Growing the European listed real estate market

What are the reasons behind the relative decline of the sector, and can we learn any lessons from the factors behind the explosion of the US REIT sector in the 1990s?

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Much has been made of the recent relative decline of the European listed sector compared to the global listed market, which raises questions as to what can be done to improve the growth of the sector. This paper, which is the first in a series on this topic, looks at three aspects of the issue:

1) How has the weight of the listed sector in Europe moved over time compared with the global benchmark?
2) What factors drove the US REIT explosion of 1993-1994, and
3) Can we draw parallels and take lessons for the European sector from that US experience?

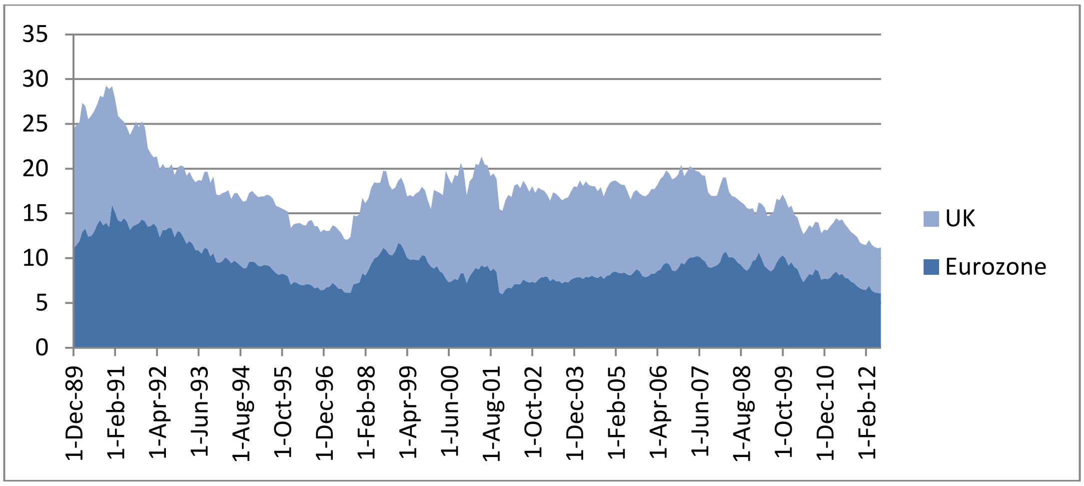
1) The size of the European listed sector

1.1 Is there a "normalised" relative weighting for Europe?

To provide some historical context foundation for the discussion, let first us examine the historic trading range of Europe's listed sector as a fraction of the global total (Figure 1). Prior to the turbocharged US REIT growth of the early 1990s, the UK and Euro zone listed sector both accounted for a peak share (in Jan 1991) of around 29% of the Global Universe, as measured by the EPRA Global Index. An initial US REIT IPO explosion of 1993-4, which we will look at in greater detail later in the paper, was followed by a series of later offerings, which continued to boost the relative size of the US sector up to 1998.

So the share of the UK and Euro zone fell steadily, reaching a trough of 12.1% in August 1997. From the beginning of 1998 to January 2010 the UK / Euro share never fell below 15% or rose above 20%. We can therefore take this 15%-20% as the "normal" weight. From February 2010 until now the relative has continued to decline, and now stands at 11.2%. (Note that the total figure for Europe is slightly higher, because it includes the Nordic countries and Switzerland, but for the purposes of this paper I am focussing on the UK and Euro zone countries in general, and on REIT structures in particular.)

Fig 1. Relative size (% of EPRA Global Index) of the UK and Euro zone listed real estate sector 1989-2012



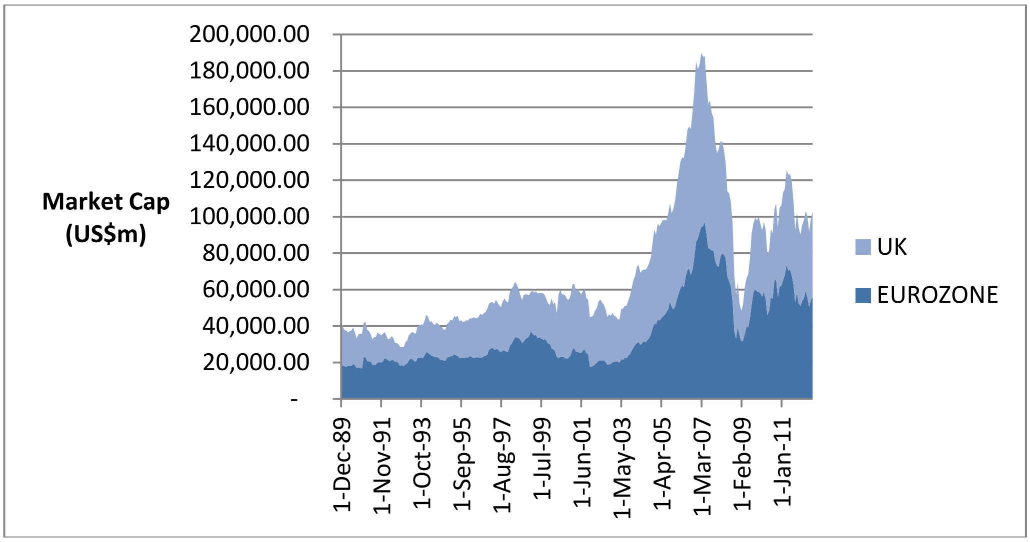
Source: EPRA. Consilia Capital

The conclusion is that, for reasons which we will examine individually, the weighting of the UK and Euro zone listed sector is currently below its normal share.

1.2 What has the change been in absolute terms?

Clearly the relative weighting will have been driven down by the dynamic growth of Asia as well as trends in the US, but has the European sector declined in absolute terms as well? The chart below provides us with the answer.

Fig 2. Market capitalisation of the UK and Euro zone listed real estate sectors 1989-2012



Source: EPRA, Consilia Capital

The peak in terms of market capitalisation was a total US$189bn in Mar 07. What is interesting, and perhaps surprising for some commentators, to note is that from a trough of US$48bn in February 2009, the combined market cap is now US$102bn, back to where it was in October 2005. This is a sharp contrast to indicators of value in the direct market: in the UK, where valuation data is most frequent, values have started to decline again and are currently not higher than in March 2000. In Europe, valuation declines looked much shallower: the annual IPD France Index for example suggests that values are now back at the levels of end-2006. A key difference between the US and Europe, is that US REITs have continued to issue equity from March 2009 to the present day, whereas European REITs had one round of “rescue” rights issue in 1H 2009, and little else since.

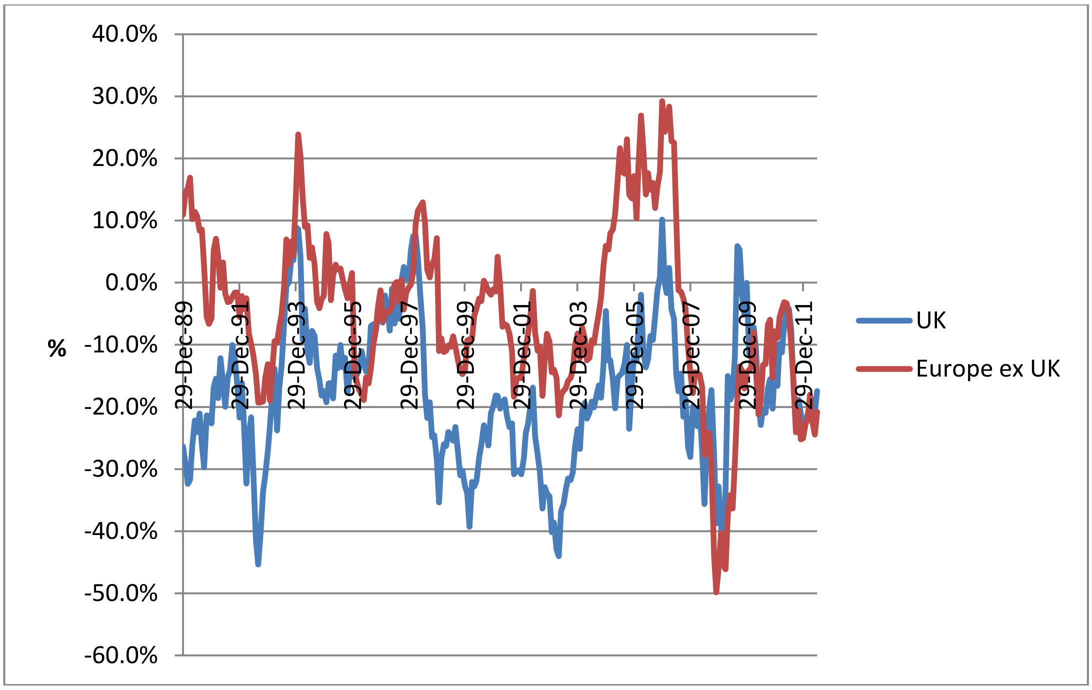
In absolute terms, therefore, we can see that the European listed sector has been more robust and healthier than its global weighting might suggest, but has failed to continue to recapitalise with equity issuance after the bottom of the crash.

1.3 Are valuations to blame?

One of the key elements behind shifts in relative market cap share valuation methodologies. In Europe a discount to NAV methodology is commonplace, whereas in the US a price multiple of Adjusted Funds from Operations (AFFO) is the norm. The extent to which and relative growth is a subject we will look at in greater detail in a subsequent paper at how far these different valuation methodologies have been responsible shifts in market caps. However, one of the causes for the decline in weighting may be an expansion of the US rating and a contraction of the European rating. This would translate, for Europe, into stocks trading at a wider discount to NAV than their long term average, i.e. below normalised levels. Figure 3 shows that this is indeed the case.

The long term average discount for UK stocks (including the pre-REIT period where Capital Gains tax was included within the NAV figure, and the CGT liability averaged c. 20-30% of the NAV per share is -17.9% and they are currently trading at -17.5% having recently been as low as -25%. In Europe where REIT regimes have been around longer and valuations have been historically tighter, the average long-term figure is -5.1% and they are currently trading at -20.8%.

Fig 3. Discount / Premium to NAV for UK and European Stocks 1989-2012



Source: EPRA, Consilia Capital

For the UK, current valuations are of concern. Prima facie, valuations post REIT conversions close to the average for pre REIT status, might imply that the benefits of a REIT structure to investors - elimination of capital gains tax and a higher dividend payout – have been zero. However, there are more plausible explanations. Firstly, using the methodology outlined in *"Real estate investing across different capital structures, Moss &Hughes March 2011"*we can assess the implied level of property value changes contained in this discount. Current pricing implies a fall in property values of around 12% over the next 12 months: using a loan to value ratio of 40% this equates to a fall of 20% in NAV per share. Given the economic outlook and brokers property market forecasts of around -8% to -10% this pricing does not seem unreasonable.

In addition to specific property forecasts there has been a widening of the discount to reflect the increase in general risk premia required to compensate for the possibility of Euro zone implosion.

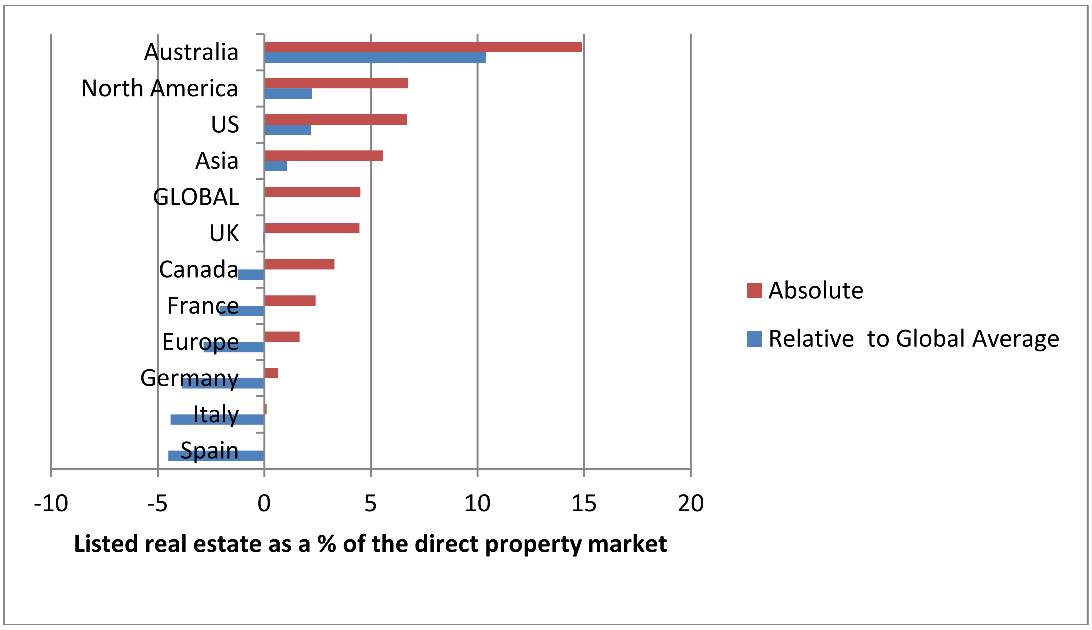
Secondly, and again a point will be explored further in a later article, it is not clear that UK management teams have fully embraced the changes in corporate strategies that REIT status were expected to bring: lower development exposure, focus on long term sustainable cash flow, moderated gearing, and regular recourse to both debt and equity capital markets for funding. Prima facie it seems there may be agency issues which are stopping UK REITs achieving superior valuations to tax inefficient PropCos.

We can therefore conclude that valuations are currently lower than their normalised rate, and are partly to blame for the current low relative weighting.

1.4 How big should the listed real estate market be?

The final question to be addressed in this section is what fraction of the total commercial real estate market we would expect to be in the listed sector. Data from EPRA's in their monthly statistical bulletin can help to assess the question. Figure 4 shows the market capitalisation of each country shown by the EPRA Index divided the EPRA estimate of the size of the overall investment market in commercial real estate. (We have taken the Index market capitalisation adjusted for free-float and Index inclusion rather than the gross market cap for all companies because we believe this "investible" figure is more meaningful). We use the rather clumsy label "equitisation" here to avoid confusion with the more commonly used securitisation, which is more commonly associated with debt rather than equity products.

Fig 4. Global comparison of levels of real estate equitisation



Source: EPRA, Consilia Capital

The results confirm previous studies that Australia has relatively speaking the biggest listed sector, which accounts for 14.9% of total real estate investment. The global average is far lower: the listed sector accounts for 4.5% of the commercial real estate market, and only 2.5% of the domestic stock market capitalisation. In terms of real estate equitisation the listed sector in Europe (less so the UK) clearly looks undercapitalised. The absolute amount (and percentage change) by which the listed sector in each of the key European countries would need to grow in each country to match the global average is:

UK +US$0.5bn (+1%)
France +US$25bn (+87%)
Germany + US$59bn (+600%)
Spain + US$29bn (infinite as starting from zero)
Italy +US$42bn (+4,245%)
Europe overall + US$213bn (+172%)

The conclusion, therefore, is that the European listed real estate sector is undercapitalised relative to the global average, and that significant growth would be required to bring it to a global norm.

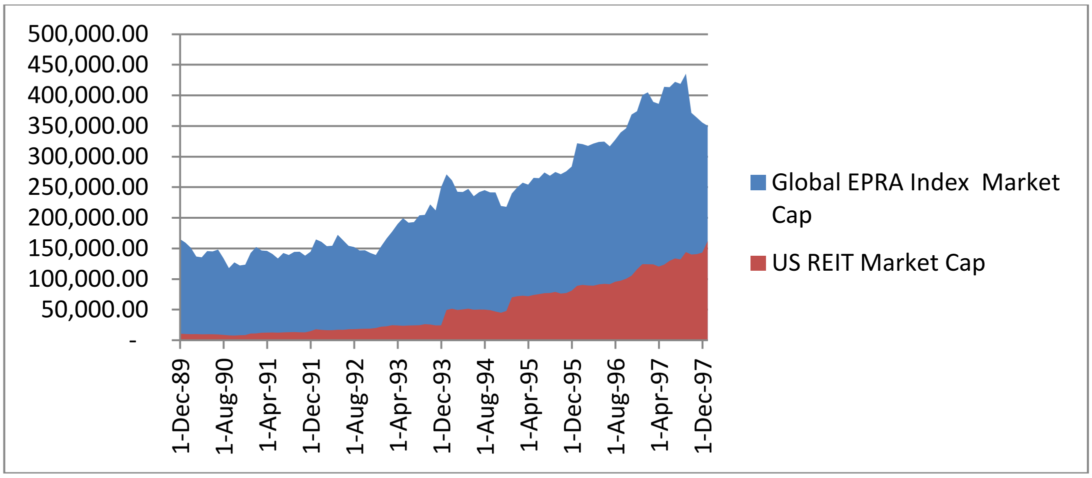
Section 2 – The 1990s growth of the US REIT market

2.1 How significant was the growth, and when did it occur?

Firstly, a few key statistics:

• It may seem hard to believe, but in 1989, the US REIT market was not only smaller than the European listed sector, it was smaller than the UK. At the beginning of 1990 the market capitalisation of the UK sector was US$ 13.4bn, Euro zone was US$11.0bn, and the US was US$10.7bn.
• Eight years later in January 1998 the market capitalisation of the UK was $5.9bn (-37%) Euro zone was $6.2bn (-25%) and the US was $ 161.8bn (+***1,415%).***
• In the same period the global market grew by 112% to $350bn.
• So the US share of the global market grew from 6%in 1989 to 46% in 1998.

Fig 5. Growth in the US REIT and Global listed real estate market 1989-1998

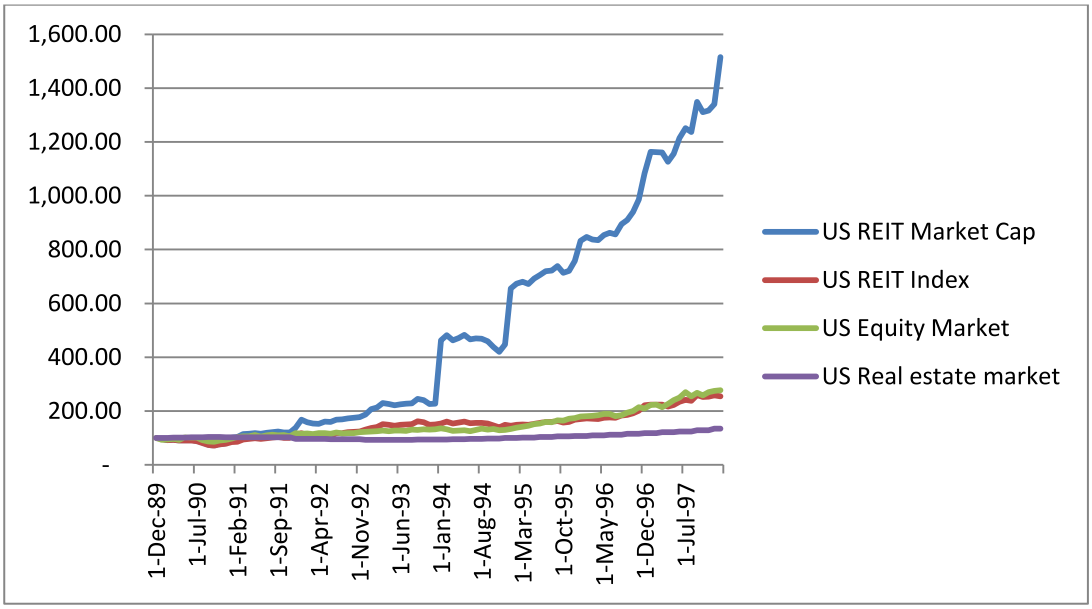


Source: EPRA, Consilia Capital

2.2 Was this growth in proportion to that of the US equity market. US REIT values, and US real estate market?

Clearly, this is the most explosive growth the global listed real estate sector has ever seen. The first point to address is how far that growth reflected the overall rise in the US equity market, as against capital growth in the direct real estate market, or price appreciation in the US REIT sector. To isolate the impacts, we have set the market capitalisation of the US REIT sector alongside with the US REIT Index (EPRA), the US equity market (S&P 500) and the US real estate market (NCREIF Index), all rebased to Dec 1989 = 100, to show how the growth of REITs compares with the growth of the real estate and equity markets.

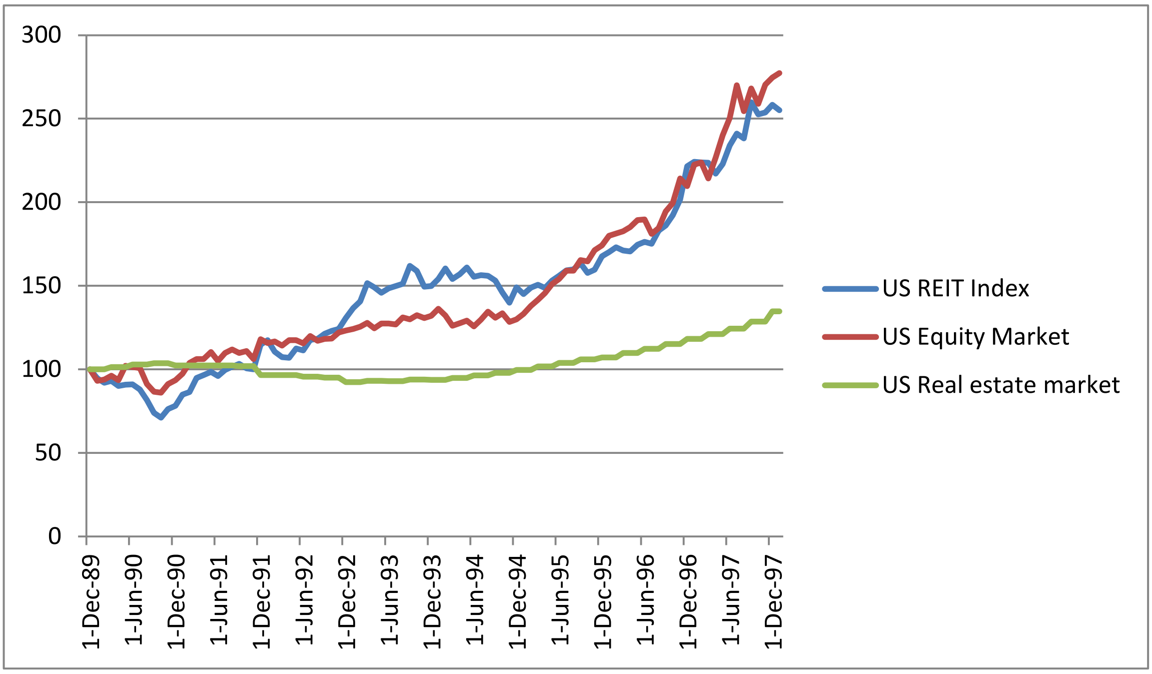
Fig 6. US REIT market capitalisation, US REIT Price Index, US Equity Price Index, NCREIF Capital Value Index, Dec 1989=100



Source: EPRA, Bloomberg, Cosilia Capital

Figure 6 clearly shows the REIT market explosion was far in excess of what can be explained by asset price movements. It is worth looking at the underlying asset classes in isolation (Figure 7) to see what occurred during that period, to tease out parallels with potential listed sector growth in Europe.

Fig 7. Relative growth in the US REIT Index, US Equity market and US CRE market 1989-1998



Source: EPRA, Bloomberg, Consilia Capital

There are several conclusions to be drawn from this data.

Firstly, pricing in the US REIT sector appears to have anticipated the turnaround in commercial real estate values. The US REIT Index turned up in October 1990, while the trough in the NCREIF was not reached until December 1992. As we have seen countless times across many markets, the listed real estate market lead the direct market. From its trough in October 1990, the US REIT market had appreciated by 84% by December 1992 when the real estate market bottomed. Positive momentum in REIT prices clearly helped the growth surge in issuance of REIT stock, but price changes alone cannot explain the quantum of the growth in market capitalisation.

Secondly, REITs were helped along by a strong overall equities market throughout the period, which they outperformed by a large margin only in 1993 and 1994. This is important, as outperformance reflects significant participation by generalist investors in addition to specialist investors who remain holders throughout the cycle.

In conclusion, therefore, there was clearly a benign set of market conditions supporting growth in US REITs, and typical of many markets who hit a "sweet spot " for generalist investors for a couple of years, but not sufficient to account for an increase in the relative weighting from 6% to 46% and in absolute terms of over 1,400%.

2.3 The specific causes of the explosion in the US REIT market

What then were the specific, one-off factors which caused this growth? We believe they can be identified as follows:

2.3.1 Regulatory changes leading to the creation of a pool of investible real estate stock

In the early 1980s a lot of US investors used Real Estate Limited Partnerships ("RELPs") as their vehicle of choice. The advantages were tax driven, allowing investors to write off passive losses against active income and shortened depreciation periods. Not surprisingly the use of these RELPs helped fuel the 1980s real estate boom, when US$80bn to US$100bn of new commercial real estate stock was constructed. ***This is an important starting point, as it provided the real estate which would become the asset base for the REITs.***

2.3.2 Regulatory changes improving liquidity of debt capital markets

This tax-fuelled construction boom led to extensive oversupply in most markets, and a financial crisis in the overextended Savings and Loans industry, ending up not surprisingly with a sharp decline in property values in the early 1990s. As a result of the debt crisis in the S&L market the Government introduced the Financial Institutions Recovery Reform and Enforcement Act of 1989 ("FIRREA). ***This led to the establishment of the CMBS market and highly liquid source of debt capital.***

2.3.3 Regulatory changes increasing the attractiveness of REITs as an investment vehicle

The Tax Reform act of 1986 eliminated the tax advantages held by RELPs, thereby increasing the attractiveness of REITs as an investment vehicle. In addition the Act eliminated a previous obligation on REITs to use external managers: this allowed REITs to own, operate and manage most types of income producing commercial properties.

However, perhaps the greatest regulatory impact came from was the Omnibus Budget reconciliation act of 1993, which improved the REIT structure in two significant ways. Firstly, it modified the restriction to "five or fewer" investors, which allowed large institutions to buy into REITs more easily. Secondly, it created Umbrella Partnership REITs (UP-REITs), a mechanism which permitted property owners to swap their property assets into a REIT structure in a highly tax efficient manner. ***Thus institutions were free to buy REIT stock, and vendors had a tax efficient way to sell real estate assets into REITs. As a result both demand for REITs and supply of assets increased exponentially.***

2.3.4 Market demand as Institutions were structurally underweight REITs

US REITs were introduced in 1960 to help private investors access the real state market, so those private investors initially dominated the market. Even in 1992, institutions accounted for only around 20% of the REIT ownership – roughly half their share of the overall equity market. ***Thus there was huge hitherto untapped institutional demand for the right assets in the right vehicle.***

2.3.5 These demand, supply and price momentum factors all created continued capacity for the issuance of REIT stock.

Initially private firms were pushed to the public market as a means of survival, as the private debt market was not available for refinancing. However, as we have seen previously the REIT sector was performing extremely well, with attractive valuations for vendors. The combination of low interest rates and bond yields, high yields on distressed property, and attractive REIT valuations meant a continual surge of IPOs. In the period 1993-94 95 capital constrained, private real estate firms went public. The amount raised in IPOs was equivalent to 65%-75% of the previous year's market capitalisation. ***From an equity market perspective REITs were a growth story, as capital raised was not just used for refinancing but also acquiring distressed assets. As the sector grew in size it became more relevant to generalists, and the momentum generated allowed subsequent fund raisings for REITs that IPO'ed.***

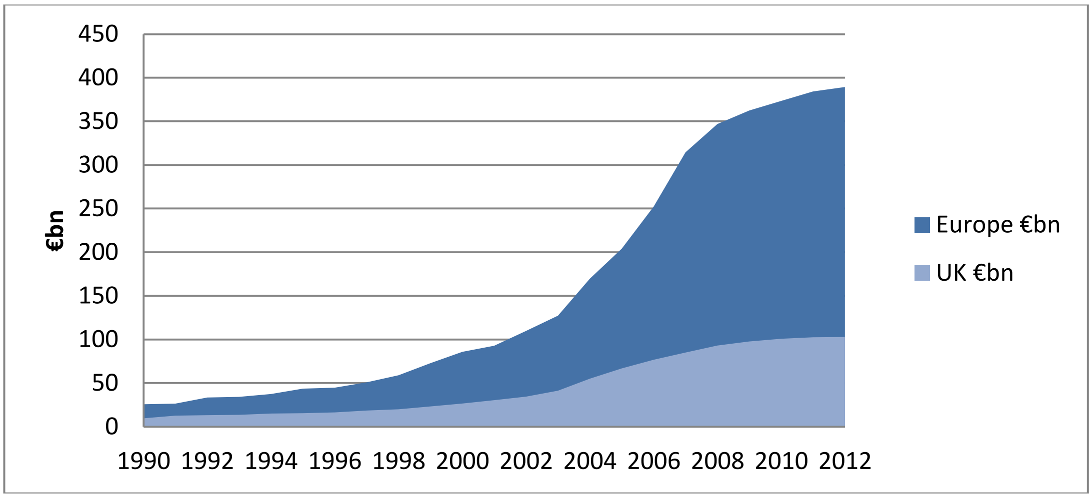
Section 3 – Parallels to be drawn for the European market

We can now look at the evidence from the explosion in the US REIT market to see if there are parallels to be drawn, highlighting similarities and differences across Europe.

3.1 Is there a pool of investible stock that could form the asset base for REIT IPOs?

A first question is whether there is a base of sufficiently high quality assets to attract institutional investment via REIT vehicles. While non-performing bank debt might seem an obvious, and certainly plentiful, source of stock anecdotal evidence suggests that confirms that the bulk of those assets are not institutional quality. We believe the most relevant source is unlisted funds, many of whom are struggling to refinance and / or coming to the end of their investment life. The chart below shows the dramatic growth in unlisted funds over the last ten years.

Fig 8. Gross Asset Values of UK and European Unlisted Funds 1990-2012



Source: Property Funds Research

Clearly, if the listed sector is to grow, transferring assets from the unlisted sector into listed vehicles is an obvious starting point. There are currently 336 UK unlisted funds with a gross asset value of €103bn, and 877 European Funds with an asset value of €389bn. Interestingly, allowing for the prevailing discount, and accounting for leverage it would appear that the UK unlisted sector is similar in size to the listed market, but the European sector is significantly larger, with stock in unlisted funds possibly up to 4 times the that in the listed sector. Intuitively this makes sense, because as we saw in the first section a number of countries are significantly underrepresented in the listed sector, most notably Germany, Spain and Italy.

Therefore the pool of investible assets to support REIT growth, particularly in Europe, is undoubtedly there.

3.2 Are the debt capital markets open and accessible?

In the US the closure of the private debt markets was accompanied by legislation which kicked off the growth of the public CMBS market. A similar debt freeze-up now prevails in the UK and Europe. Traditional bank lending is hard to get and comes only with high margins increased and low LTVs. The question therefore is can European REITs access alternative debt markets? The answer is a resounding yes. As bank debt has dried up, a number of different sources of debt have become available. The most popular are i) corporate bonds as investors continue to chase yield, ii) US private placements, iii) senior debt from insurance companies who are entering the market in response to Solvency 2, and iv) mezzanine debt from newly formed debt funds.

So far this year there have been 22 capital raisings in the listed Bond market , with a total of €3.4bn issued, compared to €4.58bn in 2011 and €5.34bn in 2010 (source: EPRA).

Therefore, as with the US market in the 1990s, alternative sources of debt are available to aid refinancing and fuel REIT expansion.

3.3 Is the REIT vehicle the most attractive option?

Whilst the French REIT model is widely applauded, and the UK model is increasingly attractive following the abolition of the conversion charge and the ability to list on AIM, it is the countries where the REIT presence is weaker where new steps are needed to make REITS a viable source of refinancing.

The most obvious case is Spain, where a new regime for property investment (SOCIMI) was introduced in 2009. But EPRA criticised the structure at the time, saying that it did not warrant a REIT label because it departed too far from the standard European model. The SOCIMI regime implemented an 18% flat rate for qualifying net income, payable by the property entity itself, rather than external investors through dividends.

Philip Charles, Chief Executive EPRA has said “the Spanish government has not yet passed the legislation to create a REIT structure that would attract domestic and international investors and their urgently needed capital.“

3.4 Are institutional investors underweight REITs

The situation in the US was an exceptional one, whereby institutions had to double their weightings in REITs to bring them up to a similar level to their holdings in equities in general. This is clearly not the case for the developed markets of the UK and France, but again, given the under representation in the listed sector, we believe there are structural underweight positions in Germany, Spain and Italy. For growth in these markets to occur there has to be a shift, not just in the assets from the unlisted sector to the listed, but also the investors. This will require the right assets, the right management team, the right REIT structure, and crucially the right valuation.

Conclusions

Looking at the evidence, we can conclude the following from the three topics examined:

1 The current weighting of Europe in the Global listed Universe

1.1 The UK and Euro zone are below their “normalised” weightings in the EPRA Global Index
1.2 Growth in the sector in absolute terms, particularly post 2009 refinancing, has been far more robust than the relative weighting suggests.
1.3 REIT valuations are currently lower than their normalised rate, and are partly to blame for the current low relative weighting
1.4 The European listed real estate sector is undercapitalised relative to the global average, and would require an increase of US$213bn (+172%) to bring it into line with this average.

2 Growth of the US REIT market in the 1990s

2.1 In 1989 the US REIT market was smaller than the UK, and also Europe. During the course of the 1990s its relative weighting in the global index went from 6% to 46%.

2.2 Although market conditions were benign they were not sufficient to explain the growth which arose from a combination of structural changes and beneficial market imbalances. Most notably:

• The creation of modern investible CRE stock for REITs from the sue of RELPS
• Regulatory change which led to the emergence of a liquid debt capital market which REITs could access
• Changes in tax laws making REITs more effective than competitive vehicles
• Legislative changes which ensured that institutions were free to invest and vendors had a tax efficient way of injecting real estate assets into REITs. As a result both demand for REITs and supply of assets increased exponentially
• A structural imbalance which meant that institutions needed to double their holdings to match their general equity weightings.
• Sufficient momentum behind the sector to allow recently Imposed REITs to have follow on offerings and move from using equity to refinance to pursuing acquisitions of distressed assets.

3 Parallels for the European market

3, 1 there is a sufficient pool of institutional quality, investible assets to support REIT growth in Europe
3.2 The Debt markets are open, accessible, and available to refinance bank debt as witnessed by bond issues by European REITs over the last three years.
3.3 Whilst the UK and French REIT models are well known, and in the case of the UK recently improved, it is the Spanish, Italian, and to a lesser extent German models which needs to be fine tuned if the sector is to capitalise on demand for real estate assets in a listed form at the turning point of a cycle.
3.4 Unlike the US in the 1990s investors are not structurally underweight the existing REIT markets.

Where is the growth likely to come from?

Having looked at the parallel of the US REIT market growth, there are a number of possibilities as to where growth in the listed sector may come from, which we will look at in detail in subsequent articles , but currently the most likely areas which meet the criteria listed above and have recent catalysts are:

1) The UK, post the abolition of the conversion charge, with potential stock and management teams from the overleveraged and redemption heavy unlisted funds sector.

2) Germany, particularly after the recent announcement that the German Government is considering legislation to phase out creation of open-ended

property funds and require that all future vehicles are closed ended. There are clear parallels here with the decline of the RELP sector in the US in the late 1980's, and also the decline of the open-ended property fund structures in Australia and the Netherlands which was the precursor to growth in the listed sector. The supply of assets (from the GOEFs) and demand for an efficient vehicle (providing a steady dividend stream) would therefore appear to be in place, although issues remain to be resolved regarding the underlying property valuation methodology.

3) Italy and Spain, which have negligible listed sectors and governments /banks which are under enormous pressure to delever. In these cases it is the REIT structure itself which needs to be fine-tuned to become institutionally acceptable.

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