Riding out the storm

Global Real Estate Investment Trust Report 2008

Ernst & Young
Quality In Everything We Do

Battered but not broken

Inevitably the results of the third annual Global Real Estate Investment Trust (REIT) Report are framed by the crash in global securities post October 2007. However, in some regions, the underlying fundamentals are still robust and property remains a vital asset class.

In the financial year to 30 June 2008 (FY2008) credit crisis storms wreaked carnage among most of the world's REIT populations. The real estate industry suffered more than most from the battering, with investors and the finance industry suddenly questioning their 'safe haven' assumptions. Yet, some countries weathered the storm better than others, and some regions delivered better returns than others.

Offering country-by-country analysis, as well as global comparisons of market size, volumes, returns, balance sheet and income measures, the 2008 Global REIT Report helps REITs and other property investors to make more informed investment decisions around the REIT market. Of course the tumultuous shake out of global markets has accelerated since 30 June 2008. We are continually monitoring the impact on global REITs and will provide a comprehensive analysis of FY2009 in next year's report.

New this year

- Three year comparison for all regional results, highlighting global performance trends
- China update — examining the drivers and hurdles to implementing a REIT regime in this important new market
- Foreign investment under the spotlight – has this been a successful strategy?
- Global comparison issues – how accounting, tax and measurement differences interfere with country to country comparisons

Analysis informed by local insight

This year's report includes local intelligence and insight from the Ernst & Young professionals who work with REITs in every market analyzed. With the REIT sector globally suffering -21% returns across 16 countries, we asked these local teams to assess why some countries held up better under the onslaught of financial and economic uncertainty. We also asked for their views on the 12 month outlook for their local markets.

We hope you will find this year's report valuable and a welcome addition to your research on global REITs.

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About the Global REIT Report 2008

The 2008 Report again concentrates on publicly listed REITs, sourcing all market data from individual country stock exchanges, predominately via Bloomberg.

Timing

The report is based on information downloaded from Bloomberg on 30 June 2008, representing the latest available information at that time. We have not updated the figures for information received after this date. However, our commentary throughout the report was current at the time of going to print. Unless stated otherwise, FY2008 refers to the period 1 July 2007 to 30 June 2008.

Data sources

All statistics quoted in the report have been sourced from Bloomberg. All charts are based on this source data and include criteria from our previous years' reports. All interest rates have been sourced from relevant country's central banks.

Countries and regions included in the report

The 2008 Report now analyses 16 countries with the addition of Germany this year.

Notable exceptions

Although Taiwan and Bulgaria also have REIT markets, they are not currently carried in full on Bloomberg, therefore they remain outside the scope of this year's report.

Italian REITs under the new legislation are also in their infancy. We will include these in future reports as market data becomes available. However we have included detail on tax regulations for Italy and Taiwan in the country and tax regulations section.

Finally, we expect China's first pilot REIT project to start in early 2009, helping to shape the eventual REIT regime. You'll find commentary on the likely timing of China's future REIT market on page 16 of this report.

Total number of REITs by country

Global region	Country	2008	2007	2006
North America	United States	148	169	253
	Canada	33	26	33
EMEIA	Netherlands	8	7	9
EMEIA is a global region made up of Europe, Middle East, India and Africa. Note Indian REITs have not been analyzed in this report.	Belgium	14	17	13
	Germany	2	n/a	n/a
	France	48	42	30
	Turkey	13	15	n/a
	United Kingdom	19	14	n/a
	South Africa	6	7	7
Pacific	Australia	64	58	58
	New Zealand	8	10	6
Asia	Japan	42	41	38
	Hong Kong	7	7	4
	South Korea	6	6	11
	Malaysia	13	13	11
	Singapore	20	16	11
Total		451	448	484

Executive summary

Few make headway in rough seas

In a year where REIT stock prices fell everywhere, only one country delivered a positive rate of return – the relatively small market of South Korea. Malaysia and Hong Kong almost held their own, while the US faired better than expected. Australia, Japan and the UK experienced the worst fallout.

REIT populations contracted in many countries, with the US shrinking substantially, bringing the pack closer together. While the number of REITs did increase in some countries, market capitalization substantially decreased. Only Hong Kong showed marginal growth in terms of full market capitalization.

However, the three year total rate of return figure tells a more important story: the returns accumulating over the previous two boom years have all but been eroded since 30 June 2007. A sobering fact for investors is that money deposited in banks on 1 July 2005 would have fared better than investing in most REIT countries over the three years to 30 June 2008.

Asia still afloat

South Korea was the highest performer – the only country to deliver a positive total rate of return. Large losses in Japan and Singapore were offset by only minor negative results in Malaysia and Hong Kong. So although Asia experienced the largest decline for FY2008, it still had the highest total rate of return for any region. Asia also remained the standout performer in terms of positive dividend yield spread, with four Asian countries in the top six for this metric.

Global region	% decline in one year total rate of return FY2008	Total one year returns at 30 June 2008	Total returns - over three years
Asia	60%	-15.77%	5.53%
Pacific	58%	-33.54%	-0.83%
EMEIA	50%	-23.56%	3.06%
North America	30%	-15.90%	3.49%

Overseas investors punished

Worst affected were Australia, Japan and the UK. Interestingly, some of the poorest performers, the Netherlands, Singapore and Australia, had major exposures to overseas investments. While overseas investment has worked well for these countries in the past, in current market conditions these strategies have been punished. Until the market settles, these REITs might do better to stay with core investments and adopt a 'back to basics' growth strategy.

Volatility in the US

In the first few months after August 2007, US-REITs had the biggest falls in market price, but seemed to be making a recovery as of 30 June 2008. However, recent events have caused a setback in REIT performance, caused by the roller-coaster ride of seesawing values. In the extremely volatile market conditions of September 2008 through mid-October 2008, US-REITs have seen the biggest days of gains and losses in their history, with unprecedented drops in price as of the time of this writing. Given the market uncertainty, it's impossible to predict at this time how long it will be before REIT share prices recover.

REITs no longer a safe counter cyclical investment

With a continued rise in betas across all regions, except Europe, investors must accept that REITs are now increasingly price sensitive to broader market movements. Given the fact that 11 of the 16 countries analyzed are over 0.5, and the beta for United States is now 1.1, REITs can no longer be considered a safe counter cyclical investment. While the results largely reflect a continued gradual rise across the world, the exception was Australia, where its 0.95 beta jumped from 0.59 in FY2007. This represents a fundamental change in the Australian REIT market that could transform REITs in terms of the type of investors they will attract.

Better headline yields for new investors

During the year dividend yields rose. However, this did not reflect higher earnings, it was simply a function of falling security prices. We see this as just the start of higher yields and believe the FY2008 results may hide a lag. We expect further jumps in the December 2008 figures with yields continuing to get higher. This is mainly due to the inverse effect that falling security prices have on headline dividend yields.

This trend in erosion of capital value (i.e., share price) is bad news for existing investors, but good news for new investors as the yields on offer are becoming more akin to REIT markets of old where the lower risk income play is more attractive to investors.

However in some countries, like Australia, New Zealand and South Korea, the dividend payouts actually fell, which outweighs the effect of falling market prices. Australia, in particular, has responded to analyst market pressure and has reduced its aggressive distribution policies to more manageable levels.

China yet to emerge but one to watch

When China finally implements a REIT regime, it will have major implications for the global market. However, despite considerable work behind the scenes, and a 2009 pilot project to help test the proposed legal framework, China's REIT market remains a few years off. Our report explains the challenges delaying the opening up of this important REIT market.

Global comparison issues

In FY2008, investors continued to find it hard to directly compare REITs between countries, with inconsistent global accounting standards and tax nuances adding to the confusion. The report discusses the key issues and trends investors and analysts should be aware of when comparing REITs across the global market, including different asset measurements and global inconsistencies around taxing active and passive income.

Mergers and acquisitions (M&A) market primed, but few takers

Never before has the global REIT market seen so many take-over targets, with many highly geared REITs underperforming. The combination of vulnerable entities and REITs themselves keen to sell non-performing peripherals should be driving a frenzy of M&A activity.

Instead, the REIT population remained stable in FY2008 as prospective investors failed to get access to debt or equity. Unlike the financial environment that supported the last surge of M&A activity from 2000–2004, banks are no longer lending with ease. On the contrary, they are trying to minimize their exposure to property. We will see more evidence of this, as banks take a very hard line on breaches in debt covenants, often using this as a reason to call in the loan.

Because ownership changes are often "trigger provisions" under banking covenants, investors have more than the cost of debt to worry about. Early covenant reviews and "poison pills" with hefty payouts for current managers are making even cashed up investors nervous of proceeding with an M&A transaction.

Outlook 2009

Has the blanket fall in REIT stock prices been driven by lack of confidence in equities generally? Or does the market anticipate further increases in capitalization rates and hence decreases in property values? It's hard to tell, but investors are now fully factoring 'risk' into the pricing of REITs, to the point of overkill.

Thus, if underlying property market fundamentals can be sustained, REITs now potentially offer good value for money. Many investors are waiting to jump on these new opportunities but are being held back by lack of finance and nervousness around market volatility, covenants and "poison pills".

Once one investor jumps, we expect a raft of transactions to follow. That said, there will be few absolute bargains, and a preference to friendly rather than hostile takeovers as it minimizes the effect of manager payout fees.

Top of the predators will be Sovereign Wealth Funds (SWFs) and other cash-rich entities from the Middle East, whose cash and investment requirements make them perfectly placed to acquire REITs.

With REITs still riding out the market uncertainty, much of the future remains unclear. However, we anticipate that with the majority of countries trading at a significant discount to net assets, investors will return to the market over the next 12 months, driving consolidation and another stormy year for the world's REIT populations.

That said, we firmly believe REITs will survive the hurricane sweeping over them now. In FY2009, gearing and distributions will be flat and a 'back to basics' approach will see this 50 year old global sector continue sailing long into the future.

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