INTERNATIONAL TRANSPARENCY IN REAL ESTATE MARKETS

As real estate goes global the pressure to disclose information will increase

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Until recently, the insular world of property has often acted like an exclusive, private club with a restricted membership that had its own vocabulary, applied its own set of country-specific rules and relied on its own idiosyncratic sources of capital. As long as there was enough money--particularly debt--to maintain the status quo, this system appeared to be a very civilized way to conduct business. The members knew one another, and local players tended to dominate their markets.

The smooth operations of this private club have been rudely and repeatedly disrupted by the ever-changing capital markets--sometimes through an overabundance of "nouveau" money or, just as often, via crippling capital shortages. The real estate club members usually blamed external sources or ill-conceived government policies for these recurring capital crises. But could it be that our own industry's parochialism contributed to these cyclical patterns?

Part of the problem is that the financial metrics of real estate vary greatly from country to country, and are not easily translated into tools commonly used by the financial community to evaluate other assets or enterprises. For example, cap rates or initial yields are relatively vague ratios that describe the relationship between a building's net income and its price. The low degree of rigor used to compute these measures would shock a bond buyer used to a precise yield-to-maturity calculation, or a stock buyer relying on price to earning ratios. Even for real estate securities, obscure calculations such as funds from operations or net asset value (NAV)are used in place of the standard tools of corporate finance such as cash flow, net earnings and book value.

Special treatment for real estate financial reporting is often justified because real estate holding companies and investment trusts operate under highly specialized tax regulations in most countries. Moreover, under GAAP real estate depreciation must be treated as a large expense, which supposedly makes earnings comparisons with other industries difficult. The response of property owners and managers to this situation has generally been to withhold meaningful information from the marketplace, leaving investors in the dark regarding many of the fundamental financial and market attributes of real estate.

It is dangerous to send incomplete or faulty signals to the growing supply of footloose global capital. Overly rosy signals can create hyperinflation of property values, frequently followed by overbuilding that is justified only by high prices, occasionally tempered by the strictness of local building regulations. It adds up to the all too familiar cyclical pattern of boom and bust. Capital shortages are hard to shake off because trust in the old set of signals and market indicators is shattered. The result? Investors attracted to real estate for stable income and preservation of capital, experience return fluctuations on a par with more volatile sectors of the equity market. At the same time, occupiers watch building costs swing back and forth, when they would prefer a more predictable pattern to their occupancy costs.

Perhaps our industry is somehow genetically programmed to experience endless bouts of Schumpeter's "creative destruction"--driving property values to new highs only to watch them plummet to new lows. This cyclical pattern, as we all know too well, has been experienced in virtually every major property market around the globe, including markets that reputedly "could never be overbuilt due to barriers to entry." Can the amplitude and severity of these cycles be reduced through rising market efficiency, heightened financial disclosure, greater alignment of management interests with capital and the development of more accurate market signals to broadcast to the global capital markets? This is the question we face today. The answer will emerge during this decade.

MARKET EFFICIENCY AT WORK

A move toward market efficiency is not a panacea for investors, occupiers or those seeking to raise capital. Market efficiency does not eliminate risk, nor does it guarantee attractive returns to investors. In fact, in efficient markets it is much more difficult to earn excess returns, even though the possibilities for stochastic shocks, which can greatly impair values, are still present.

There are several key characteristics of improved real estate market efficiency. Foremost among these is timely, consistent, accurate information. This contrasts greatly with the use by many American real estate investors of NCREIF return data, which lags the market by as much as 18 months. An active "market" in data should discriminate between accurate and unreliable information, and attach value--which grows over time--to those firms that consistently generate reliable information. Even when investors and occupiers are armed with information, the future remains unknown. Nevertheless, as the number of investors increases, the value of insider information begins to fall. An investment firm's ability to beat the market is thereby reduced, as long as it stays within the envelope of the efficient market. The Capital Asset Pricing Model (CAPM) a single-factor risk model developed by William Sharpe, and Arbitrage Pricing Theory (APT), a multifactor risk model developed by Richard Ross and Steven Roll, seek statistical relationships between pricing and risk. These models are only beginning to be broadly applied to real estate. In contrast, both techniques have long been used in other industries. Eventually, these models of risk and return will matter more than models based on geography and property type. In other words, as market risk and specific risk are more efficiently priced by the market, "investment style" becomes the way that money managers and fund sponsors differentiate themselves. Hence, the opportunity fund management model, which seeks higher risks and returns, versus the value-added manager or more conservative "core" approach.

As market efficiency rises, investors will necessarily continue to take risks every day, but they will be making bets based on more thorough information and an expectation that risk and return are related to one another. Market efficiency is also increased when an insular market becomes more competitive and is forced to align itself with risks and returns offered by other assets. No longer will a good relationship with a friendly banker be enough to generate real estate capital. In fact, the demise of local bankers has forced successful real estate entrepreneurs to be sophisticated enough to attract global capital. New entrants to the property market will require the following attributes: financial transparency of investment vehicles; independent governance of shareholder interests; management compensation tied to the performance of investment vehicles; and transparency of market risks. But most important, they will have to demonstrate how they will profitably serve a well-defined target population.

Integration in the larger capital markets, which is hastened by rising market efficiency, can put real estate's access to capital at risk. For example, even if its risk-return profile does not change, real estate is impacted as the perceived risk-return profiles of other assets change. Hence, capital could withdraw from real estate even when the underlying property markets are strong, because risk-return combinations are perceived by investors to be even more rewarding in other sectors or assets. This is a new phenomenon for real estate, which previously could always rely on a steady flow of capital when its markets were in relative equilibrium.

As market efficiency rises, real estate is required to compete for capital on a global basis, based on the ever-changing risk-return characteristics of both real estate and alternative investments. If the broader capital markets perceive that real estate does not adequately compensate investors for the current risk level relative to alternatives, capital will be withdrawn and return requirements for real estate will rise. By the same token, if the capital markets perceive that real estate offers reasonable or attractive risk-adjusted returns relative to other options in the market, then capital will flow into the sector and the cost of capital will fall. The point is clear: once risks are revealed, they will be priced. When risks are concealed, they are more easily mispriced--a situation that generally damages the reputation of the asset class and lessens the credibility of the industry. Ultimately this mispricing leads to higher long-term capital costs and lower values due to higher risk premiums.

The net result is that the long-term cost of capital is reduced for those investment entities (both private funds and public companies) willing to make more complete disclosure of their operating results, but only if this disclosure reveals a "tight ship." The losers in the efficient-markets game are those entities with something to hide, or nothing very positive to reveal. Real estate has historically relied on closely-held "private" information to allocate its captive pool of dedicated capital. As it has been forced to attract footloose, non-dedicated real estate capital, it has shifted to rewarding "public" information.

RISING TRANSPARENCY

Wide disparities exist throughout the world in terms of the transparency of real estate markets. One attractive strategy is to enter inefficient markets and use proprietary research and the introduction of more transparent business practices to help raise the efficiency of the market. The only way to get this done is through the time-consuming task of documenting market supply/demand characteristics and reviewing financial information on each deal that comes to market. Newcomers are well-served by teaming up with local market specialists to obtain and evaluate this critical information. However, newcomers have one important advantage over the locals--they can see a market from a global perspective, which is nearly always unnoticed by those closest to the action.

Across the world, great strides are under way in market research and reporting standards, but much work remains. A higher level of transparency is the minimum price of admission that today's brutally honest global capital markets demand of real estate markets. The good news is that the trend toward rising market efficiency, once started, is difficult to stop. Not every market will open up quickly to new demands from investors, but those that do need to focus on a number of key areas.

Governance structure matters to global capital sources. Outside, truly independent directors who are beholden to shareholders, not management, are a critical requirement for institutional investors. Boards loaded with executives, family members, neighbors, the company's bankers, lawyers, and accountants, are simply not acceptable. The intertwined interests among banks, life companies and property funds in many countries raise questions regarding independent board oversight in the minds of investors. While good corporate governance does not guarantee results, it guarantees that when the unexpected occurs the interests of shareholders are addressed swiftly and sincerely.

Close adherence to international accounting standards (IAS) or international generally accepted accounting principles (GAAP) helps institutional investors make peer group comparisons and distinguish between recurring and extraordinary revenues or expenses. The emphasis on NAV, particularly in Europe and Australia, is different from the emphasis on cash flow or funds from operations (FFO) that has been adopted in the U.S. real estate investment trust (REIT) market. For institutional investors, both measures are important. Europe and Australia do a better job than the United States with NAV, but American companies are better at reporting different categories of cash flow and expenses. Financial reporting in Asia varies greatly from country to country, but the higher reporting standards in Singapore and Hong Kong are gradually being adopted in Japan, Korea, Taiwan and Thailand.

Whether the organization is a private vehicle or a public entity, regular and informative communication with investors is crucial. The same is true of the communication between building owners and their tenants. In fact, lead institutional investors and major tenants expect special treatment in this regard. When our European Securities team set up business in Amsterdam in 1997, it had difficulty securing access to the senior management at the largest property companies. Today--two years later--the CEOs of these companies understand the importance of meeting with potential investors and providing much better access. The new challenge for CEOs and building owners is to manage the expectations of shareholders and tenants. Learning to underpromise and overperform is the best course of action. This is a massive cultural shock to traditional real estate parlance, which is historically couched in the dream of development which overpromises (and often underperforms).

Research coverage of the major property companies in Europe has vastly improved in the past three years. The number of analysts covering the large British and French companies has grown rapidly, and the critical edge to their research is often sharper than what we see in the United States or Asia. While the disclosure of tenant rollover schedules at the portfolio level is still lacking, market summaries for geographic concentrations of assets are quite good. The difficulty remains that the companies themselves need to do a better job of disclosing financial and operating data to the analysts.

The role of performance statistics, such as those published by Jones Lang LaSalle and others--IPD (Europe) and NCREIF (United States), the Property Council (Australia) and Frank Russell (Canada)--are also critical in educating the institutional market about past performance. The publication of new IPD indices for various countries in Europe will help raise the efficiency of the private market, but appraisal-based indices still suffer from an inability to react to real-time changes in the capital markets or other macro-economic events. The founding of the European Public Real Estate Association at MIPIM in March 1999 represents an important first step in establishing European-wide reporting standards and investor education for the quoted sector, similar to the standards promoted by NAREIT in the United States. A similar effort to improve transparency standards for the Asian property companies would be welcomed by global investors.

The United States, the United Kingdom and Australia are the clear leaders in the documentation and publication of property market supply/demand fundamentals, but other Asian and European countries are catching up quickly. Much remains to be done. For example, accurate time series of rents, absorption rates, and data on new construction are beginning to be made available throughout Western Europe and developed Asia. However, data for Central and Eastern Europe and developing Asia are still very scarce.

The public market is leading the way toward the "alignment of interests" model used in the larger world of money management and corporate compensation. The private market vehicles in many countries still lag. The next generation of managers is starting to be incentivized to perform through aggressive stock option programs. We expect that the private investment markets in Europe and Asia will follow suit and adopt more back-ended performance fee structures in the years ahead. The U.S.-sponsored opportunity funds that operate in Europe are already using this model. Moreover, the global capital industry has come to expect this type of aligned interest fee arrangement across all other asset classes. In this model, a tiered fee structure gives first preference to the investor and then allows the fund sponsor to share in returns earned above previously-set thresholds. It also requires that the sponsor put up money side by side with investors.

BEST PRACTICES

The pace of change around the world is rapid, but much work remains to raise the transparency of many markets to an international standard. Quarterly reporting of financials is still a rarity and accurate cash flow statements are also difficult to come by. And a clearer alignment of interests among an independent board, a professional management team and shareholders/investors needs to be more widely implemented, perhaps starting in the United States.

Transparency is not currently being practiced to perfection for property investors and occupiers in any country. The ideal model for real estate is not necessarily the U.S. REIT, the U.K. property unit trust (PUT), the German open-end fund, the Asian property company, the Australian listed property trust (LPT) or the "opportunity fund" structure—each of which has its own problems. Most of these structures give an exemption from corporate taxation in exchange for a requirement to distribute earnings. The exception is the Asian property company--a highly entrepreneurial model, which generates revenue from active trading and ancillary real estate services. Rather, the ideal models, in terms of transparency, are the practices being implemented by many of the world's most innovative and well-respected multinational corporations and money management firms. These companies are setting the standards for real estate to follow.

As market efficiency and transparency rise around the world, the stakes rise and the winners and losers become evident. Access to capital and major tenants becomes a function of willingness to disclose material information about past and future performance. Poor past performance gets punished swiftly, while success generates swifter--and cheaper--access to additional capital. Investment managers and property managers who operate in the established markets of the Americas, Asia, Australia and Europe will soon start to enjoy access to more data than they ever envisioned. However, as closely guarded information becomes more widely available, investors will have to stretch their creative abilities to beat the indices.

The process of improving market efficiency will ultimately reward those who diligently analyze and compare new markets. Once these findings are disclosed to a wider audience, access to capital will broaden because global investors will be able to price risk more accurately. Global, footloose capital can create short-term volatility, but most important, rising efficiency for property markets around the world will help reduce the long-term amplitude of the underlying real estate fundamentals cycle in the years ahead.

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