Listed real estate in the rearview mirror

From discount to premium

Including the Company Overview and Asset managers' view of the listed property companies
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LEIMDÖRFER
PART OF BRUNSWICK REAL ESTATE

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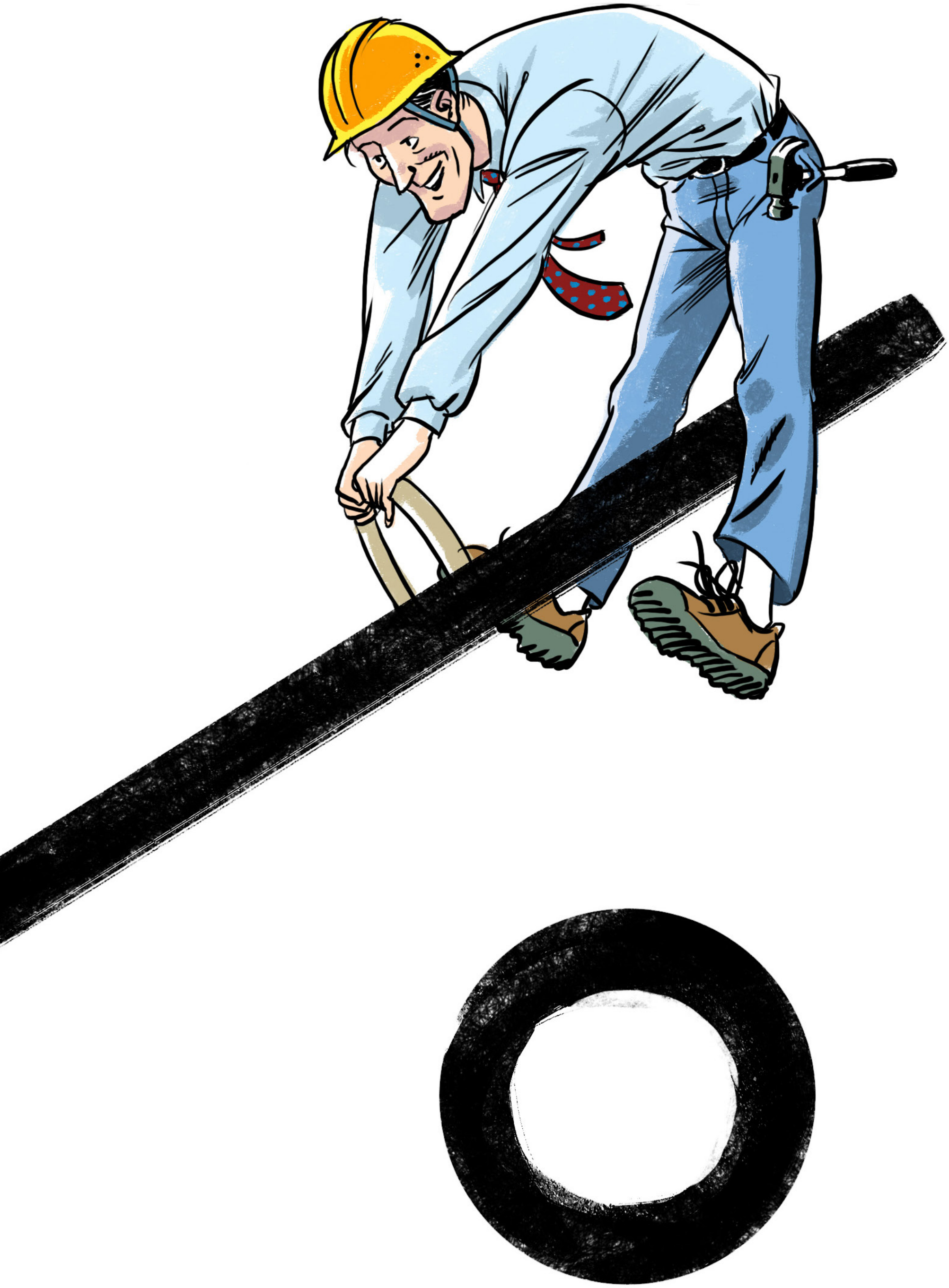
An intriguing characteristic of listed real estate is the parallel pricing of assets, i.e. that assets which are held by listed real estate companies are assigned a value not only by the stock market through the share price but also by investors on the direct real estate market. A listed company whose real estate portfolio is valued higher by the stock market than by the direct market is traded at a premium whereas in the reverse case that company is traded at a discount.

Before 2005, Swedish listed real estate companies were only obliged to report values at cost, requiring all analysts and investors to make their own assessments of the market values of the companies' asset portfolios to be able to estimate whether those companies were being traded at a premium or at a discount on the stock market.

In 1996, Leimdörfer launched its Company Overview, providing market values of each individual listed real estate company's asset portfolio based on Leimdörfer's direct market data, knowledge and insights. Since then, Leimdörfer has regularly calculated premiums and discounts for the Swedish listed real estate sector and in 2009 and 2016, respectively, listed real estate companies in Finland and Denmark were added to the Company Overview.



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Valuation of the listed real estate sector – from discount to premium

In the long run, should the listed real estate sector be valued at a premium or at a discount? For certain structural reasons, a discount may be the normal state of affairs, including opacity of fair values, double taxation, the listed real estate sector constituting a comparatively small segment of the total stock market, a lack of control when investing indirectly instead of directly as well as the costs which arise from complying with stock market regulations and accommodating the capital market's demand for information.

On the other hand, equally plausible structural factors point toward a premium as the long term normality, most notably the listed real estate sector's ability not only to transform relatively illiquid assets into relatively liquid shares, but also to make real estate as an asset class available to more investors than those who are able to deploy the large amounts of capital usually required to make direct investments. Furthermore, investors might be willing to pay a premium for the specialist competence, intellectual capital and market position that a well-established listed company can provide them with.

During the late 1990s and early 2000s, Swedish listed real estate companies were on average traded at a discount. In 2004, however, implicit values overtook direct market values as a result of sharply increasing share prices, and the listed sector has on average been traded at a premium since then, with a brief exception during the financial crisis of 2008-2009.

The shift from discount to premium in Sweden can in part be explained by changes in the structural factors mentioned above, i.e. that factors pointing toward a premium have gained prominence and/or that factors implying a discount have lost importance. In addition, the shift can also be explained by cyclical factors, i.e. general economic trends having pushed the stock market's valuation toward a premium. Contrary to changes in structural factors, these trends are expected to reverse at some point in time.

Structural factors explaining the shift from discount to premium

Introduction of IFRS

Before 2005, the reported values of listed real estate companies' asset portfolios were measured at cost. Direct market values were presumably rather difficult to assess for equity investors possessing limited knowledge of the direct real estate market, and the resulting uncertainty as to the market value of assets, coupled with reported values being substantially lower than direct market values, probably gave rise to a discount.

In 2005, IFRS was introduced requiring all listed real estate companies to report their real estate portfolios at market value, making these visible to everyone and not only to those investors which had insights into the direct market, in turn improving the stock market's valuation of the listed real estate sector.

A more favourable tax situation

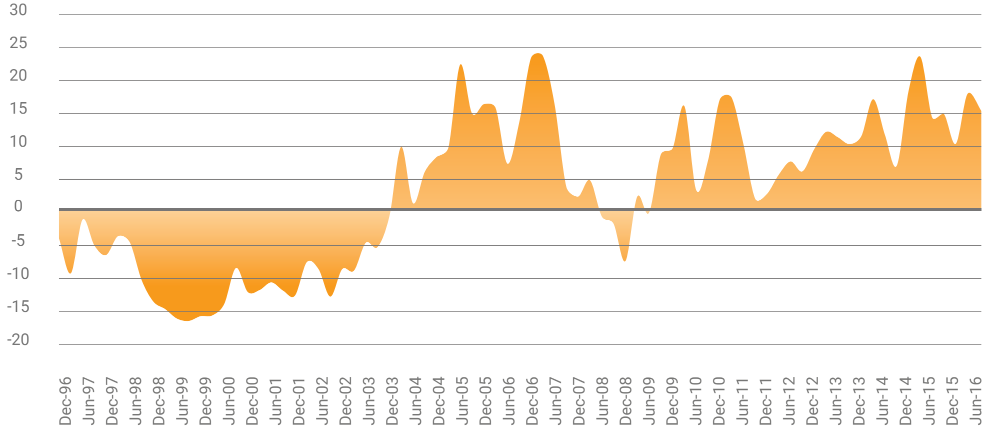
Investors in listed real estate companies normally suffer from double taxation as profits are taxed both at corporate level and at investor level (when distributed as dividends). Hence, listed real estate companies should, all else equal, be traded at a discount compared to directly held real estate for tax reasons.

However, during the mid-2000s listed real estate companies were given or created for themselves a more favourable tax situation relieving their owners of at least part of the burden of double taxation.

- A change in legislation in 2003 made it possible to divest shares in operating subsidiaries without triggering capital gains tax. Under the assumption that listed real estate companies to a relatively large extent owned their assets through property holding companies, they were given a tax relief.
- Several of the real estate companies which were listed during the early 2000s were former ICT companies holding substantial tax loss carryforwards. These could then be used to offset real estate income for tax reduction purposes.
- Third, before 2004 the listed real estate companies had an average equity ratio of 40% whereas it has been 35% on average 2004 onwards. Hence, the companies have since 2004 to a larger extent than before utilized debt as a tax shield.

Valuation of the listed real estate sector in Sweden, 1996-2016 (June)

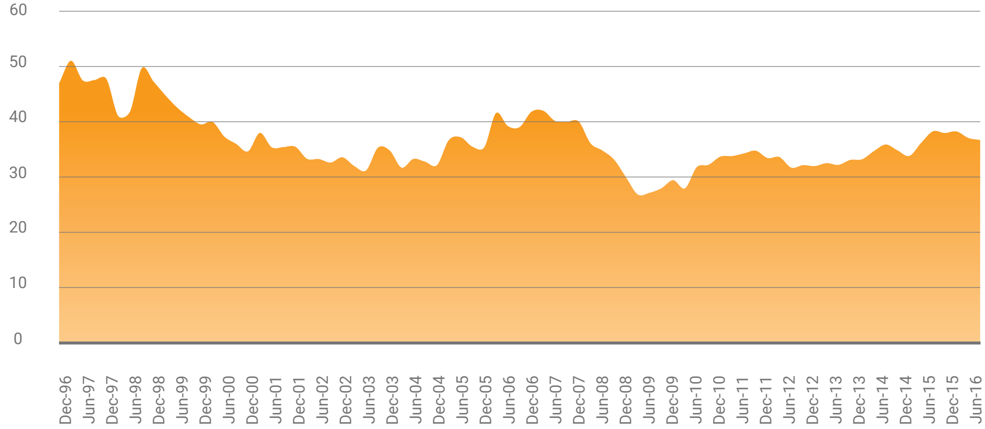
Premium (+)/discount (-) to gross asset value, %



Source: The Leimdörfer Company Overview

Equity ratio for the listed real estate sector in Sweden, 1996-2016 (June)

Equity ratio, %



Source: The Leimdörfer Company Overview

Growth of the real estate sector

The listed real estate sector's relative importance has increased over the past 20 years. Total market capitalisation of all companies included in the Company Overview, as a percentage of the total stock market capitalisation, has more than doubled from 2.2% in 1996 to 4.5% in 2016 implying that real estate's weight in equity portfolios, as well as the resulting attention from these portfolios' managers, should have increased.

Further underlying this, turnover of listed real estate shares amounted to some SEK 80 million per day between 1996 and 2005, which more than doubled to SEK 200 million per day on average over the following ten years.

The combined effect of more attention from money managers, stronger demand for the sector as well as higher liquidity and turnover should have been an improved stock market valuation of the listed real estate companies.

According to figures from EPRA, Sweden hosts a relatively large listed real estate sector in an international comparison, accounting for 5.8% of the total stock market[1] as compared to 2.5% in the United Kingdom, 3.2% in Europe as a whole, and 4.4% in the United States.

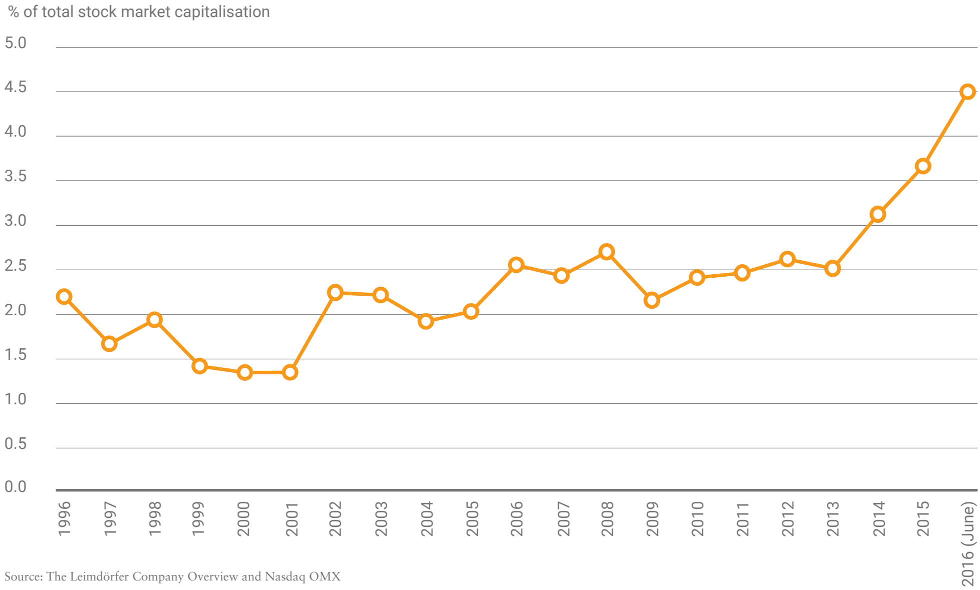
Higher foreign ownership share

Foreign investors have been significant owners of Swedish listed real estate for a long time, and their share of the sector's total market capitalisation increased from 17% in 1997 to 25% in 2015. At the same time the total market size quintupled.

Stronger demand for listed real estate from a defined investor group, at the same time as the total market has grown, should all else equal translate into an improved valuation of the sector. Furthermore, listed real estate is probably the fastest and easiest way for foreign investors to get exposure to the Swedish real estate market, and a stronger demand from abroad should thus lead to an increase in share prices before that demand impacts prices on the direct market, thereby creating a premium.

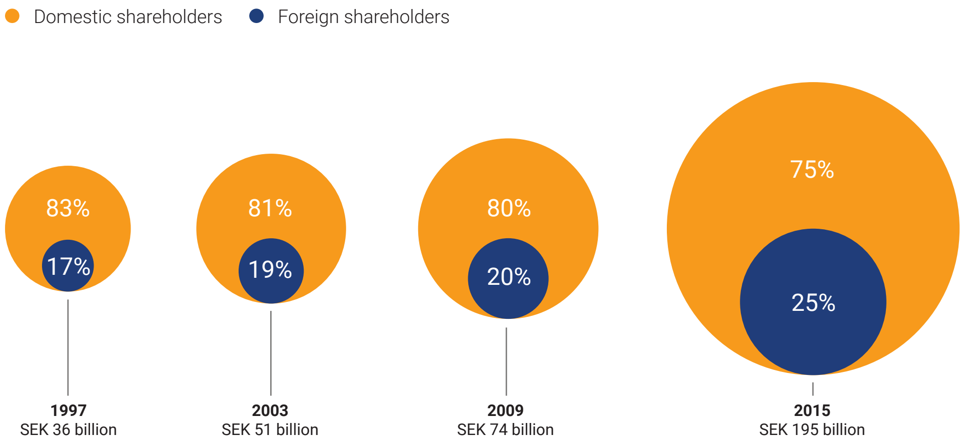
1. The difference between 4.5% according to the Company Overview as mentioned earlier and 5.8% according to EPRA arises because EPRA's definition of the total listed real estate sector comprises of more companies than were included in the Company Overview as per June 2016.

Market capitalisation of the listed real estate sector in Sweden, 1996-2016 (June)



Source: The Leimdörfer Company Overview and Nasdaq OMX

Total market capitalisation and foreign ownership of the listed real estate sector in Sweden, 1997-2015



Source: The Leimdörfer Company Overview and Nasdaq OMX

Cyclical factors explaining the shift from discount to premium

Falling interest rate

Being a capital-intensive investment, real estate prices are to a significant extent driven by interest rate movements and, as it appears, listed real estate share prices respond more quickly to fluctuations in interest rates than do prices of directly held real estate.

Possible explanations for this might be that the stock market normally reacts more quickly to exogenous stimuli than does the underlying asset market and that all listed real estate companies are leveraged – albeit to varying extent – whereas a substantial amount of real estate on the direct market is held by unleveraged, i.e. institutional, investors[2].

As interest rates have moved downwards over the past 20 years, the stock market's valuation of listed real estate shares has in line with the above reasoning trended upwards and shifted from a discount to a premium.

Discounted companies have been taken private

Listed real estate companies which are traded at discounts are rational targets for public-to-privates since their assets are worth more on the direct market than on the stock market. Similarly, privately held real estate portfolios should be introduced on the stock market when their owners expect them to trade at a premium as listed companies.

Since 1996, a total of 27 companies have been taken private during times of discounts, representing a total market capitalisation of SEK 47 billion, whereas only 5 companies, at a total market capitalisation of SEK 13 billion, have been taken private during times of premiums. Since 1996 a total of 18 companies have been listed during times of premiums, adding SEK 59 billion to the listed real estate market capitalisation. During times of discounts, 14 companies with a total stock market capitalisation of SEK 23 billion were listed[3]. In total, investors have over the past 20 years made a total net gain of SEK 19 billion from well-timed buyouts and listings, whereof SEK 11 billion from buyouts and SEK 8 billion from listings[4].

Public-to-privates during times of discounts therefore improve the valuation of the listed real estate sector as a whole, since the companies taken private tend to be the ones having the lowest valuations. Perhaps less intuitive, the entrance of companies during times of premiums might also lead to a higher valuation of the sector as a whole, as only those real estate portfolios which are expected to trade at a premium are listed[5].

Rationality on behalf of investors might therefore give rise to a natural predisposition of the stock market towards a premium, at least until the premium has led to listings of poorer-quality companies which in the longer run become traded at discounts and/or to an excess supply of real estate shares if owners of listed real estate companies attempt to benefit from the premium by issuing new shares.

Other explanations

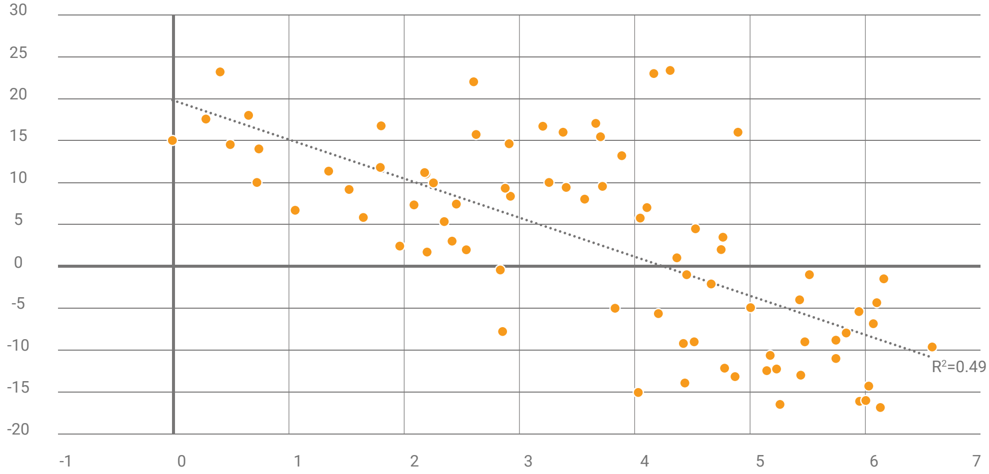
Other factors, mainly of a structural character, which are not further explored in this article, include:

- Investors assigning a higher value to the specialist competence, intellectual capital and market position which is easier to build up in a company than in a directly held real estate portfolio.
- A reduction of investors' control discount when holding real estate through a listed company rather than directly.
- Higher operating efficiency among the listed companies, for example in the form of higher operating surplus and/or lower central administration costs.

2. In addition, the listed companies appear to have applied shorter interest rate durations than private companies over the past five years. Before that, however, public and private real estate companies applied very similar interest rate durations.
3. The perhaps surprisingly large amount of companies listed at times of discount can be explained by IPOs of a number of former bad bank real estate portfolios during the late nineties.
4. The net gains are derived as the difference between the market capitalisation and the net asset value of all listings and public-to-privates, respectively, under the assumption that all such transactions are done at the general premium or discount of the listed real estate sector at the time of the listing or public-to-private.
5. An increase in the size of the listed real estate sector might also by itself improve the stock market's valuation as discussed earlier.

Valuation of the listed real estate sector in Sweden vs. interest rate, 1996-2016 (June)

Premium (+)/discount (-) to gross asset value, %



Source: Leimdörfer and Bloomberg. Quarterly observations.

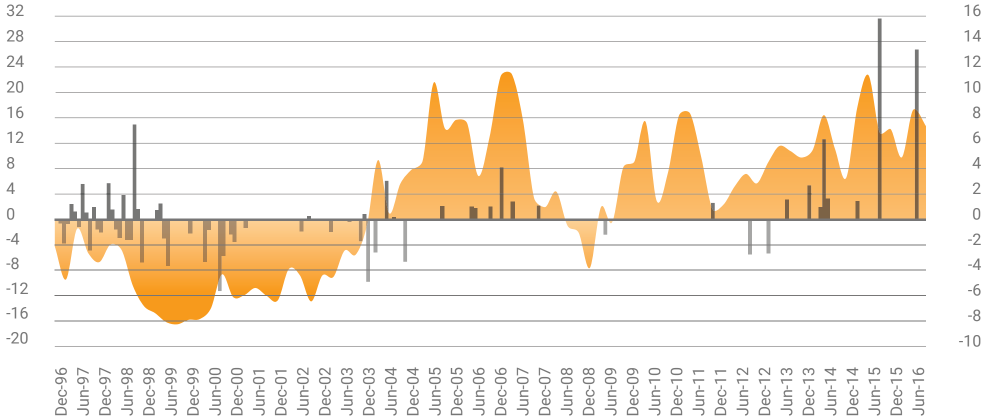
5-year SEK swap rate, %

Swedish listed real estate sector valuation and market capitalisation inflow and outflow, 1996-2016 (June)

Premium (+)/discount (-) to gross asset value, % Market capitalisation inflow (+) outflow (-)

Premium (+)/discount (-) to gross asset value, %

Market capitalisation inflow (+) or outflow (-), SEK billion



Source: Leimdörfer. Including large acquisitions of privately held real estate portfolios by listed companies.

Sweden compared to Europe...

The general pattern in Sweden has been similar to the one in Europe. However, some differences are clearly visible:

First, the stock market's valuation of the Swedish listed real estate sector has since 2003 been higher compared to Europe as a whole. One explanation for this gap might be that investors in listed real estate in Europe, and in particular in the United Kingdom, tend to be reluctant to invest in companies whose share prices deviate too far from their net asset values.

Second, discounts were much smaller in Sweden than in Europe during the financial crisis of 2008-2009 which might be explained by the fact that Sweden, and the Nordics in general, were less affected by the financial crisis than was Europe, and in particular the United Kingdom(6).

Third, whereas Europe has continued to be traded at a discount or on par ever since the financial crisis, the Swedish listed real estate sector rapidly bounced back to a premium, probably due to the European debt crisis which affected the Nordics to a much more limited extent than the rest of Europe.

...and to a close neighbour

The listed real estate sector in Finland, which is comprised of only three companies, followed a similar pattern as in Sweden, albeit at a lower absolute level, up until a couple of years ago when valuations diverged as the Swedish premium increased while the stock market's valuation of Finnish listed real estate companies moved into discount territory.

The economic outlook, which as of recently has been significantly poorer in Finland than in Sweden, can probably explain the diverging valuations since 2014, but how can the generally lower stock market valuation in Finland compared to Sweden be explained?

First, although its share of total market capitalisation has grown by 60 basis points since 2009, the real estate sector accounts for a substantially smaller part of the total stock market in Finland compared to in Sweden.

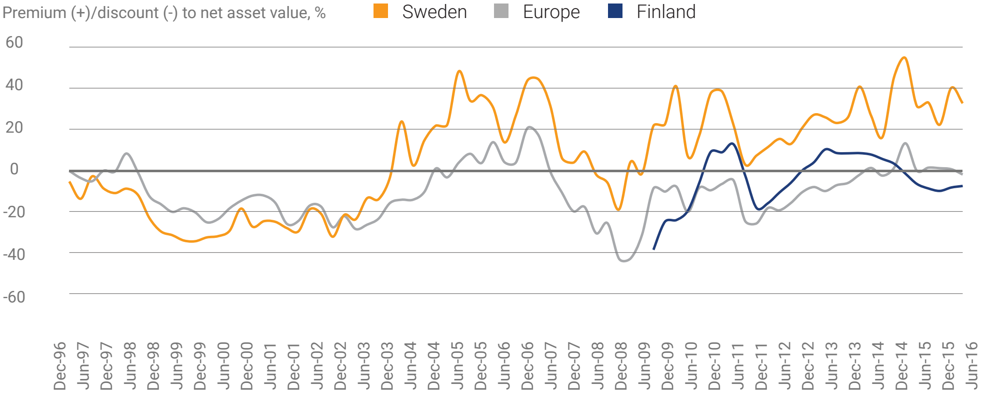
Second, there has been considerably less activity on part of investors in Finland compared to in Sweden with regard to buyouts and listings, i.e. companies traded at discounts have not been taken private and no real estate portfolios have been listed during the (albeit short) periods with premiums.

Third, unlike in Sweden, capital gains tax cannot be postponed by divesting a property holding company instead of the actual asset, and previous years' losses cannot be used to offset current profits, making Finnish companies more exposed to double taxation compared to their Swedish counterparts.

On the other hand, Finnish companies also report market values of assets according to IFRS, interest rates have fallen quite dramatically in Finland (being a member of the euro area) and the share of foreign ownership is relatively high at 35%, laying a solid foundation for a higher valuation of listed real estate going forward.

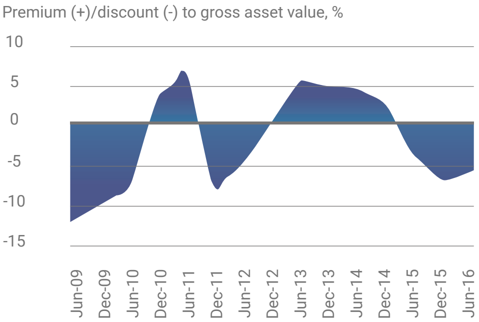
6. An alternative explanation might be that Swedish premiums and discounts are calculated as the difference between Leimdörfer net asset values, i.e. based on estimated direct real estate market values, and market capitalisations, whereas European premiums and discounts are calculated as the difference between EPRA net asset values, i.e. based on reported real estate values, and market capitalisations. Reported real estate values can be assumed to fluctuate less than direct real estate market values due to lagging and smoothing effects.

Valuation of the listed real estate sectors in Sweden, Finland and Europe, 1996-2016 (June)



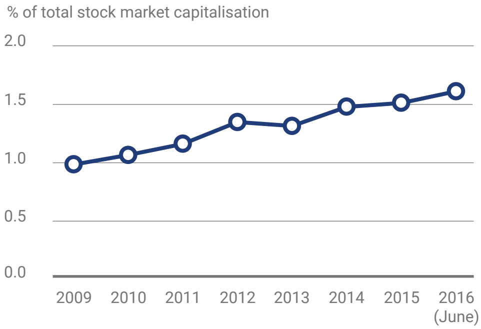
Source: Leimdörfer, EPRA

Valuation of the listed real estate sector in Finland, 2009-2016 (June)



Source: The Leimdörfer Company Overview

Market capitalisation of the listed real estate sector in Finland, 2009-2016 (June)



Source: The Leimdörfer Company Overview and Nasdaq OMX

Understanding the past to prepare for the future

The relative importance of structural versus cyclical factors explaining the shift from discount to premium has a bearing on whether the current premium can be expected to prevail or turn into a discount, and in the latter case; when that might occur.

Should the stock market's valuation to a large extent be determined by cyclical factors, discounts will most likely return. If structural explanations dominate, on the other hand, investor preferences, legislation or fundamental economic conditions must change for the current premium to disappear.

Investors believing in the prevalence of the cyclical factors mentioned above should therefore closely monitor the interest rate yield curve and look for early signs of an upward shift, as well as carefully scrutinize the new companies entering the stock market and analyze whether they are premium-accretive or in due time might tip the stock market's valuation of the listed real estate sector toward a discount.

Investors putting more confidence in structural factors might instead want to keep an eye on foreign investors' preference for Swedish real estate as well as on forthcoming tax proposals which can make double taxation reappear as an issue for investors.