REITs: AN ATTRACTIVE ASSET CLASS

In a low-return environment, REITs merit consideration as an alternative to low-yielding bonds and as the demographic shift in Europe moves towards retirees, real estate remains an important portion of an individual's asset allocation

By Martin Hess and Christian Kempe

Real Estate Investment Trusts (REITs) can be defined as "a special legal form of incorporation applicable to Real Estate companies". These trusts mostly manage commercial and residential properties and are obliged to pay out most of their profits. Usually, a minimum pay-out ratio of 90% is required. REITs' dividend yield is therefore often more than 5%, which makes REIT investments attractive vis-à-vis risk-free bonds. A rule of thumb could be that REITs should deliver a spread of 100 to 250 basis points over long local government bonds.

REITs are tax exempt at the corporate level when profits are distributed; earnings retained remain taxable. Some REITs may use leverage. The degree of permitted leverage differs substantially between legal jurisdictions. In France, for example, leverage is unlimited, whereas in Belgium it is limited to 50% of assets.

There are other differences unique to their respective jurisdictions. These include internal/external management, minimum ratio in real estate investments, overseas assets and possibilities in development.

The first REITs were established in the US in 1960 after the real estate investment trust tax provision classified REITs as pass-through entities whose primary purpose is to avoid having to pay taxes at a corporate level.

REITs have also gained popularity in Australia, Japan and Hong Kong since 1985, 2000 and 2003, respectively.

In Europe, the first REITs were introduced in the Netherlands – the most established continental European REIT market – in 1969; Belgium and France followed in 1995 and 2003, respectively.

Other European countries, like Germany, the UK and Italy, are planning REIT legislation within the next few years. The size of the global REITs market currently comprises more than €410 billion, with the US having a dominant share of about €250 billion.

What influences REITs performance?

As with usual stock investments, total returns of REITs can be dissected into their two component parts: price appreciation and dividends.

Dividend yields account for most of the income due to a steady flow of rental income or gains and losses from property disposals. Real estate investors should look for markets with favourable macroeconomic conditions for property. Strong economic growth and high inflation are the ingredients for rental growth. However, an economic environment that is too strong negatively impacts the sector via a rise in interest rates. Should this occur, it might trigger a shift in flow of funds from property investments to equities, especially if corporate earnings also rise rapidly. On the other hand, a recession is positive in terms of interest rates, but negative for property market fundamentals. As a result, in most cases, REIT investors prefer a "middle of the road scenario" – that is moderate economic growth and slowly rising interest rates combined with solid property market fundamentals.

The currently low absolute level of interest rates increases the flow from income-oriented investors, but also provides low financing costs, thus increasing the yield on property investments.

Comparison with other asset classes

For comparison, we conducted a thorough analysis of three asset classes:
- listed European real estate companies,
- European equities, and
- European sovereign debt.

As basic data series we chose:
- the European Public Real Estate (EPRA Europe) Total Return Index, the most comprehensive index of listed European real estate companies, as a substitute for an analysis of REITs performance;
- the DJ Euro Stoxx 50 Total Return Index, as a proxy for European equities;

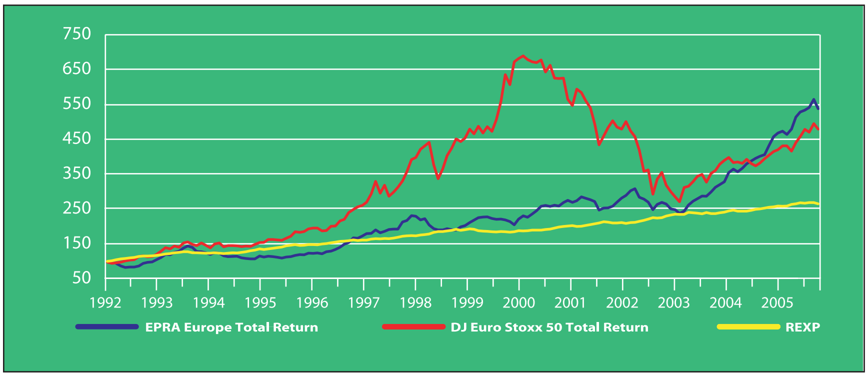

Figure 1: Performance of EPRA Europe Total Return Index, DJ Euro Stoxx 50 Total Return Index, and REXP (1992-2005)

- REXP as benchmark for investment in European sovereign bonds.

All indices include the assumption that dividends or coupons are reinvested at the time they are distributed. Figure 1 depicts the performance of these indices between 1992 and October 2005.

> *"Real estate investors should look for markets with favourable macro-economic conditions, ideally moderate economic growth and slowly rising interest rates"*

It is interesting to note that European listed real estate companies, as measured by the EPRA Europe Total Return Index, lagged the performance of European equities before 2000. After the giant market wave of the 1990s, the stock bubble burst in March 2000. European equities erased 60% of their value in the following three years, while listed European real estate and European bonds offered decent returns.

Starting in March 2003, the EPRA Europe Total Return index started its stellar outperformance versus the other two asset classes. To go beyond a graphical explanation of past returns and gain further insight, we conducted an analysis of return, risk and correlation characteristics of the EPRA Europe Total Return, DJ Euro Stoxx 50 Total Return and REXP between January 2000 and October 2005. We used monthly percent changes and analysed the time series data on a rolling basis. The results are shown in Table 1. Listed real estate companies had an astonishing 16.17% performance versus –4.65% and 6.09% for the DJ Euro Stoxx 50 Total Return and REXP, respectively.

In terms of risk, we calculated the standard deviation and worst drawdown. The latter comes closer to defining risk in a manner consistent with the way most investors actually perceive risk, that is the maximum loss in a given time horizon. EPRA Europe exhibits a negative correlation of –0.09 with bonds and a correlation of 0.52 with European equities, thus providing diversification benefits.

For further illustration, Figure 2 plots the risk/return profiles of the asset classes between January 2000 and October 2005. It presents compelling evidence that listed real estate companies offered investors a superior relationship between the two dimensions of risk and return.

The full set of data illustrate that in the recent past an investment in listed European real estate companies offered an attractive return while at the same time providing a valuable diversification potential to portfolios due to their low correlation to other asset classes with respect to their special risk/return characteristics. Listed real estate companies are enjoying an increase in desired real estate allocations from ageing populations requiring higher levels of income, lower volatility, higher transparency and liquidity.

	EPRA Europe TR	DJ Euro Stoxx 50 TR	REXP
Return analysis			
Number of months	70	70	70
Best month performance (%)	7.79	14.70	2.53
Percent profitable months (%)	68.57	51.43	72.86
Worst month performance (%)	–8.64	–18.64	–1.20
Maximum successive negative months	4	5	3
Average monthly return (%)	1.32	–0.22	0.50
Median monthly return (%)	2.12	0.32	0.60
Compounded annualised return (%)	16.17	–4.65	6.09
Maximum 12-month profit (%)	51.63	40.05	12.91
Minimum 12-month profit (%)	–18.75	–45.08	1.24
Risk analysis			
Worst drawdown (%)	–22.45	–59.90	–2.15
Annualised standard deviation (%)	12.44	20.35	2.93
Correlation analysis			
Correlations to EPRA	1.00	0.52	–0.09
Correlation to REXP	–0.09	–0.43	1.00
Correlation to DJ Euro Stoxx 50	0.52	1.00	–0.43

Table 1: Analysis of EPRA Europe Total Return, DJ Euro Stoxx 50 Total Return and REXP (January 2000 to October 2005)

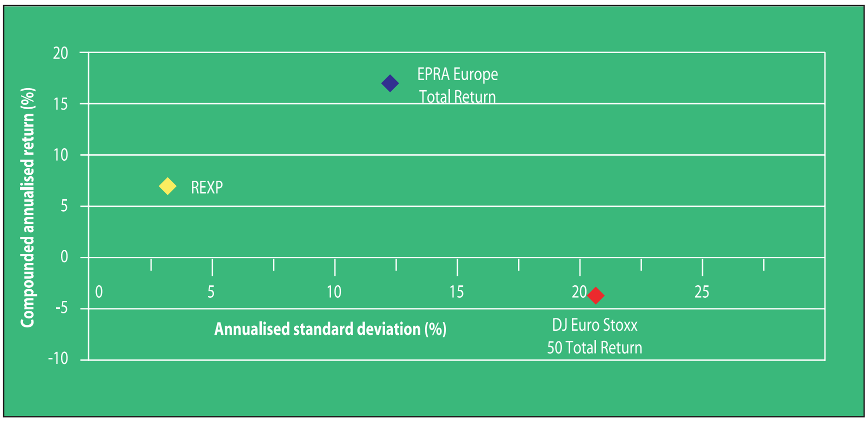

Figure 2: Risk/return scatter plot (January 2000 to October 2005)

German legislation will enhance REITs development in Europe

Early in 2004 the German Ministry of Finance made a statement on a possible introduction of REITs in Germany. This could occur as early as 2006 or 2007. Foreseen regulatory framework is expected to impose a specific dividend policy, and German REITs could possibly be forced to pay out at least 90% of profits. It is expected that they will be required to distribute rental profits to shareholders even in the event of losses on disposals. Furthermore, REITs will probably be forced to distribute capital gains if not reinvested within a two-year period.

Germany's listed property sector currently has a negligible market cap of only about €10 billion. There are about forty listed property companies, but only three are of international dimensions in terms of market cap and liquidity. Other real estate investment forms are more common, such as open-end funds (total

market cap: €88 billion) and closed-end funds (total market cap: €15–20 billion).

Some German open-end funds ran into a crisis at the end of 2004. As a result, the market had to cope with substantial outflows of funds. These funds might contemplate converting into REITs, which are more liquid than funds because they trade daily on stock exchanges.

REITs would be subject to stock exchange rules, forcing them to disclose more information about their holdings which, in turn, would provide investors better transparency. Additionally, German companies are characterised by excessive real estate holdings, which typically do not belong to their core businesses.

A possible REIT introduction might encourage property asset sales on a large scale without the need of having to pay prohibitive capital gains taxes. Indeed, the German government estimates that the country's 200 biggest companies own properties assets worth €60 billion. As a consequence of the aforementioned implications the German REIT market might grow to over €100 billion by 2010.

Germany has been flooded by US private equity firms, like Blackstone Group, Cerberus and Fortress Investments, which invested billions in German property in 2004 and 2005. This massive flow of funds might hint at a bottoming out of German real estate prices, which have significantly underperformed other property markets in all other countries in the past decade. House prices in the former West Germany increased below the rate of inflation from 1990 to 2004, which was 1.4% on average. In former East Germany prices declined by 2.6% per year from 1995 to 2004.

The UK already has one of the largest and most advanced real estate markets despite a lack of a REIT regulatory framework and aims to legislate for REITs in the 2006 Finance Act. The Italian government might also adopt a model in 2007.

What are the risks?

When REITs are introduced in Germany, for many investors it will be the first time they will have to conduct due diligence on REIT management teams – a challenging and arduous task. Additionally, REITs differ from country to country, so investors should be familiar with the regulations and design of the specific REITs. One concern is that the introduction of REITs in Germany in 2006 or early 2007 could lead to a rising supply of real estate that could damage prices over the following years and make planned exit strategies redundant.

The biggest risk for REIT investors would be a sudden sharp rise in interest rates as a result of unanticipated inflation. This would be particularly pronounced because current interest rates are at a multi-decade low. Higher interest rates lower the comparative attractiveness of REIT dividend yields versus bond yields and increase the cost of financing, thereby making certain real estate investments unattractive. Other risk factors comprise a strongly rising equity market, because this lures investors away from engaging in property investments, and deteriorating real estate market fundamentals.

Summary

In mid 2005 the spread of property yields over bond yields stood at a historically high level of 250 basis points. In contrast to open-end real estate funds and direct real estate investments, REITs provide more transparency, fungibility and liquidity, while offering a tax advantage. A REITs investor can also allocate broadly using smaller funds unlike a direct investor.

It would appear prudent to allocate part of a portfolio to REITs because they deliver a healthy stable income with less risk than usual stocks while achieving diversification benefits. However, investors could be faced with rising interest rates in the future. From the strategic asset allocation perspective, it may be expected that European institutional investors, such as pension funds and insurance companies, will gradually shift a certain part of their funds to European REITs. ◆

THE AUTHORS
Martin Hess is a Portfolio Manager, Berlin & Co, Frankfurt, Germany E-mail: MHess@berlin-co.com

Christian Kempe is a Portfolio Manager, Berlin & Co, Frankfurt, Germany E-mail: CKempe@berlin-co.com