CITY OF LONDON
Investment Management Company Limited

An Opportunity for Listed Real Estate over Private Real Estate?

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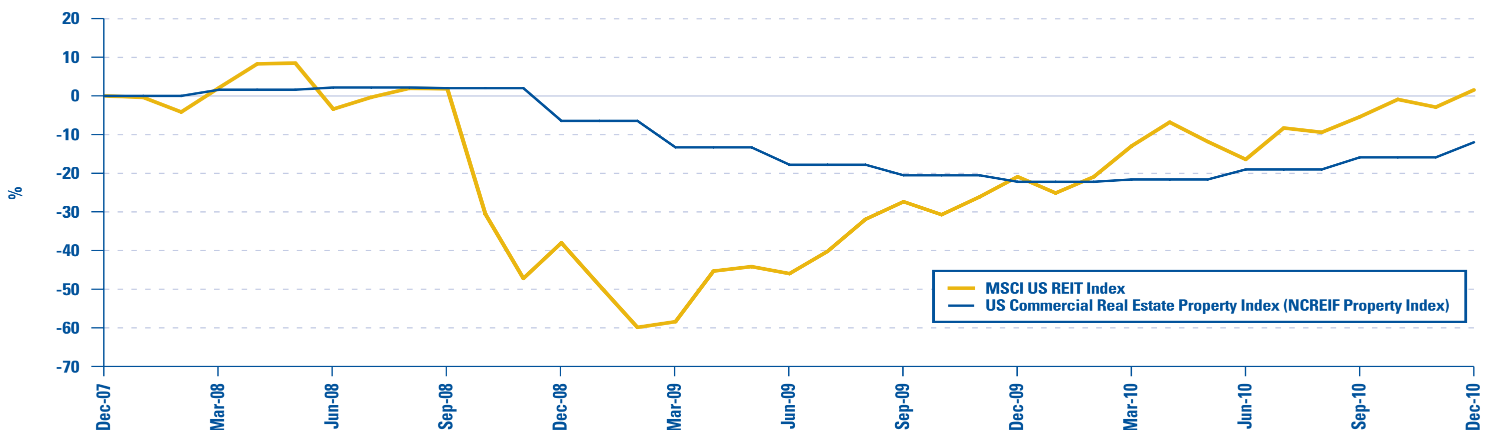
The issues we hear regarding a number of well known open-ended commercial real estate funds around the globe have again highlighted the benefits of listed real estate. We believe REITs/listed real estate should play an important role in a balanced portfolio's allocation to property. The liquidity of listed real estate allows investors to easily move their allocation over or underweight, and between regions and sectors cheaply and efficiently. They are also often the only way for investors to get access to prime real estate in certain geographies, i.e. the easiest way to get exposure to prime malls in the US is through REITs (as they own a significant proportion of these assets). Another example would be prime Tokyo office space. Other than the large Japanese companies that own their offices the only way to get decent access to the prime Marunouchi district in Tokyo would be through Mitsubishi Estates, and the same scenario is true across emerging markets as well.

The issue with liquidity is that it makes listed real estate/REITs more volatile than direct/private real estate in the short term. However, this is only because they are priced daily on a stock exchange. Remember in the long run they will trade in line with their underlying assets, and are a very tax and cost efficient structure. This provides an opportunity for investors as they can benefit from short term dislocations between share prices and net asset values (NAVs) to buy companies' at historically large discounts and sell them when their discounts have narrowed, or ideally when they are trading at premiums. Benjamin Graham put it best 'in the short run the market is a voting machine, but in the long run it is a weighing machine'.

Green Street Advisors put it perfectly in a recent note when they said that some investors in the institutional real estate market have a vested interest in the 'volatility laundering' private real estate funds provide. i.e the monthly or quarterly pricing to NAV leads to a 'seemingly' much lower volatility that helps when creating portfolios for clients.

Another point that is very relevant today is that looking back over history we normally see that the listed real estate market pricing usually leads the physical real estate market by 3-6 months. The period over the GFC shows this clearly:

Chart 1: US Commercial Real Estate Property Index (NCREIF Property Index) versus the MSCI US REIT Index December 2007 to December 2010

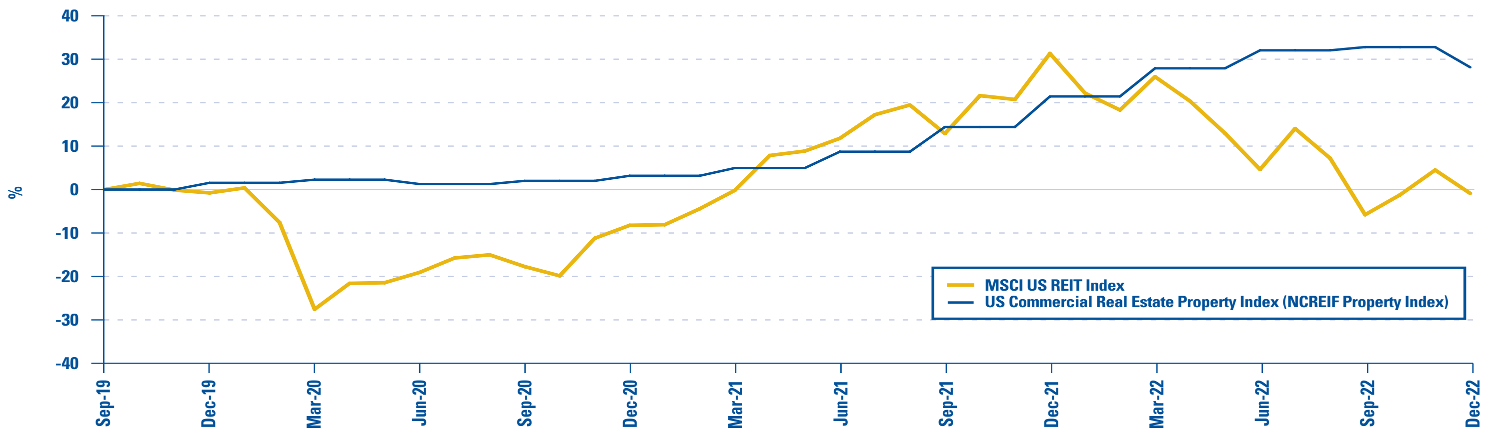


Source: Bloomberg

As you can see from the above after Lehman's went bankrupt on 15th September 2008 the US REIT market quickly priced in (most would argue over priced in) the stresses this would cause across global financial markets. The direct/private commercial real estate space took another three months to start pricing in the extreme stress it would create in the lending markets. Then in March 2009 the debt markets started to re-open and with listed real estate pricing off over a 10% yield we saw the space start to rally strongly back to more normal levels. Meanwhile the direct/private commercial real estate index continued to sell off for another year.

Fast forward to today and there seem to again be a glaring dislocation between direct/private and listed real estate. Elevated inflation and increasing interest rates have led to a sharp sell-off in the listed real estate on the expectation that these pressures will lead to higher debt costs and lower asset values (assets cap rates/yields moving out). At present these issues have only just started to be priced in to the direct/private commercial real estate market:

Chart 2: US Commercial Real Estate Property Index (NCREIF Property Index) versus the MSCI US REIT Index September 2019 to December 2022



Source: Bloomberg

History shows when prices between listed and private real estate diverge, there are opportunities to capture outperformance by investing in the listed space.

Guy Mountain (Head of Real Estate Investment Trusts)

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Listed real estate investment trusts ("REITs") and listed real estate-related companies (together with REITs, "RECs") invest in real estate properties, residential developers or real estate-related loans. RECs generally derive their income from rents on the underlying properties, developing and selling residential properties or interest on the underlying loans, and their value is impacted by changes in the value of the underlying property or changes in interest rates affecting the underlying loans owned by the RECs. Investments in RECs are subject to many of the same risks as direct investments in real estate, such as fluctuations in the value of underlying properties, defaults by borrowers or tenants, market saturation/oversupply, changes in general and local economic conditions, decreases in market rates for rents/decreases in prices for properties, increases in competition, property taxes, capital expenditures or operating expenses, and other economic, political or regulatory occurrences affecting the real estate industry. Individual RECs may own a limited number of properties and may concentrate in a particular region or property type. REITs whose underlying assets are concentrated in properties used by a particular industry, such as health care, are also subject to risks associated with such industry. Investing in REITs exposes investors to the risks that relate specifically to the way in which REITs are organized and operated. Operating REITs requires specialized management skills. REITs may have limited financial resources, may trade less frequently and in a limited volume and may be subject to more abrupt or erratic price movements than larger company securities. Historically REITs have been more volatile in price than larger capitalization stocks. Investing in securities issued by companies domiciled or operating in, or that derive a majority of their income from, Emerging Markets carries risk. Emerging securities markets tend to be smaller, less liquid and more volatile than the major securities markets in the United States. There is less publicly available information about the issuers in emerging markets than is regularly published by issuers in the United States. Also, there is generally less government supervision and regulation of exchanges, brokers and issuers in emerging markets than there is in the United States. The legal infrastructure and accounting, auditing and reporting standards in certain emerging markets do not provide the same degree of investor protection or information to investors as would generally apply in more developed countries. An investment in Emerging Markets could be adversely affected by delays in or a refusal to grant any required government approval or by the lack of availability of foreign exchange and will be subject to the risks of government control, political instability and social unrest.

The definition of the NCREIF Property Index is available here: https://corporatefinanceinstitute.com/resources/commercial-real-estate/ncreif/.

The MSCI US REIT Index is a free float-adjusted market capitalization weighted index that is comprised of equity Real Estate Investment Trusts (REITs). The index is based on the MSCI USA Investable Market Index (IMI), its parent index, which captures the large, mid and small cap segments of the USA market. With 129 constituents, it represents about 99% of the US REIT universe and securities are classified under the Equity REITs Industry (under the Real Estate Sector) according to the Global Industry Classification Standard (GICS®), have core real estate exposure (i.e., only selected Specialized REITs are eligible) and carry REIT tax status.

Each index is unmanaged and has no fees. One cannot invest directly in an index.

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