative to public real estate. In other words, the longer the lock-up (liquidity), the larger the returns (premium) that should be demanded by investors.

So toss in a little efficient market theory, and one would expect lower average returns on liquid REITs when compared to private property investing — right? Well, the markets appear to tell a different story. "Historically, there has been zero cost to REIT liquidity," declares Peter Zabierek, chief executive at Presima, the Montreal-based manager of global listed real estate strategies.

Pointing to a study of the years 1990–2008 by the US-based National Association of Real Estate Investment Trusts, or NAREIT, Zabierek observes that REITs "actually outperformed all direct real estate strategies, including opportunistic, value-added, and core over the long haul." He concludes, "This analysis shows that the liquidity premium is likely much smaller than previously assumed."

Of course, NAREIT might not be considered an impartial body, and the study pertains only to the United States, and it considered peak-to-peak returns through only one cycle, albeit a long one. Still, although the NAREIT finding may appear counterintuitive, on second consideration perhaps there are market explanations for such a result.

Institutional direct property investors do not focus on daily fluctuations in value, but rather on expected cashflows and perhaps a longer-term exit strategy, notes Dr Rüdiger Mrotzek, board member of Hamborner REIT AG, a German public REIT. But expected cashflows are also largely what determines REIT values, says Mrotzek. Other macroeconomic variables that impact REIT values impact direct property investments similarly.

"In other words, apart from the fact that a REIT is traded on the stock market on a daily basis and the shares are therefore subject to price fluctuations, the economic reality of a direct property investment is not so very different from a REIT," Mrotzek explains.

The idea that direct real estate has steadier values than REITs may be a myth, suggests Alex Moss, founder of Consilia Capital and a member of the research and accounting committee at EPRA, the European Public Real Estate Association, a trade group for listed property companies. "There is now a general acknowledgement that volatility in the direct property market is significantly understated, as appraisal-based valuations are smoothed," notes Moss. Sellers of discrete properties might indeed encounter "volatility" if they were under an imperative to sell by a deadline.

In another way of looking at it, REIT investors are akin to buyers into long-term bond funds. Both the long-term bond fund buyer and the REIT investor extract the higher yields associated with longer maturities, but still retain liquidity. No wonder REITs are booming.

Europe and REITs

In comparison to the United States, continental Europe is under-REITed — but perhaps not for long. Through November 2014, €7.1 billion was raised by

Net returns to US listed equity REITs and private equity real estate investments over the last full market cycle

Form of commercial real estate investment	Leverage	Fees and expenses	Full cycle (peak-to-peak)		Bull market only (trough-to-peak)	
			Duration	Returns	Duration	Returns
Property values	0%	≈100 bps	17.75 years Q3 1990–Q2 2008	275% 7.7%/yr	15.5 years Q4 1992–Q2 2008	331% 9.9%/yr
Open-end diversified core equity funds (ODCE)	≈22%	107 bps	17.75 years Q3 1990–Q2 2008	272% 7.7%/yr	15 years Q2 1993–Q2 2008	341% 10.4%/yr
Value-added private equity real estate funds	≈51%	170 bps	17.5 years Q3 1990–Q4 2007	348% 8.9%/yr	14.75 years Q2 1993–Q1 2008	464% 12.4%/yr
Opportunistic private equity real estate funds	≈64%	257 bps	17.25 years Q3 1990–Q1 2008	716% 12.9%/yr	14 years Q4 1993–Q4 2007	1,104% 19.1%/yr
Publicly-traded equity REITs	≈38%	≈50 bps	17.5 years Q3 1989–Q1 2007	802% 13.4%/yr	16.5 years Q3 1990–Q1 2007	1,041% 15.9%/yr

Note: Listed equity REIT returns exceed private equity real estate fund returns even over bull markets and relative to funds that use much greater leverage.

Source: NAREIT analysis of data from NCREIF (NPI, ODCE, Townsend fund indices) and FTSE NAREIT All US Equity REITs Index

European listed real estate companies through initial public offerings, according to EPRA. This was raised by 17 companies with gross proceeds ranging from €3 million to €1.25 billion.

REITs in the United States have a bit of history, extending back into the 1960s. In Europe, in contrast, governments only began to accept the REIT structure in the 1980s and 1990s. Moreover, bank financing for institutional property was strong in Europe, especially Germany.

But with the new REIT IPOs, the picture is changing. The European market capitalisation of real estate listed companies was €144.8 billion as of August 2014, up 37.8 percent from €105.1 billion in 2013, reports EPRA. To be sure, Europe has a way to go; there are €282.8 billion worth of REITs in Asia and €497.3 billion in North America. And for purposes of some types of diversification, there needs to be even more REITs in Europe, say some.

"Unfortunately, REITs in Germany … are still too small for major international investors. Institutional investors [seeking diversity or exposure] therefore use other vehicles that are not always more advantageous, such as special funds or private equity funds," observes Hans Richard Schmitz, board member at Hamborner.

Other nations are also suffering from a REIT shortage — indeed, Italy's prime minister Matteo Renzi in August 2014 signed measures improving existing REIT regulations there. "There is currently interest in Italian real estate, but there are not enough listed vehicles to satisfy the demand," Henri Quadrelli, an analyst with Société Générale SA, told *The Wall Street Journal*.

Interestingly, the pressure for REIT shares is not only coming from institutional property barons, but from other large buyers as well. Titan investors such as George Soros, through his Quantum Strategic Partners Ltd, have been buying European REITs, as has New York City–based Paulson & Co, led by John Paulson, usually typecast as an "alternative investor."

In terms of performance, it is not hard to see the attraction of European REITs: since the nadir in January 2009, an index of Europe REIT values is up 119 percent. Even since the start of 2011 and the more-normal if sloggy economies since then, the European REIT index is up 54 percent, according to Investing.com.

Interestingly, some institutional investors are willing to take the plunge on the economically struggling areas of Europe, perhaps sensing value, as such regional REITs are trading at steep discounts to net asset values (as discussed in the next section). Savills recently reported that REITs "have provided a platform for international buyers to achieve exposure in southern Europe through indirect investments, with figures showing that approximately €820 million and €2.55 billion were invested in Greek and Spanish REITs, respectively, by international investors in the past 12 to 18 months."

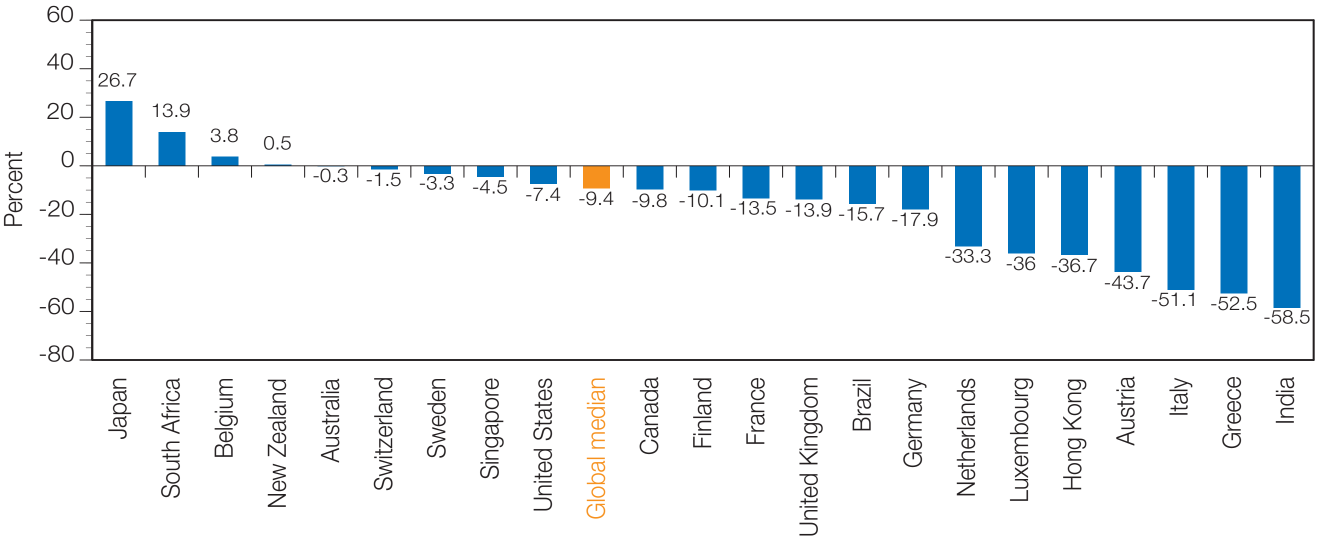
Eri Mitsostergiou, director of European research at Savills, sums it up: "REITs have provided a safe and efficient investment structure for overseas purchasers to enter the southern European commercial real estate markets."

The emergence of REIT exchange-traded funds and other indices puts a whole new dimension on diversification through REITs, notes Moss. For example, "the FTSE EPRA NAREIT Global Developed Index offers exposure to North America, Europe and Asia across 20 countries," Moss observes. Interestingly for time-strapped money managers, extensive "due diligence" into such a vehicle as the FTSE EPRA index is not really practical or necessary — there are simply too many properties owned, exposed to too many markets. But such a vehicle obviously offers balance against any regional direct property investment.

Net asset values

For the uninitiated, one of the more puzzling traits of REITs is that they publicly trade for a premium or discount to their net asset value; that is, the value of

Global real estate median premium/discount to NAV (%)



Source: SNL Real Estate NAV Monitor, Q3 2014

The City of London skyline has been transformed in recent years, largely as a result of CBD office tower development activity by global investors in tandem with UK REITs. The development activity has not been controversy-free. British Land and Oxford Properties are building the 47-storey Leadenhall Building at 122 Leadenhall Street, also known as the Cheesegrater; recently, two of the 3,000 large steel bolts that connect the nodes on the megaframe broke, fortunately without incident. Last year, reflected sunrays off the 37-storey Walkie-Talkie office tower at 20 Fenchurch Street, being developed by Land Securities and Canary Wharf Group, melted parts of a car parked nearby. Passers-by with a frying pan and a spatula to hand were also able to cook fried eggs, any way up.

REIT property minus mortgages, or other encumbrances. Thus, a REIT might have a market cap above or below what could be garnered if the properties were auctioned off.

In the 1990s in the United States, REIT market capitalisations often soared above NAVs, a virtue that ever-ready analysts attributed to greater liquidity and the ability of REIT operators to access capital while culling inferior properties from their portfolio. Those advantages meant that a REIT should trade above NAV, in contrast to a single, illiquid property that might have idiosyncratic problems.

However, back then in the United States many property mavens took the obvious cue, and took their portfolios public — or even hastily assembled a portfolio and took that public — and eventually the market levelled off. Today, the opposite pattern may be emerging in Europe. At the most recent tally, REITs in parts of Europe are well below their NAVs, reports SNL Financial, the business intelligence service. For example, Italian REITs are trading at a 51.1 percent discount to NAV, while in troubled Greece, REITs are trading at a wider 52.5 percent discount.

But even steadier nations offer cheap REITs for consumption. German REITs are discounted by 17.9 percent, Dutch REITs by 33.3 percent and Austrian REITs are trading off 43.7 percent from NAV, reports SNL. The US REIT market, much deeper and more mature, shows less divergence from NAVs. But, just as in the United States a couple of decades back, investment dollars and returns tend to level, just like water. Investors, institutional or otherwise, may be discovering German and European REITs.

"In recent years, Hamborner always traded below NAV. This has now changed thanks to our reliable business model and the resulting continued increase in acceptance on the capital market. We are currently quoting hardly any discount on NAV, and on some days are even slightly above it," Schmitz says.

Nature abhors a vacuum, and in the world of investing, assets do not stay cheap for long.

Following a well-worn path

The REIT model has proved its worth over a couple of cycles in the United States, and appears ready to do the same in Europe in coming years. With huge flows of capital seeking placement in the next several years, REITs are advantageously placed. European REITs are especially intriguing due to market capitalisations that often appear to be below NAVs, and to the ready market acceptance of recent European REIT IPOs.

Perhaps institutional investors are learning what retail REIT buyers concluded long ago — that one can buy for the long term and yet stay close to the exits. Liquidity and yield can live in the same house — if the home is owned by a REIT. ❖

Benjamin Cole is a freelance writer based near Korat, Thailand.