LISTED OR PRIVATE REAL ESTATE?

Max Arkey
Vice President
Product Management
MSCI Real Estate

Summary

Two roads lead asset owners into real estate: the private (direct and indirect) ownership route and the public equity route. With private assets, investors can analyze performance in detail, down to the asset and vehicle level. However, listed real estate, which includes public Real Estate Investment Trusts (REITs), rarely offers that level of data, making it very difficult for asset owners to monitor a seamlessly integrated portfolio consisting of both private and public assets. This divergence is taking on new importance because of two key developments. First, the upcoming reclassification of real estate in August 2016 into a separate sector within GICS® may draw greater attention and scrutiny to real estate securities. Second, the gradual globalization of the real estate investment market may lead institutional investors to look to international listed real estate as a simpler and often liquid way to diversify their real estate portfolios geographically, rather than purchasing individual properties or holdings in private unlisted funds in various markets.

Listed Real Estate as a Share of the Equity Market

The weight of listed real estate companies within the total equity market has increased considerably in the past 16 years (Exhibit 1). This rising weight, along with lower correlations with other listed financial sector firms, contributed to the decision to move real estate into a separate sector within the GICS classification. Listed real estate's increasing size and market share has been notable in Europe; however, the sector still is relatively small compared to the other regions.

Despite its growing prominence, institutional investors treat listed real estate differently in their asset allocations: Some consider listed property to be part of the real estate allocation while others see it as merely another part of their equity exposure.

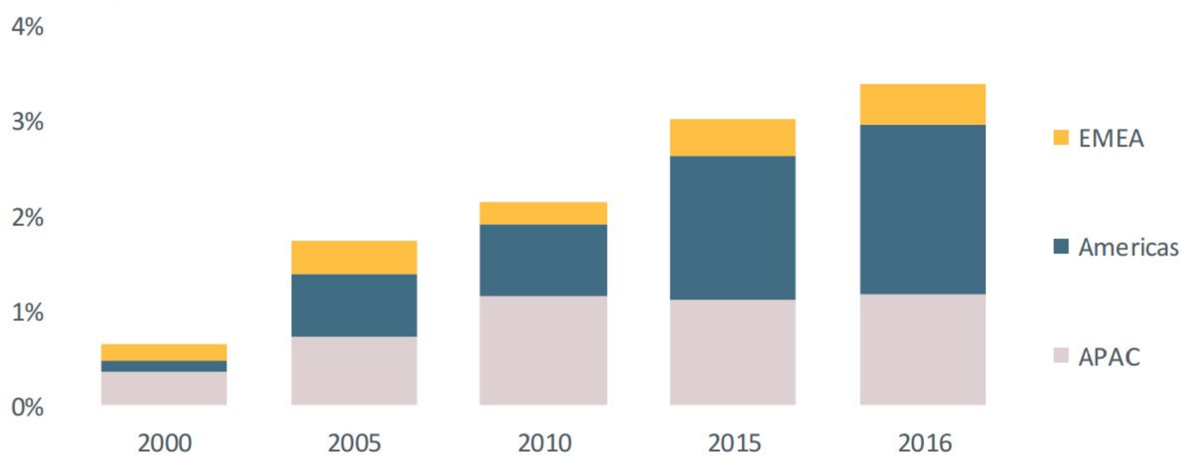

Exhibit 1: Evolving Weight of the Real Estate Industry Group (in ACWI across regions)
Source: MSCI
Weight (% in MSCI ACWI index)

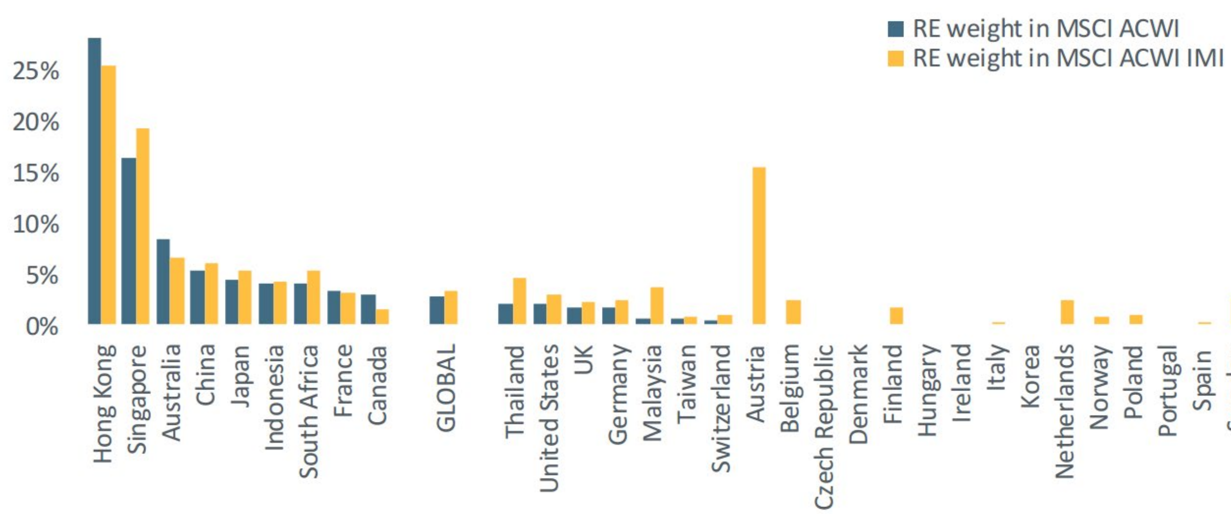

Exhibit 2: Listed Real Estate as a % of Total Equity Indexes, December 2014
Source: MSCI

Exhibit 2 compares listed real estate weights in 31 countries against two global equity indexes, the MSCI ACWI Index and the broader MSCI ACWI Investable Market Index (IMI), as of December 2014. In general, Asian markets held the highest real estate weights, particularly Hong Kong and Singapore; real estate companies in those city-states tended to own significant non-domestic assets, especially in China and other countries in that region. The only European country where listed real estate firms held a weight larger than 5% in one of the two global equity indexes was Austria, due to listed companies having a large nondomestic exposure in Central and Eastern Europe. There were far more real estate companies in the broader MSCI ACWI IMI than in the MSCI ACWI Index, reflecting that these firms generally are smaller than companies in other sectors. As of October 2015, Austria, Belgium, Finland, Italy, Netherlands, Poland, Spain, and Sweden, for example, did not have real estate firms meeting the minimum threshold of $5 billion in market capitalization for inclusion in the MSCI ACWI Index (MSCI, 2016). However, those countries had plenty of smaller companies included in the MSCI ACWI IMI Index.

Listed Real Estate as a Share of the Managed Market

Many institutional investors view listed real estate as part of their overall real estate exposure and thus evaluate those holdings against real estate benchmarks. Thus, comparing listed real estate to the professionally managed real estate market has merit. Exhibit 3 shows listed companies as a proportion of the professionally managed real estate investment market by country. Again, we find that listed companies are significant players in Asia, but much less so in Europe, where the only country for which the proportion of the managed market owned by listed companies exceeds 30% is Sweden. That uneven situation exists because the European market is dominated by relatively large asset owners with direct portfolios, including insurance companies, pension funds, and sovereign wealth funds (SWFs). Unlike Asia, Europe also supports a relatively large unlisted fund sector. Some differences in the data may have a bearing on performance attribution analyses. For example, some countries may appear under-represented in Exhibit 3 because the proportions shown are based on the actual location of the

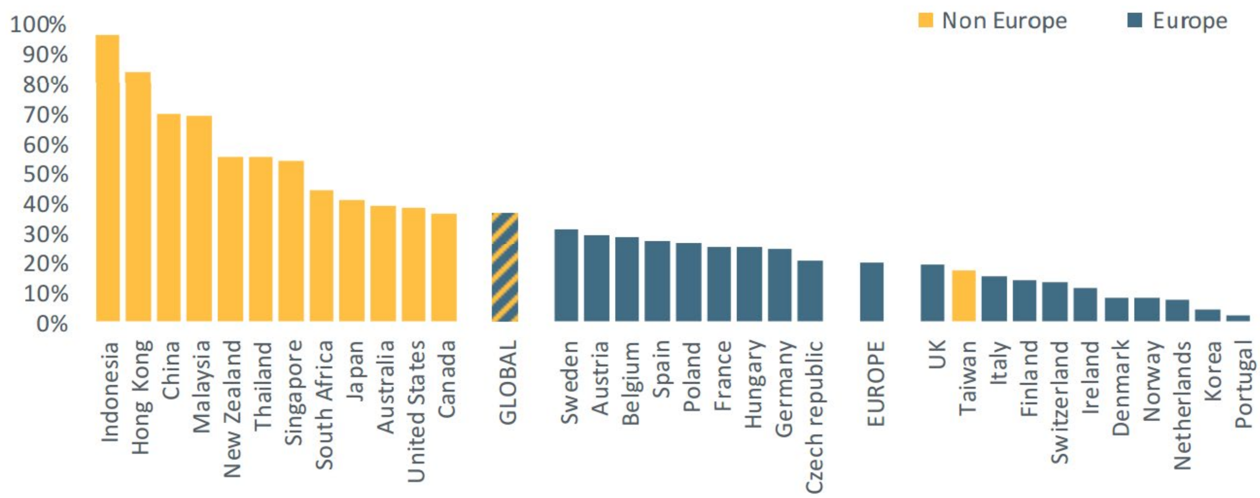

Exhibit 3: Listed Real Estate as a % of Total Professionally Managed Market, 2014
Source: MSCI

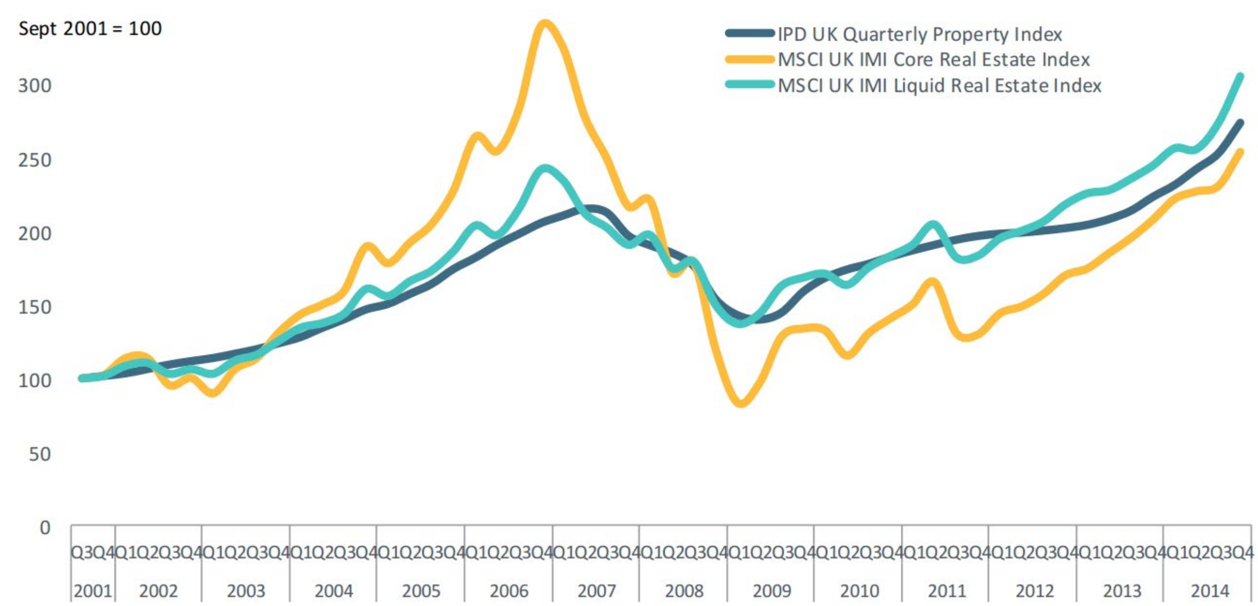

Exhibit 4: Listed vs. Direct Real Estate Performance in the U.K.
Source: MSCI;

assets owned rather than the country of listing for the real estate company, e.g., real estate companies listed in the Netherlands held relatively large proportions of non-domestic investments. At a global level, over 85% of listed real estate holdings are located in the country of listing. In Europe, the average level is only slightly lower (82%). In some countries, such as Germany, Spain, Sweden and Switzerland, the home bias ratio exceeds 95%; in others, such as Austria and the Netherlands, domestic holdings fall below 40%.

The Research Landscape

In theory, an asset owned by a listed company should be indistinguishable in performance from an equivalent privately owned asset. In practice, however, this comparison has been difficult to quantify, as researchers and equity analysts have discovered. One approach to comparing performance between listed and private assets has focused on long versus short time horizons. Share prices of listed companies are affected by volatility in the stock market, while underlying real estate values are subject to infrequent appraisals. As a result, correlations between the listed real estate and direct real estate are relatively low, particularly in short time horizons. The noise and volatility of continuous equity pricing clashes with the smoothed and lagged nature of periodic appraisal valuations. To correct for this, attempts have been made to substitute transaction-based indexes for valuation based indexes in some markets. The more sophisticated the studies become, the higher the correlations between listed and direct performance. Recently, MSCI developed new indexes that mimic the performance of direct real estate by seeking to reduce volatility and deleverage the listed index. This methodology is now applied in the MSCI USA IMI Liquid Real Estate Index and the MSCI UK IMI Liquid Real Estate Index. As can be seen in Exhibit 4, the Liquid Real Estate Index more closely tracked the performance of the IPD® UK Quarterly Property Index (a direct property index) than the MSCI UK IMI Core Real Estate Index (which tracks real estate stocks) during the sample period.

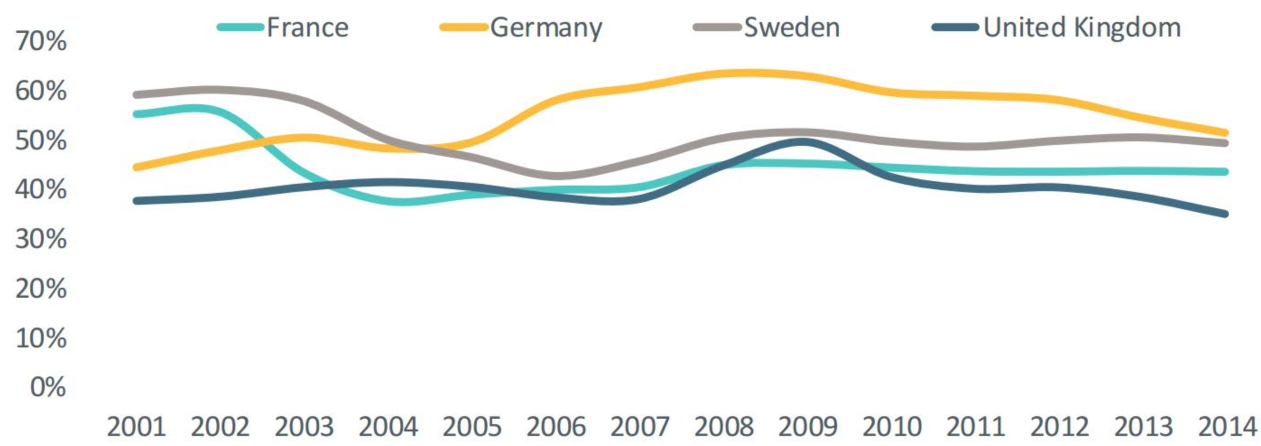

Exhibit 5: Average Loan-to-Value (LTV) Ratio for European Listed Real Estate
Source: MSCI

How Do Corporate Strategies Differ?

The main elements of the real estate strategies related to allocation (property type and geographic focus) and management decisions (leverage and development exposure).

Allocation Decisions

- *PROPERTY TYPE.* Listed real estate companies in the U.S. often diversify across regions, states or metropolitan areas, while focusing on one property type. This approach is less common practice in Europe, though a few listed companies do favor a similar national and sector focus, centering on the retail, office, residential, industrial, healthcare or hotel/resort sectors. The forthcoming GICS classification will follow sector specific classifications, further institutionalizing a sector-specific framework within the listed environment.
- *GEOGRAPHY.* Unlike the U.S., European countries are smaller and more densely populated, prompting many listed companies to opt for geographically focused strategies diversified across property types [Global Securitized Real Estate Benchmarks and Performance, 2009].

Management Decisions

- *LEVERAGE (GEARING).* Leverage can have a huge impact on returns for both direct and listed real estate. While direct real estate performance is measured free of leverage at the asset level, vehicles can have significant leverage. Commingled (unlisted) real estate funds vary in the use of leverage. Funds with a low leverage are referred to as core funds, while those with relatively high leverage are referred to as value add or opportunistic funds. The PREA/IPD U.S. quarterly property fund indexes (produced at the core fund and all-fund levels) show how leverage can have a positive impact on fund returns in periods of cyclical expansion but a negative impact during down cycles. The level of leverage has also produced an overall impact on performance volatility. For European listed real estate, the use of leverage as a strategy varies, with loan to-value ratios ranging from 40% to 65% at a country level (Exhibit 5). Although leverage is one of the main drivers of risk at the vehicle level, few listed European companies incorporated a flexible view on the use of gearing. This lack of flexibility leaves investors potentially vulnerable. Vehicles offered by listed companies may have embedded very different risk levels which can impact performance significantly across the real estate cycle.
- *DEVELOPMENT EXPOSURE.* Active management can range from the cautious, such as a focus on long-term leases, to the speculative, such as greenfield property development. Other strategies, such as active lease-up, refurbishment, privatization of residential units, expansion and redevelopment, lie in the middle of the risk spectrum. Development property garners little space in the balance sheets of listed companies in Europe. Exposure to development averages approximately 5% of total assets, and this ratio differs considerably across countries. Opportunistic development strategies can lead to higher returns, but this is coupled with elevated risks.

Conclusion

The conundrum for investors is that real estate companies tend to provide data at the company (security) level, but relatively few are transparent at the asset (individual property) or vehicle (fund) level. Instead, most listed companies compare their performance to equity market benchmarks. While such benchmarks make sense for passive equity market investors, many institutional investors could benefit from participation of listed real estate companies in established real estate benchmarks. This way, institutional investors could explain the impact on performance of market and property type, show the impact of debt and active management at a vehicle level and isolate and quantify market sentiment.

Dynamics in performance between listed and unlisted real estate has been widely researched from a top-down perspective. Several remedies to close this gap have been proposed, most recently with the birth of the 'liquid real estate index'. Research now needs to shift to a complementary bottom-up approach, focusing on granular attribution analysis and reconciliation across asset, vehicle and security levels. This approach will assist sophisticated investors to better integrate their real estate allocations across multiple asset classes. In short, a solution needs to be mapped that can show quantitatively how much of a listed real estate firm's return is attributable to fundamental property performance at the asset level, how much is contributed by debt and active management decisions at the vehicle level and how much of the remaining performance is explained by market sentiment alone at the security level. In the current environment, asset managers and asset owners lack the fundamental tools needed to analyze their listed real estate portfolios properly. This situation leaves them ill equipped to make strategic and tactical allocation decisions.

The next Global Intel update will lay out a methodology that enables institutional investors to assess exposure across both listed and unlisted real estate. By peeling away market sentiment at the security level and active management decisions at the vehicle level, the underlying performance of the assets — including net operating income (NOI), NOI growth, capital growth, yields and income risk — can all be compared seamlessly and like-for-like across a global portfolio of listed and unlisted holdings.

Author's Bio

Max Arkey
Vice President
Product Management
MSCI Real Estate

Max Arkey works in product management at MSCI Real Estate where he heads up indexes and market information products. These analytics are mission critical to the investment process for 19 of the top 20 largest global asset managers, all the way through to specialized domestic investors.

For further details contact: max.arkey@msci.com\

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