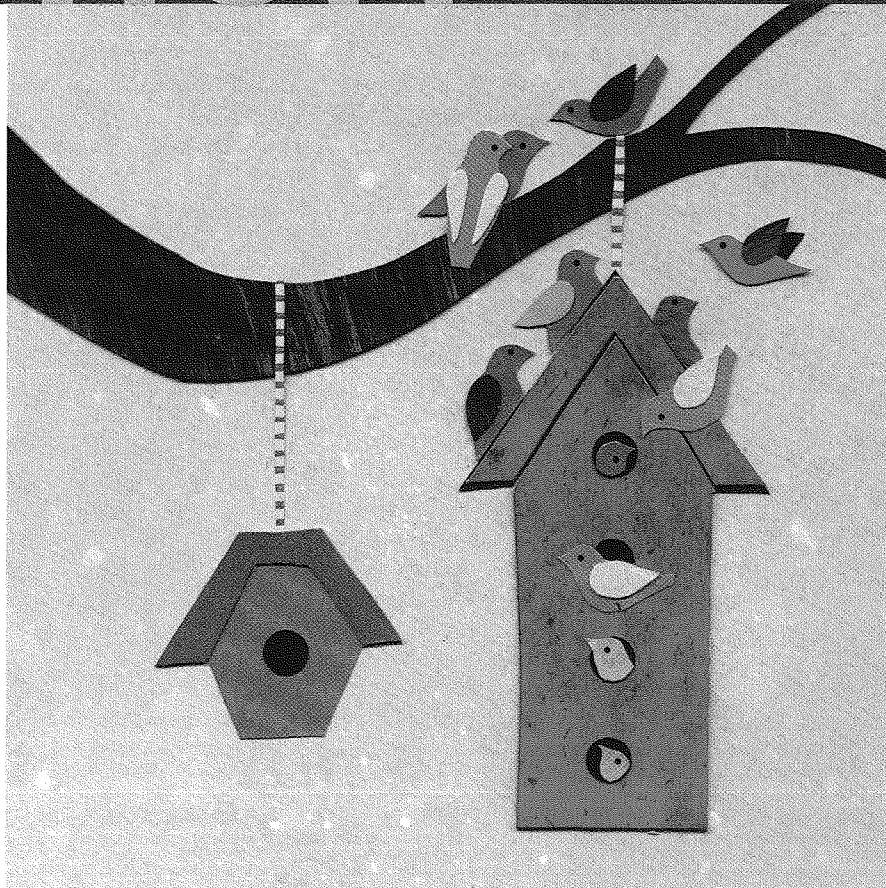


UNDER CONSTRUCTION



ASHLEY BARRON

While private real estate struggles, public real estate begins to rebound.

BY JERRY MOSKOWITZ

After a rocky end to 2008 and a tumultuous market environment through Q1 2009, individual and institutional investors worldwide are examining their portfolios closely—assessing losses, identifying opportunities and looking for signals from the marketplace on what may be next. Equity markets have improved, and there have been optimistic whispers that the worst may be behind us, but the state of commercial real estate still weighs heavily on the minds of active investors in that market. With average allocations to real estate in institutional portfolios ranging from about 8% to 15%, the size of these investments is enough to suggest that real estate, although often viewed as an alternative investment, is treated as a core element in many institutional portfolios.

Private Versus Public Markets

For portfolio allocation purposes, “real estate” refers to income-producing commercial real estate as opposed to the residential housing market. There are two markets for commercial real estate: the private market and the public (listed) market. The private market is much larger than the public market. It involves the purchase of commercial property through direct investment or private equity pools on the equity side, or the purchase of credit derivatives such as commercial mortgage-backed securities (CMBS) on the debt side.

The performance of private commercial real estate is still rather dismal, as fundamentals across all property types remain poor. With high levels of unemployment and weakening demand from consumers, income from rentals has been declining and vacancy rates have been increasing. Hotel properties have also experienced significant pressure on revenues with record-low occupancy rates. The recent market downturn has left banks unwilling to lend, and

the CMBS market is basically closed, which has made the financing and refinancing of real estate properties nearly impossible. As debts mature, this illiquidity has forced distressed sales and hurt property values.

Publicly listed commercial real estate consists of real estate companies that own and manage properties and list on public stock exchanges. Real estate investment trusts (REITs) are the most common example of this type of real estate. As in the private real estate market, investors can gain exposure through debt and/or equity. They can purchase these companies' stocks or bonds directly, or through mutual funds.

Leading Relationships

It is relatively easy for investors to move in and out of such holdings because they are tradeable, whereas private property investments are highly illiquid. Because of the inherent liquidity of listed real estate, its performance tends to lead private real estate—both on the way down and in recovery. This is often referred to as the lead/lag relationship between public and private commercial real estate.

“Returns in the private real estate market lag behind returns in the publicly traded REIT market by an average of 15 to 18 months,” says Meredith Despina, vice-president of investment affairs and investor education with the National Association of Real Estate Investment Trusts (NAREIT). “[However], the lag is not constant at all phases of the market cycle. REITs tend to complete their downturns very quickly and recover quickly, while private property values take a long time to reach their bottoms and a long time to recover from them.”

Despina explains that the private market tends to reach its peak roughly 12 months after the REIT market but tends not to reach its trough until approximately 30 months after this market has bottomed out. For example, during the last major commercial real estate recession, equity REIT prices peaked in August 1989, troughed in October 1990, and recovered fully by March 1991. Meanwhile, private prices didn't peak until Q3 1990, didn't trough until the Q4 1992, and didn't recover fully until the Q2 1995.

There are four reasons for the lead/lag relationship. One, REIT investors anticipate future developments in the underlying real estate market, just as the stock market anticipates future developments in the general economy. Two, even after buyers and sellers in the private market negotiate a transaction price for a property (on the basis of current information about the real estate market), it

is generally several months before the transaction is finalized. Three, after transactions close, there is another lag of several months before data on comparables are incorporated into the appraised values of non-transacting properties. Four, there is also a final reporting lag. The NCREIF Property Index, for example, doesn't appear until roughly six weeks after the end of the quarter it values.

Positive Performance

The REIT market seems to be well past the downturn still buffeting direct real estate. Listed real estate stock prices continue to rise and have shown dramatic improvement after having lost 73% in total returns since their previous peak on Feb. 7, 2007. As of October 2009, U.S. equity REITs gained almost 103% since hitting their trough on March 6, 2009. While U.S. REITs are still down 50% from their 2007 peak, in Q3 2009, the FTSE NAREIT All-REIT and Equity REIT indexes posted their best-ever quarterly gains since their inception in 1973. And across all major geographic regions (including Europe, the Middle East, Africa, Asia-Pacific and North America), the indexed value of public real estate companies has risen more than 77% since the end of March 2009. Likewise, listed properties in the Asia-Pacific region have realized close to 76% increases, on average, since that time.

Another positive signal is the \$23.6 billion in new capital raised by U.S. equity REITs this year. This includes 78 secondary equity offerings totalling \$21.1 billion and eight initial public offerings totalling \$2.6 billion. Additionally, U.S. REITs have raised \$6.7 billion through 22 unsecured debt offerings. The market is rewarding these equity offerings. REITs have had average gains of 1.25 percentage points in stock price on the day of the secondary equity offerings, relative to the publicly traded REIT market on the same day.

This recapitalization means that REITs have been able to tap the public equity markets, using funds to pay off debt and strengthen their balance sheets. It also puts them in a good position to take advantage of the sale of distressed properties—something the private side of the market cannot easily do. REIT prices seem to be anticipating this coming opportunity for REITs to pick up assets at favourable prices.

Proceed with Caution

Of the average 8% to 15% allocation to real estate in institutional portfolios, typically, only a small slice (about 6%) is currently allocated to public real estate globally. Many large institutional plan sponsors view commercial real estate as a core asset class—one that has historically contributed diversification and solid long-term investment returns to their portfolios. Jean-Louis Ponce, director of risk management and quantitative analysis in the pension asset management group with Bombardier, is among them. He uses REITs to access the global real estate market and measures their performance against the FTSE EPRA/NAREIT Global Real Estate Index benchmark. The purpose, he says, is to improve the risk/return ratio by adding an asset class that protects against long-term inflation.

Ryan Kuruliak, vice-president with Proteus Performance Management, says that of his clients who invest in real estate, the majority use pooled (private) vehicles. “We have seen some concerns from plan sponsors regarding the drying up of liquidity in some investment products that have direct holdings of real estate,” he says. “On the other hand, although publicly listed real estate may be more transparent and liquid in comparison, it also has a high correlation to the overall equity market, which can diminish its diversification benefits.”

Recent industry news indicates that a number of plan sponsors have increased their allocations to commercial real estate from a strategic standpoint, as well as to capitalize on current values in the marketplace. Kuruliak advises pension plan sponsors and endowment or foundation investment committees that are considering real estate investment to become educated about the unique characteristics and constraints of this asset class, including the fundamental difference between public and private real estate.

As investors review their asset allocations in light of the current economic environment, real estate will continue to gain attention. Many are considering how their portfolios should be repositioned based on lessons learned from the credit crisis, including how to tactically capture new opportunities owing to financial market dislocations. But even among those with capital to invest, a wait-and-see approach has been the norm. News of the private market will likely continue to include weakening fundamentals, illiquidity and distressed property sales; however, public market real estate companies are in a unique position to lead future recovery. ■

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