Taking a public stand

More investors are discovering the advantages of listed real estate in their Asia Pacific portfolios

by Mard Naman

Institutional investors often ask which is better: listed or unlisted real estate securities in Asia Pacific. The short answer is they both have advantages — it is not an either/or proposition.

"It's about the duration of your investment horizon, that's the critical question," says John White, managing director and lead portfolio manager for Heitman's Asia Pacific real estate securities strategies. "If you can amortise your costs of going direct over a period of 10 to 30 years, then timing the cycle is probably not as important for you as an investor," he says. However, White says, if investors are getting into the listed market, then having an element of timing and having an understanding of listed valuations relative to their long-term trends and relative to NAV is a more important consideration.

The approach to public real estate varies with the cycle, according to Gek-lang Lee, managing director and portfolio manager with Pramerica Real Estate Investors (PREI), based in Singapore. "Listed real estate stocks generally provide an attractive form of investment during down cycles as they tend to get oversold, thus presenting an excellent value proposition for investors who are prepared to be contrarian," she says. Large sell-offs, in other words, can mean savvy investors will be able to pick up some good undervalued stocks. "Conversely, during bullish market conditions, they tend to become overpriced, thus giving the investor an opportunity to get an enhanced return," Lee adds.

One big advantage of the listed market: It gives investors the chance to own some of the highest quality real estate in Asia that in some cases has taken decades to assemble and may be impossible to replicate in the direct market, especially in gateway cities. "If you want to allocate money to institutional-grade real estate across Asia, much of the good stuff has already been bought," White says. If investors want exposure to Central in Hong Kong or Marunouchi in Tokyo, or even high-grade institutional shopping centres in Australia, assets are pretty much owned by the listed players. "They're in public hands, and generally, there's a sponsor such as a tycoon, a family or group of investors that will never, ever sell," White says.

Using listed as a benchmark

Asia Pacific investors are increasingly looking at listed real estate securities, particularly REITs. "One of the most noteworthy features of the last decade has been the proliferation of REITs," says Russell Platt, CEO of Forum Partners. REITs vary by governmental and regulatory design from country to country, but they generally share the same broad principles: tax redistributions of incomes, advantageous treatment of capital gains from sales of assets and distribution of capital gains to investors.

"Listed real estate can play an important role, and we've increasingly seen that institutions in countries such as Australia and Holland actually treat listed real estate as their baseline," Platt says. He sees the same trend happening in South Korea and Japan. "They view their index exposure as their listed holdings, and private real estate plays a supplementary role," he adds.

Public real estate securities, because of their liquidity, are attractive to those investors set up to time the market. But long-term players who are going to buy and hold rather than time the market also are moving increasingly to public real estate, according to Platt. "Many New Zealand and Australian funds have decided that public is going to be their benchmark," Platt says.

Platt recently had a candid conversation with the head of real estate for a major superannuation fund from that region. "He told me if he's shown a private investment proposition, the first thing he does is scour the existing listed market to find if there's any place he can get that exposure synthetically through a public company," Platt says. "And if he can, that private alternative is immediately eliminated from consideration."

But what about corporate governance issues with public real estate securities in Asia Pacific? "I think most of these folks would prefer to put their fates in the hands of a public board with public scrutiny and public transparency than into a purely private vehicle, all else being equal," Platt answers.

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Russell Platt
Forum Partners

This might seem like an extreme proposition to some. It is the opposite of how most US institutional investors view their real estate portfolios, where direct is primary. But it is important to remember that the public markets have always played a more important role in the capital formation process in Asia than in Europe or the United States. Listed developers are few and far between in the United States and trade at pretty big discounts to their value.

"By contrast, development companies play a very important role in the listed sector in Asia," Platt says. "The big listed property development companies dominate the development skyline, literally, in markets like Tokyo and Osaka," he adds. Residential and commercial development business in China is conducted largely through listed companies — although state-owned enterprises (SOEs) and private developers are also involved — and listed developers also dominate in Hong Kong, Singapore, Indonesia and India.

Platt believes using public real estate as a benchmark with private in a supplementary role

Central business district, Hong Kong

is a viable approach for some long-term investors. "We're concerned about short-term volatility, but if you buy into a REIT, you're getting a high disposable distribution of 4 percent to 8 percent," he says.

For investors with a 20-year horizon, "you're going to get your money back and more just in dividend distributions over that 20-year period," Platt says. "You're playing with the house's money." Compare that to a private vehicle, where there might be a low initial distribution, and the return comes in the form of capital gains. "You've de-risked your investment. It's almost as if you're amortising your principle," Platt says. "That's the way a lot of these funds think about it."

Of course, this analysis makes more sense if an investor is buying into REITs, not public developers. Public developers do not have to pay dividends and may plow their profits from a successful development into a risky new development. "That's why it's no surprise that the proliferation of REITs has really gone hand-in-hand with this growing respect and acceptance of the public markets as a viable tool for executing a real estate strategy," Platt says.

Listed leading the way for private

"As a general rule, listed real estate markets are leading indicators of the private real estate market, somewhere between one quarter and four quarters," says Heitman's White. As an example, he mentions how the public markets priced in some cap rate compression in the United States early this year before it actually happened in the private markets. "In Australia and Japan, we're already seeing REITs trading at premiums to their NAV, primarily because there's an expectation that the cap rates of the underlying assets will compress," he says.

Listed real estate securities lead the way for several reasons. First, direct real estate transactions are far less frequent than listed transactions, so changes in valuation of direct property holdings usually occur with a lag time. And because the listed market is so liquid, "it is able to immediately respond to any change in market fundamentals, or even any indication of a potential change in market fundamentals," says PREI's Lee. Also, government policies play an important role in Asian real estate markets. "Usually, there are hints of policy directions ahead of their implementation, which are rapidly picked up by the equity markets," Lee says.

While listed real estate is more volatile than direct, over time the valuations of listed real estate will not stray too far for long from the value of its direct cousins. That is because listed real estate securities are still based on real property and real property values underneath. White says the 10-year return is roughly 10 percent on

listed real estate securities, and it is about the same for private real estate (within 1–2 percentage points). "But how you get there — it's a very different kind of ride," he notes.

In other words, if you can ride out the cycles for a decade, the total returns for public and private real estate may look quite similar, but in the interim the listed securities will provide a much bumpier ride because of substantially higher volatility. "The volatility of publicly listed real estate in Asia is higher than the rest of the world," White says.

But Forum Partners' Platt thinks this volatility may be misunderstood, especially among US investors. He says there is a sense among US investors that property stocks have a lot of random noise that is not representative of the underlying trends in real property markets. "That's been a function of the smoothing of private market valuation appraisals," he explains. Plus, public real estate securities can be linked in the very short run with small cap stocks that are not real estate related.

"But the fact is, in the Asia Pacific region, real estate stocks do show cyclical patterns, and that pattern is a manifestation of what is going on in the underlying direct market," Platt says. However, it is important to remember that the underlying markets in Asia are also much more cyclical than those in the United States. They are shorter and sharper, and the public markets reflect that.

Keeping a close eye on the public markets is vital. "Even if you're not going to be an investor in the public markets in Asia, you ought to really pay attention to what's going on because they're a great weather vane that tells you which way the wind will be blowing," Platt says. "If you disregard the signals in the public markets, you do so at your own risk."

Direct sometimes preferred

When does it make most sense to make direct investments? "When investors think about direct, increasingly they're saying they want to do investments they couldn't otherwise do in the public markets because the public markets are such an easy way to get access," Platt says. At a minimum, when public real estate is expensive, then investors will do direct.

There are several situations where direct may make more sense. First, it may be better in small emerging markets, where liquidity is a frequent issue. "It's a little tougher to play in the public realm in Vietnam or Indonesia," Platt says.

"Generally, in emerging markets people are always rushing in and rushing out at pretty much the same time, so you can have liquidity problems if you try to move a lot of stock in a short period of time," White adds.

Second, an investor may want to invest in a property type that isn't really represented well in the public markets, such as retail in South Korea. Third, an investor may wish for a risk/return basket that is not readily available in the public markets. "Let's say I really like the mezzanine market's risk/return basket, but there are no listed mortgage REITs," Platt says. "I'm going to do that through a private manager, private vehicle or separate account, but I can't get that on my own in the public markets."

A 50-50 blend?

While global investors' portfolio mixes vary dramatically, the US-based National Association of Real Estate Investment Trusts (NAREIT) reported in 2011 that "the past 22 years of historical data show that an optimally blended portfolio including approximately one-third in REITs has provided stronger returns, even on a risk-adjusted basis, than portfolios dominated by private real estate investments." Of course, NAREIT's report looked at US REITs, but it raises the question: Could the same "blend" be optimal for Asia?

Interestingly, the ratio in many Asian funds is actually higher. "In Australia, which has the longest dated real estate allocations from superannuation pension funds, the spread is generally 50-50 between public and private," says Heitman's White. "In terms of asset allocation models, consultants generally have a more equally weighted blend between the two," he adds. One proviso: White says big industry or state-based pension funds often have a higher weighting to direct over listed. "They're probably doing that to minimise the volatility," he says.

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John White
Heitman

The balance between public and private in individual investors' portfolios varies according to many factors. "Part of it is where you're domiciled," Platt says. "If you're based in the region, you might feel more comfortable doing more direct, whereas if you're from outside the region, it sure is easy to get that exposure through the public markets."

The risk-adjusted return for public real estate is not as compelling an argument in Asia as it may be in North America, White believes, though he says the risk-adjusted returns for Hong Kong and Singapore REITs are actually quite strong. "The reason you want to hold Asian real estate securities is to have exposure to some of the best quality real estate in key gateway markets like Singapore,

Hong Kong, Tokyo and Sydney, which you probably couldn't replicate elsewhere," White says.

Over the longer term, White says you should look for slightly higher returns for listed REITs or listed real estate securities over the private market. "You need some kind of compensation for the volatility," he says. "But at the same time, you're getting liquidity. You can liquidate US$200 million worth of securities in a couple of days. Obviously, you can't do that on the private side."

Real estate securities also allow investors to get a diversified portfolio easily. White says investors can get a portfolio diversified across the major economies in the region with a few hundred million dollars. Platt adds that if investors have a 50-50 mix, they have the ability to tactically adjust their portfolio because they have liquidity, are in a good position to manage their exposures across cycles and can get asynchronous markets — for instance, the markets of India and Japan have fundamentally no correlation.

White concludes that public and private real estate are complementary asset classes. "The reality is that the valuations of the securities don't deviate too far away from their fundamental values, adjusting for corporate governance factors," he says. And if they do deviate too far and too long, White says either private equity comes in and takes a company private or there is M&A activity.

Liquidity versus governance

However appealing it is to get exposure to the best quality real estate through public securities, minority investors give up some control in exchange. "If you're a minority owner investing in Hongkong Land [a major public developer], you don't have the ability to influence decisions in terms of strategy and buying and selling of real

Most desirable public markets

Which Asia Pacific markets offer the best choice of REITs and other listed real estate securities? John White, managing director and lead portfolio manager for Heitman's Asia Pacific real estate securities strategies, believes China and Hong Kong present good value for investors at this time. In China, the listed real estate market consists of public developers because China has no REIT structure yet.

"China has my highest conviction right now, as the economy is picking up reasonably strongly," White notes. He says buyers have come back to scoop up housing from developers' stocks. Buyers have more confidence, financing is more accessible, and developers have started to replenish their land banks — all positive signs.

"We're confident we're going to get 10–15 percent growth rates in the top-line Chinese developers," White says. "That should translate into similar or higher levels of net profit or earnings growth," he says. For sectors, he likes retail and residential in China, depending on where the assets are located and the price points. "As a cyclical play right now, Chinese developers are looking reasonably attractive," he says.

"In terms of valuation, Singapore REITs remain among the most attractive," says Gek-lang Lee, managing director and portfolio manager with Pramerica Real Estate Investors. But Lee says this is less true in terms of structure and corporate governance. "The payout ratio is too high, as some REITs pay out in excess of 100 percent," she says. "Also, there have been too many real estate acquisitions by REITs which are structured with income support, thus artificially boosting the acquisition yield," she adds.

Despite this, White says the corporate governance standards in Singapore are probably the highest in the region. Foreign investors looking to invest in China through REITs can best do so through Singapore. "Singapore is the original hub for REIT cross-border investing," he says. There are also two REITs listed in Hong Kong that have exposure to China.

Japanese public developers had a fantastic run in 2012, but the party may be winding down. White says Japanese developer stocks were up about 35 percent in fourth quarter 2012, and year-on-year they are up close to 80 percent. "There's been a real strong rally in Japan, but that valuation support is now gone," he says. However, while valuation support may be gone, White notes "top-down drivers are still working constructively for Japan."

The Bank of Japan's Asset Purchase Programme includes REITs, and that has helped put a floor on the J-REIT sector. But while there is not much downside to that market, there also does not appear to be a lot of upside in the near term. "We think the recovery in the underlying markets is still a long way away," White says. "The REITs still have rent roll-downs in their portfolios, and rental growth has only really been experienced in the small downtown Marunouchi area in Tokyo. You can't go too far until you actually start imputing some rental growth in the portfolios," he concludes.

— Mard Naman

Bunkyo Ward, Tokyo

estate," White says. "You're going along for the ride, and you're never really sure whether your motivations are aligned with the major investors or management interests."

Investors need to understand the regulatory regimes in which they are investing. These regulations vary widely from country to country, and investors also need to know the motivations of sponsors or key stakeholders, White believes.

White says corporate governance concerns exist in almost every market. In Hong Kong, for example, investors might be investing side-by-side with a family or a tycoon who may have completely different motivations about what they want to achieve out of holding their stock. "We're seeing families that are more in the asset-protection phase of their wealth management strategy. They won't be taking high risk in development, but will be investing in more yielding-type assets," White says. For some Australian REITs, "the level of remuneration of the board of directors and senior management had just gotten out of control," he adds. And in Japan, J-REITs generally have external managers owned by sponsors, and are motivated to grow the assets under management and not necessarily grow the earnings profile, according to White.

Investors in public securities must constantly perform a balancing act. "I'm balancing liquidity versus governance," White says. He says real estate companies with high levels of governance, transparency and liquidity will see their stocks trade around their intrinsic underlying real estate value or even at a premium. By contrast, investors generally take a discount to the underlying intrinsic value in markets with limited liquidity in the listed space as well as conflicts of interest with major investors, low transparency or questionable corporate governance.

The bottom line

Whether Asia Pacific investors are trying to time the market or they are long-term players, listed real estate securities are playing an increasingly important role in their portfolios. Some are now using listed real estate as their benchmark. While listed has much more short-term volatility, listed and unlisted achieve comparable returns over periods of 10 years or more.

Listed and direct real estate are complementary asset classes, and it makes sense to have a strong blend of both as a strategy for foreign investors in Asia. A healthy portfolio would then have exposures across geographies and corporate structures, across a spectrum of control, liquidity and volatility. Questions always exist about the corporate governance in particular markets and particular companies, and investors need to dig into the particulars before jumping into public real estate securities. ❖

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