

FOCUS ON INVESTMENTS

The Global REIT Revolution

BY MARC A. LOUARGAND, Ph.D., CRE, FRICS

INSTITUTIONAL INVESTORS LIKE TO POINT to the so-called Modern REIT Era to distinguish between the sleepy world of passive real estate investment trusts that drew modest amounts of capital between 1960 and 1991, the year Kimco Realty Corp. came public and adopted the REIT format. Following Kimco, the capitalization of U.S. REITs took off, growing from less than \$9 billion equity capitalization in 1991 to more than \$400 billion at the end of 2006. Along with that growth came a shift in business focus.

Before Kimco and other trusts formed in the 1990s, REITs had been passive investment portfolios typically run by external advisers who often held them captive. A series of regulatory changes between the mid-1970s and late 1980s made it possible by the 1990s to use REITs to recapitalize entrepreneurial portfolios. That event gave rise to today's REIT in the U.S.; a modern vehicle in the business of owning and operating real estate. REITs now routinely engage in the development, repositioning, management and sale of assets. This ability to play across all lifecycle stages is a vital part of the REIT success story.

Today there is a parallel evolution taking place in many countries as REITs are adapted to meet the needs of European and Asian property capital markets.

RISE OF THE J-REIT

The Japanese REIT market launched in 2001 and has grown to more than ¥5 trillion in capitalization. J-REITs follow an early model and are externally advised. The self-managed REIT may make its appearance in Japan within the next few years as the regulatory and capital market

players become comfortable with the concept. J-REIT performance since inception has been nearly double the broad Japanese equity market returns: 19 percent vs. 10 percent, according to the STB Research Institute.

CREATION OF THE SIIC

More than 10 years after the introduction of the J-REIT, France weighed in with the SIIC, or *Societes*



About the Author

Marc A. Louargand, Ph.D., CRE, FRICS, is managing director and chief investment strategist for Cornerstone Real Estate Advisers LLC, based in Hartford, Conn. Previously, he was a professor of real estate finance at Massachusetts Institute of Technology and a consultant to institutional portfolios, industrial and financial corporations, and domestic and foreign governments. Louargand is co-editor of the Journal of Real Estate Portfolio Management, associate editor of the Journal of Real Estate Literature, and a member of the editorial boards of the Journal of Corporate Real Estate, Briefings in Real Estate Finance, and the Journal of Real Estate Research. He is the founding director of the Pension Real Estate Association Institute, president of the American Real Estate Society, a fellow of the Homer Hoyt Institute and has served as chair of the Portfolio Strategy Committee of the National Council of Real Estate Investment Fiduciaries.

The Global REIT Revolution

d'Investissements Immobiliers Cotees. Introduction of a REIT-like instrument helped France through the resolution of its own property market recapitalization. In just four years, SIICs have grown to €50 billion in capitalization spread across about 45 firms. Recent regulatory proposals in France appear to be designed to encourage broader ownership and greater transparency in the SIIC market.

UK PROPERTY TRUSTS

Listed Property Trusts are not a new thing in the UK, which has a well-developed public real estate market. In January 2007, however, seven firms announced their intention to convert to the newly approved REIT status. Observers have been handicapping the REIT conversion race in the UK and Germany for the past 18 months or so and though Germany has announced its plans, it appears that the UK will be the first of the two to make the change.

In all, 26 countries have REITs or REIT-like vehicles listed on public exchanges today. More are expected to follow in the near future as global capital markets become increasingly integrated.

GERMAN REITS

The German property market may be most in need of new vehicles and fresh capital. The introduction of the G-REIT in 2007 will be a major force for resolution of the country's issues. The German property market has not seen meaningful value increases in the past 15 years, according to one observer in early 2006.¹ Since that time, the residential market has shown signs of revival and opportunistic buyers have entered the general property market. Despite some reluctance on the part of the current government, Germany has committed to the introduction of REITs in 2007 and we may see the equivalent of the mid-1990s REIT boom in the U.S.²

A TRUE GLOBAL MOVEMENT

Capital will flow to tax-advantaged opportunities wherever possible, so expect the marketplace to apply firm pressure on reluctant governments.

SOME EVOLUTIONARY THEMES

Having lived through the entire U.S. REIT era as a real estate investor, I can accept that things have truly changed in the Modern REIT Era contrary to the appropriate cynicism that greets most Wall Street announcements of a new paradigm. The global REIT movement likely will follow

parallel or similar paths of change as it grows and matures. Changes could include:

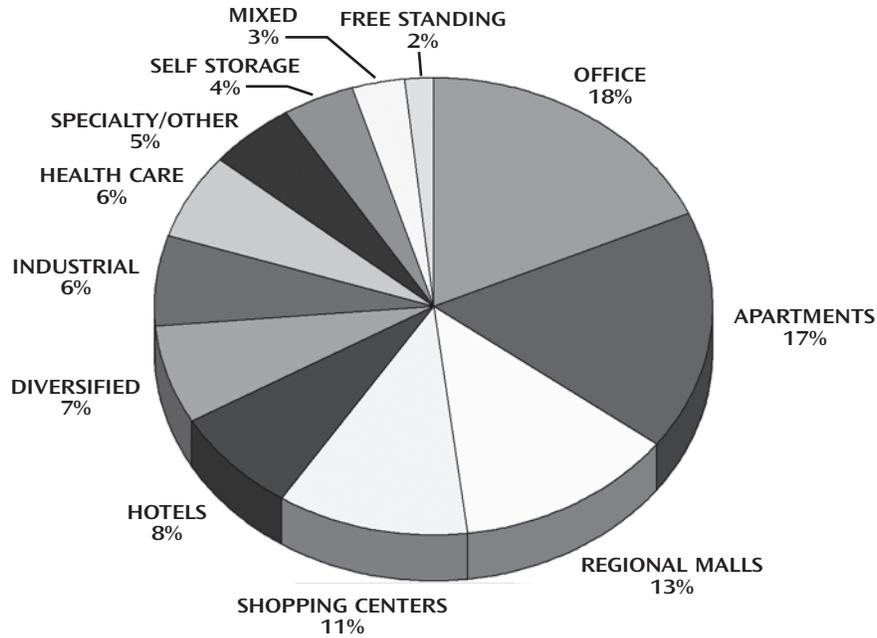
- **Diversification**—The U.S. REIT has proven to be a successful vehicle for capitalizing portfolios of virtually every property type. Outside the U.S., a more limited range of sector bets are available. Figures 1 and 2 illustrate the difference and another key disparity between the two groups. Early on in the U.S., the investor and analyst community's actions showed that it valued single-sector firms more highly than diversified ones, and the industry evolved in that direction. The diversified category in the U.S. is primarily a blend of office and industrial park investors and developers. In Europe and Asia, numerous firms operate across a broad range of property types, lifecycle stages and national boundaries. Several also engage in property services of one type or another.

It will be interesting to watch this market mature and see whether it goes with the single-sector model, the diversified model or can maintain a rationale for applying two standards at once. If forced to hazard a guess, I would predict the single-sector model will hold sway but may be suboptimal in jurisdictions where every project is perforce mixed use, as in much of urban Europe and Asia.

- **Self-management**—Where REITs are structured only as passive, externally managed investment portfolios, they probably will evolve into actively managed operating companies. This step is necessary to achieve parity across national and regional boundaries. Absent self-management, a permanent risk premium penalty will apply to those markets.
- **Rationalization**—Some companies that will convert or subsequently become public will represent suboptimal collections of assets, ill-conceived strategies or will be the product of weak management. Expect these firms to be rationalized by merger or acquisition, or privatized as a result of disinterest.
- **Globalization**—The spread of the REIT concept is itself a good example of globalization. Capital markets have become porous. Funds flow around the world at will. Nations with a tax-advantaged

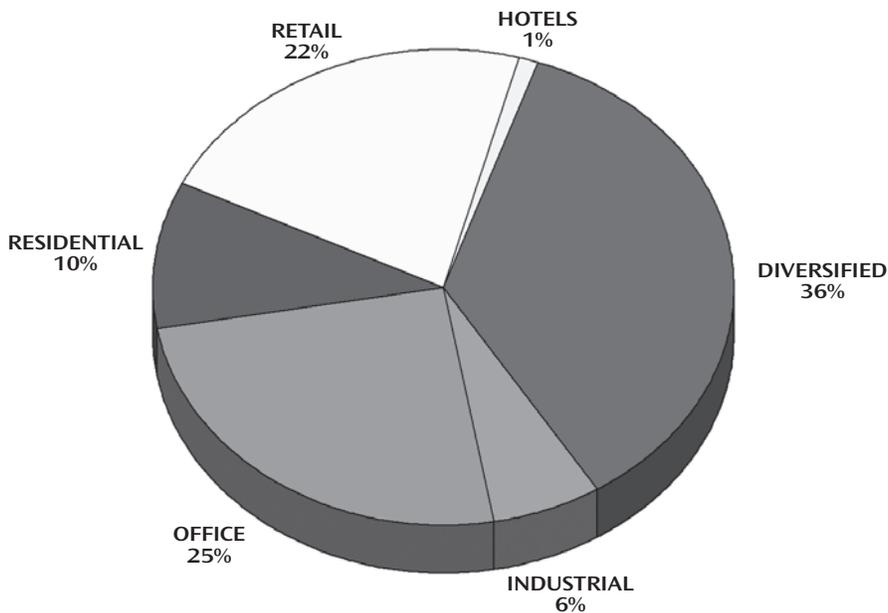
INSIDER'S PERSPECTIVE
The Global REIT Revolution

Figure 1
U.S. REITs by Property Sector



Source: EPRA/NAREIT, Cornerstone Real Estate Advisers LLC

Figure 2
Global REITs by Property Sector



Source: EPRA/NAREIT, Cornerstone Real Estate Advisers LLC

The Global REIT Revolution

REIT structure will draw capital away from those that do not have one. This fact alone will serve to spread the REIT presence through the world. More important, the rise of REITs with multinational interests such as ProLogis and AMB foretell the likely path of the sector.

Firms domiciled in one country will acquire or form joint ventures with firms in another, and global operating companies will emerge. If Procter & Gamble can make the world's toiletries, why can't one firm operate office buildings around the world, as some already do?

Firms domiciled in one country will acquire or form joint ventures with firms in another, and global operating companies will emerge. If Procter & Gamble can make the world's toiletries, why can't one firm operate office buildings around the world, as some already do?

- **Integration**—Globalization in real estate will bring integration in many areas, just as it has in consumer behavior, styles and products. How might it affect the REIT business?
- **Tenants**—Thousands of firms maintain multinational locations today. Large transnationals like P&G, United Technologies, General Motors and others have highly sophisticated and integrated property strategies. Those competencies have filtered down the size scale in the past decade as outsourcing corporate real estate services to third-party providers made them available to smaller firms. Today's economy allows nearly every firm to pursue business across borders so these services should become available on an even wider basis. Will the tenant-rep broker go global to survive as well?
- **Developers**—Hines and others have shown the way for many years in this area. It is quite possible and logical for the providers of buildings to go global in service of their clients. U.S. REITs with in-house development capacity and good development pipelines tend to enjoy higher valuations than their peers who lack these capabilities. If this metric spreads around the globe, it may bring a swift end

to the passive, externally advised structure. Follow the acquisition news to see which competencies are valued most highly.

- **Information**—The 1970s advent of institutional real estate investment in the U.S. brought the development of benchmarks and reliable information resources that supported the onset of fundamental economic analysis in real estate with consistent data. Most Counselors whose careers go back to the 1970s or beyond can identify with the comment that “20 years ago I was begging for data, now I'm begging for mercy.”³ In the U.S., investors are awash in data. This situation does not yet exist in Europe and Asia, but it will. Early movers in the information business will prosper and grow along with the REIT movement, and the capital markets will have increased transparency as a result.
- **Professionals**—Observing the rapid evolution of this investment sector, it becomes clear that we are witnessing a massive technology transfer between and among the investor and analyst communities around the world. Firms that had been national or regional property firms are adopting a new legal and operating format. There is a saying in the investment community: “Deal guys don't make good asset managers.” Deal guys (inclusive of both genders) will counter that asset managers don't do good deals. We are witnessing a second showing of the evolution that occurred in the U.S. in the past decade. Deal guys were forced to become competent operators and good operators were forced to make good deals. We will see this play out again.

In the first showing, some adapted, some sold out and some simply became irrelevant. We probably will see more of the same in Europe and Asia in the coming decade. The primary beneficiaries of this evolution will be practicing property professionals of all stripes as the world of opportunity becomes truly global. At first, this business environment will provide a much enhanced set of lifestyle choices for Counselors and others. As the sector grows, true labor shortages will develop in markets as industry capitalization grows,

The Global REIT Revolution

introducing global labor mobility for real estate professionals. Individuals will benefit, of course, but whole societies will as well. The mature societies of the developed world will benefit immensely from the creation of a pool of human capital elsewhere as their own professional cadres age into full retirement.

One of the bothersome aspects of revolutions, apart from the guns and barricade type, is that we generally don't know we are in them until after they're over or nearly over. We are in a global revolution in the property world today, driven by the Global REIT Revolution. Let's all enlist and enjoy the ride. ■

ENDNOTES

- 1 Sven Lorenz, "How to Buy into Germany's Coming Property Boom," *MoneyWeek* (MoneyWeek Ltd., Feb. 2, 2006).
- 2 Karl-Werner Schulte, CRE, was instrumental in the design and creation of the G-REIT.
- 3 Marc A. Louargand, "Information and Real Estate Markets," *Journal of Real Estate Portfolio Management, Volume 4, Number 1* (American Real Estate Society, 1998).