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Implications for the Strategic Development of UK REITs from the Experience of LPTs in Australia

Research Findings

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This programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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IMPLICATIONS FOR THE STRATEGIC DEVELOPMENT OF UK REITs FROM THE EXPERIENCE OF LPTs IN AUSTRALIA

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EXECUTIVE SUMMARY

UK REITs were established in 2007 and are the 4th largest global REIT market and, accounting for over £26 billion, the 2nd largest REIT market in Europe. Established in 2007, UK REITs have experienced extensive property market volatility and uncertainty in this initial year, resulting in considerable underperformance. In contrast, listed property trusts (LPTs) in Australia are a long-standing, mature REIT market with a track record of strong investment performance and market growth over the last 15 years.

The report reviews the development of LPTs in Australia and identifies factors that may have implications for the future strategic development of UK REITs. It looks at operation, performance, investor support and recent LPT initiatives in the four areas of specific factors, development and growth factors, environment factors and investment demand factors. The report then identifies strategies for facilitating the ongoing successful development of UK REITs as a high-standard global investment vehicle in the expanding global REIT market.

1. INTRODUCTION

International property investment has taken on increased importance in recent years; this being driven by investors seeking portfolio diversification benefits, better returns and a lower cost of capital. This has been characterised by an increased appetite for property by investors such as global pension funds and global property securities funds. This saw over US$682 billion invested globally in commercial property in 2006, of which 42% was cross-border (JLL, 2007).

The growth in global REIT markets has been a key factor in this international property investment environment. This saw the global REIT market have over £335 billion in market capitalisation in December 2007, with nearly 500 REITs available globally.

Importantly, as well as the traditional established REIT markets in the US and Australia, recent years have seen the development of active REIT markets in Europe and Asia. In Europe, significant REIT markets have been established in UK, France, Netherlands and Belgium, with these European REIT markets now worth over £73 billion, representing 22% of global REIT market capitalisation and accounting for over 100 REITs. This has provided international investors with increased opportunities for more liquid indirect property exposure in the European stockmarkets, in addition to investing in the traditional property companies in Europe.

Importantly, the UK has been a major player in the development of REITs in Europe with the establishment of UK REITs in 2007. This saw 18 UK REITs established by December 2007, with a total market capitalisation of over £26 billion. The UK REIT market is currently the 4th largest global REIT market and the 2nd largest REIT market in Europe, only exceeded by REITs in France.

Established in 2007, UK REITs are a new market, and have experienced considerable property market volatility and uncertainty due to both local and international factors including tighter conditions in the global credit markets. This is in contrast to other mature REIT markets (eg Australian LPTs) which have an extensive track record of strong performance and market growth over the last 15 years. As such, the purpose of this report is to reflect on the LPT experience in Australia and identify the potential implications for UK REITs to ensure their ongoing strategic development as a leading property investment vehicle in Europe and internationally. This will be achieved by the following:

- Review of the development of LPTs in Australia; specifically identifying the key success factors in this well-established LPT market and the potential implications for the future strategic development of UK REITs. These success factors will cover LPT rules, regulations, structure, operational parameters, property market parameters, financial parameters, investment culture and players, and institutional investor acceptance/strategies; with these success factors covering both the supply-side and demand-side aspects of UK REITs
- Identify major regulatory/operational differences between Australian LPTs and UK REITs
- Identify how the structure of LPT operations has evolved in Australia
- Identify the major investors in Australian LPTs, the function of LPTs in their property portfolios and broader investment portfolios, and how their investment holding patterns have changed over recent years
- Identify the return and risk profile of Australian LPTs over 1985–2007; comparing with the other major asset classes in Australia
- Identify the key success factors (and potential risk factors) for ensuring the ongoing future strategic development of UK REITs in Europe.

2. SIGNIFICANCE OF INVESTORS IN INTERNATIONAL PROPERTY VIA REITs

This section highlights the growth in REIT markets globally, how these global REIT markets have performed in recent years and the significant growth in global property securities funds that have provided attractive investment opportunities to invest in global REIT portfolios. This section also provides a fuller context regarding the positioning of UK REITs in the rapidly expanding global REIT environment.

2.1 Global REIT markets

As well as the established REIT markets in the US and Australia, recent years have seen the establishment of REIT markets in many countries in Europe and Asia. Nineteen countries now have established and operating REIT markets, with more likely to be established in the next few years. Notably 2007 saw REITs established in the UK.

The status of these global REIT markets at December 2007 is shown in Table 1. There are currently 487 REITs with a total market capitalisation of £335 billion. While the US accounts for 46% of the global REIT market, significant contributions are also seen in Europe (22%), Australia (16%) and Asia (12%). This sees the top 10 global REIT markets as:

#1: US	#2: Australia	#3: France	**#4: UK#**	5: Japan
#6: Canada	#7:Singapore	#8: Netherlands	#9: Hong Kong	#10: Belgium

Table 1: Global REIT market: December 2007

Country	REIT market cap. (£)	Number of REITs	Percentage of global REIT market	Percentage of local listed property market
AMERICAS	£165.7bn	207	49.4%	
US	£153.4bn	175	45.8%	78.3%
Canada	£12.3bn	32	3.7%	39.3%
EUROPE	£73.2bn	103	21.8%	
UK	£26.4bn	18	7.9%	55.7%
France	£34.9bn	32	10.4%	81.4%
Netherlands	£6.5bn	7	1.9%	78.5%
Belgium	£3.4bn	14	1.0%	78.8%
Turkey	£0.8bn	11	0.2%	62.2%
Greece	£0.5bn	2	0.1%	22.9%
Bulgaria	£0.2bn	18	0.1%	97.2%
OCEANIA	£54.3bn	65	16.2%	
Australia	£52.7bn	57	15.7%	85.6%
New Zealand	£1.6bn	8	0.5%	91.7%
ASIA	£40.4bn	107	12.0%	
Japan	£24.0bn	42	7.2%	26.8%
Singapore	£9.7bn	20	2.9%	20.8%
Hong Kong	£4.3bn	7	1.3%	2.0%
Taiwan	£0.8bn	8	0.3%	14.8%
Malaysia	£0.8bn	13	0.2%	9.5%
South Korea	£0.5bn	10	0.2%	92.6%
Thailand	£0.2bn	7	0.1%	5.2%
AFRICA	£1.6bn	5	0.5%	
South Africa	£1.6bn	5	0.5%	29.1%
Total	**£335.2bn**	**487**	**100.0%**	

Source: AME Capital (2008)

2. SIGNIFICANCE OF INVESTORS IN INTERNATIONAL PROPERTY VIA REITs

Within Europe, UK and France dominate the £73 billion European REIT market, accounting for 18.3% of the global REIT market, and 83.7% of the European REIT market. Importantly, REITs in the UK and France now provide a significant percentage of property exposure on these two stockmarkets; 56% and 81% respectively. This is consistent with the higher levels of REITs seen in countries with long-standing and mature REIT markets such as US (78%) and Australia (86%).

The stature of REITs globally is further shown in the largest REITs at December 2007; see Table 2. The top 20 REITs see REITs across all of the major REIT regions (US, Europe, Australia and Asia), as well as seeing these leading REITs with both diversified and sector-specific portfolios. While office, retail and industrial property dominate these portfolios, non-traditional property sectors are also evident (eg self-storage, retirement and healthcare). The Australian retail LPT (Westfield) is the world's largest REIT. Importantly, UK REITs also figure prominently among these leading REITs, including Land Securities (#4 globally), British Land (#12) and Liberty International (#16). This sees three UK REITs in the top 20 REITs globally. Other leading UK REITs include Hammerson (#26) and Segro (#42); seeing five UK REITs in the top 50 REITs globally.

Table 2: Largest REITs: December 2007

REIT	Market cap (£)	Country	Sector
Westfield	£18.0bn	Australia	Retail
Simon Property Group	£ 9.8bn	US	Retail
Unibail-Rodamco	£ 9.0bn	France	Office, retail
Land Securities	**£ 7.0bn**	**UK**	**Retail, office**
Vornado Realty	£ 6.8bn	US	Office, retail
Public Storage	£ 6.4bn	US	Industrial
Boston Properties	£ 5.5bn	US	Office, hotel
Stockland	£ 5.4bn	Australia	Diversified
General Growth Properties	£ 5.1bn	US	Retail, leisure
Equity Residential	£ 5.0bn	US	Residential
Gecina	£ 4.9bn	France	Diversified
British Land	**£ 4.8bn**	**UK**	**Diversified**
Kimco Realty	£ 4.6bn	US	Retail
Host Hotels & Resorts	£ 4.5bn	US	Hotel
Plum Creek Timber	£ 4.0bn	US	Agricultural
Liberty International	**£ 3.9bn**	**UK**	**Retail**
HCP	£ 3.8bn	US	Retirement, healthcare
GPT	£ 3.8bn	Australia	Diversified
AvalonBay Communities	£ 3.7bn	US	Residential
Nippon Building Fund	£ 3.7bn	Japan	Office

Source: AME Capital (2008)

A range of REIT operational and regulatory models has been established in the various countries with REIT markets. A comparison of the key characteristics for REITs in various major REIT countries is given in Table 3, including the UK, US, Australia, France, Netherlands and the major Asia REIT markets in Japan, Singapore and Hong Kong. These key characteristics include their management structure, minimum level of property required, whether international property can be included, whether property development is allowed, maximum debt levels, distribution requirements and tax transparency. Importantly, no one operational model fits all countries, reflecting the property dynamics and regulatory systems in these various countries.

Table 3: Global comparison of key REIT criteria for selected countries

Criteria	US	Australia	UK	France	Netherlands	Singapore	Japan	Hong Kong
Management	Internal & external	**Internal & external**	**Internal & external**	Internal & external	Internal	External	External	Internal & external
Property investment	75%+	**Flexible**	**75%+**	Flexible	100%	70%+	75%+	100%
Overseas investment	Yes	**Yes**	**Yes**	Yes	Yes	Yes	Yes	Yes
Property development	Yes	**Yes**	**Yes**	Yes	Minimal	Max. 20% assets	Restricted	No
Gearing limit	No limit	**No limit**	**1.25x interest cover test**	No limit	60% total assets	35% total assets; 60% total assets if credit rating	No limit	45% total assets
Distribution percentage	> 90% taxable income	**100% taxable income**	**> 90% of rental asset income**	> 85% taxable income	100% fiscal earnings	>90% taxable income	> 90% taxable income	> 90% taxable income
Tax transparency	Yes	**Yes**	**Yes**	Yes	Yes	Yes	Yes	No

Source: EPRA (2007a), UBS (2007)

The stature of these global REIT markets has been further assisted by the creation of regional professional associations to represent the interests of REITs and to support their development. This includes NAREIT (National Association of Real Estate Investment Trusts, www.nareit.com) in the US, EPRA (European Public Real Estate Association, www.epra.com) in Europe and APREA (Asian Public Real Estate Association, www.aprea.biz) in Asia. The introduction and development of UK REITs has been further supported through the advocacy roles of the IPF and BPF.

2.2 Global REIT performance

The global importance of the REIT sector has been evident in recent years. Specifically for global REITs, Table 4 shows global REIT performance at June 2007 over the last one, three, five and 10-year periods for selected REIT markets. Strong performance across these various REIT markets was evident; in most cases, exceeding their respective stockmarket performance over these time periods. In particular, REITs in France and the Netherlands strongly performed over the one year and three year time periods; being significantly above the global REIT performance in these time periods. Several of the Asian REIT markets (eg Singapore, Japan) and Australian LPTs have also performed strongly in recent years, with Singapore being the top performing REIT market globally in recent years.

However, 2007 has proven to be a volatile and uncertain year for most REIT markets, reflecting tighter conditions in global credit markets and property market uncertainty. Global REIT performance in 2007 is shown in Table 5 for the various mature market REITs and emerging market REITs. Among the mature REIT markets, 2007 performance has been poor compared to previous strong track records, with only Hong Kong and Singapore delivering positive returns. Among these mature REIT markets, UK REITs (-35.1%) were the worst performing REIT market; significantly under-performing the overall UK stockmarket. Overall, this global REIT performance under-performed global stocks (10.2%) in 2007.

Table 4: Global REIT performance: June 2007

Country	Average annual total returns			
	1Y	3Y	5Y	10Y
Australia	43.1%	28.3%	28.0%	16.1%
Belgium	17.6%	17.7%	21.5%	12.7%
Canada	33.4%	33.3%	28.8%	16.0%
France	44.1%	43.8%	NA	NA
Hong Kong	15.6%	14.4%	NA	NA
Japan	34.2%	20.2%	26.7%	NA
Netherlands	36.5%	30.1%	30.8%	16.1%
New Zealand	53.6%	27.1%	29.6%	NA
Singapore	88.1%	44.3%	NA	NA
US	12.4%	21.4%	18.7%	13.9%
Global	**22.0%**	**24.2%**	**21.6%**	**14.7%**

Source: S & P (2007)

Table 5: Global REIT performance: December 2007

Sector	Annual return 2007
Mature market REITs	
US	-20.08%
Australia	-7.93%
UK	**-35.08%**
France	-17.50%
Canada	-5.62%
Netherlands	-11.24%
Belgium	-7.02%
Japan	-2.94%
Singapore	4.54%
Hong Kong	13.48%
Emerging market REITs	
Bulgaria	43.43%
South Korea	27.69%
South Africa	23.32%
Thailand	19.88%
Malaysia	18.02%
Turkey	0.52%
Taiwan	-10.58%
Greece	-29.33%
Global property stocks	1.50%
UK property stocks	-33.60%
Global stocks	10.23%
UK stocks	8.91%

Source: AME Capital (2008)

2.3 Significance of global property investors

International investors have recently shown an increasing appetite for property, with most global pension fund allocations to property being significantly below their target allocations. The creation of REIT markets in many countries has provided an effective opportunity for increased property exposure in these established and emerging REIT markets in a more liquid investment format.

Importantly, this has seen the rapid growth in global property securities funds, with over 250 global property securities funds having US$81 billion in funds under management in 2007. Table 6 presents the leading global property securities funds at October 2007, with 20 funds having in excess of US$1 billion in funds under management. A significant number of these funds are global REIT funds (eg Nomura Global REIT Fund, DLIBJ DIAM World REIT Income Fund), while others have a global property mandate and include both global REITs and global property stocks in their portfolios. These global property securities funds have been established by most of the leading institutional property investors (eg Nomura, ING, ABN Amro, Cohen & Steers, Morgan Stanley). These funds have full global mandates and do not include those property securities funds with more regional mandates.

Indicative benchmark allocations for UK property exposure in these global property securities funds is an 8% allocation, based on the FTSE EPRA/NAREIT Global Real Estate Index. Other benchmark allocations in these global funds are US (37%), Australia (13%), Japan (13%), Hong Kong (12%), France (4%), Netherlands (2%), Germany (1%) and Sweden (1%). The resulting regional benchmark allocations are North America (40%), Europe (19%) and Asia-Pacific (41%).

Table 6: Leading global property securities funds: October 2007

Property securities fund	**Assets under management (US$)**	**Mandate**
Fidelity Real Estate Investment (US)	$5,890m	Global
Nomura Global REIT Fund (Japan)	$5,761m	Global REIT
DLIBJ DIAM World REIT Income (Japan)	$4,275m	Global REIT
Standard Life Select (UK)	$3,407m	Global
DJE Real Estate (Luxembourg)	$2,546m	Global
Alpine International Real Estate (US)	$2,215m	Global
ING Clarion Global Real Estate Income Fund (US)	$2,119m	Global
AMP Wholesale Global Property Securities Fund (Australia)	$2,096m	Global
Alpine Global Premier Property (US)	$1,908m	Global
ABN AMRO Global Property Securities Fund (Netherlands)	$1,822m	Global
Total of 250 funds	**$81,378m**	

Source: Hughes and Moss (2007)

Similarly, Table 7 presents the leading global REIT funds at October 2007. There are currently over 50 global REIT funds with approximately US$21 billion in total funds under management, with most of these leading funds domiciled in Japan.

Table 7: Leading global REIT funds: October 2007

Global REIT fund	Assets under management (US$)
Nomura Global REIT Fund (Japan)	$5,761m
DLIBJ DIAM World REIT Income (Japan)	$4,275m
MAQ-IMM Global REIT (Korea)	$1,348m
Nikko AMP Global REIT Fund (Japan)	$1,149m
Kokusai World REIT (Japan)	$1,121m
Sumitomo Global REIT (Japan)	$903m
Daiwa Global REIT (Japan)	$809m
DLIBJ DIAM World REIT (Japan)	$575m
Nippon Global REIT (Japan)	$538m
Mitsubishi UFJ Europe/Aust. REIT (Japan)	$502m
Total of 51 funds	**$20,863m**

Source: Author's compilation from Hughes and Moss (2007)

Overall, recent years have seen an increased international focus by property investors seeking access to the global property markets and global property portfolio diversification. The expanding global REIT markets are seen as an increasing opportunity to extend this global property exposure to quality REIT markets in a liquid format. In particular, the increased role of these global property securities funds has seen significant changes in the investor profile for REIT markets in recent years; this is discussed for LPTs in Australia in the next section of this report.

2.4 Significance of UK REITs

2.4.1 Context for UK REITs

The UK has a transparent and competitive economic and financial environment, as well as being seen as a highly transparent property market. In particular, the UK is rated as the 10th most globally competitive country of the 125 countries assessed by the World Economic Forum in 2006 (WEF, 2007); see Table 8. Similarly, the UK is rated as the 12th least corrupt country of the 163 countries assessed by Transparency International in 2007 (TI, 2007); see Table 8.

Table 8: UK economic and financial environment

Business competitiveness (WEF)	UK (#10 most competitive); compared with: Switzerland (#1), Sweden (#3), US (#6), Germany (#8), Netherlands (#9), France (#18)
Corruption (TI)	UK (#12 least corrupt); compared with: Finland (#1), Denmark (#1), Sweden (#4), Netherlands (#7), Germany (#16), France (#19), US (#20)

Source: WEF (2007), TI (2007)

Importantly, the UK property market is rated as the 5th most transparent property market of the 56 countries assessed by Jones Lang LaSalle in 2006 (JLL, 2006); see Table 9. This sees the UK rated as the most transparent property market in Europe; being one of only 10 countries globally in the top JLL transparency category of 'highly transparent'. Other European countries in this top JLL property market transparency category are Netherlands, Sweden and France. Most other European countries are classified as transparent, with several Eastern European markets still only being seen as semi-transparent (eg Czech Republic, Poland, Hungary and Russia). In comparison, Australia is the world's most transparent property market, with LPTs a key factor in this high level of property market transparency.

Table 9: Global real estate transparency index

Highly transparent	Australia, US, New Zealand, Canada, UK, Hong Kong, Netherlands, Sweden, France, Singapore
Transparent	Finland, Germany, South Africa, Denmark, Austria, Ireland, Belgium, Spain, Switzerland, Norway, Italy, Malaysia, Japan, Portugal
Semi-transparent	Mexico, Czech Republic, Hungary, Poland, Israel, Taiwan, South Korea, Slovakia, Chile, Greece, Russia, Philippines, Brazil, Slovenia, Thailand, Argentina, India
Low transparency	China, Macau, UAE, Costa Rica, Indonesia, Turkey, Peru, Romania, Colombia, Uruguay, Saudi Arabia, Panama
Opaque	Egypt, Venezuela, Vietnam

Source: JLL (2006)

The UK has a long-established tradition of property companies as major players in the UK property market and internationally. Table 10 presents the significance of these property companies in a UK and global property market context; particularly highlighting the significance of the listed property sector compared to the total property market. Overall, the UK contribution by listed property is comparable to that seen globally, as well as with several other European countries (eg France, Spain). This UK listed property market also has a benchmark allocation of approximately 8% in global property securities funds.

Table 10: Global significance of listed property: 2007

Countries	Size of property market (US$)		Size of listed property market (US$)	Listed property versus total property	Listed property versus stockmarket
Germany	$1,258bn	7.3%	$15.4bn	1.2%	0.7%
UK	**$1,241bn**	**7.2%**	**$94.0bn**	**7.6%**	**2.3%**
France	$955bn	5.5%	$77.5bn	8.1%	2.7%
Italy	$793bn	4.6%	$6.9bn	0.9%	0.6%
Spain	$505bn	2.9%	$35.0bn	6.9%	3.0%
Netherlands	$281bn	1.6%	$13.5bn	4.8%	2.2%
Belgium	$167bn	1.0%	$5.3bn	3.2%	1.3%
Switzerland	$165bn	1.0%	$6.4bn	3.9%	0.5%
Sweden	$163bn	0.9%	$18.3bn	11.3%	3.1%
Austria	$137bn	0.8%	$18.9bn	13.8%	7.0%
Norway	$129bn	0.7%	$2.9bn	2.2%	0.7%
Denmark	$116bn	0.7%	$2.0bn	1.8%	0.8%
Greece	$101bn	0.6%	$2.0bn	2.0%	0.8%
Europe	$6,706bn	39.0%	$312.8bn	4.7%	1.7%
US	$5,602bn	32.6%	$446.6bn	8.0%	2.5%
Australia	$321bn	1.9%	$163.9bn	51.0%	11.3%
Asia	$3,361bn	19.5%	$470.5bn	14.0%	2.9%
Total	**$17,216bn**	**100.0%**	**$1,441.0bn**	**8.4%**	**2.5%**

Source: Author's compilation from EPRA (2007b)

2.4.2 Establishment and significance of UK REITs

The UK REIT market was established in January 2007, with nine property companies converting to REIT status. Table 11 lists the UK REITs at December 2007, covering both diversified and sector-specific property portfolios. These portfolios include office, retail and industrial property, as well as the self-storage and healthcare property sectors.

Table 11: UK REITs: 2007

REIT	Listing date (2007)	Sector
Big Yellow	January	Self-storage
British Land	January	Diversified
Brixton	January	Industrial
Derwent London	July	Office
Great Portland Estates	January	Office
Hammerson	January	Diversified
Land Securities	January	Diversified
Liberty International	January	Retail
Local Shopping REIT	May	Retail
McKay Securities	April	Office
Mucklow Group	July	Office, industrial
Primary Health Properties	January	Healthcare
SEGRO	January	Industrial
Shaftesbury	April	Retail
Town Centre Securities	October	Retail
Warner Estate	April	Retail
Workplace Group	January	Office, industrial

At December 2007, this saw UK REITs as the 4th largest global REIT market, only exceeded by the US (#1), Australia (#2) and France (#3). The UK REIT market accounts for 7.9% of the global REIT market capitalisation and 36% of the European REIT market capitalisation as well as UK REITs accounting for 56% of the property exposure on the UK stockmarket (see Table 1). The operational and regulatory environment for UK REITs was shown previously in Table 3.

While UK REITs were established in 2007, they did not enjoy the initial success that has been evident in many other global REIT markets in the last five years; particularly in Asia. This reflected uncertainty in the UK property market and tighter conditions in the global credit markets, resulting in the increased cost and less availability of credit. This saw considerable volatility and uncertainty in the performance of UK REITs in 2007 (-35.08% return); being one of the least-performed REIT markets globally in 2007 (see Table 5).

This context and lesser initial performance for UK REITs in 2007 is the catalyst for this report to reflect on the Australian LPT experience as a long-term and successful REIT market to identify any issues that may impact on the future successful development of UK REITs.

3. SIGNIFICANCE AND DEVELOPMENT OF AUSTRALIAN LPTs

The following sections highlight the significance and recent strategic developments with LPTs in Australia. This will provide the context to examine the potential impact of various strategies regarding the future development of UK REITs.

3.1 Background to LPTs

In Australia, listed property trusts (LPTs) are the equivalent of UK REITs, and were established as a listed property investment vehicle more than 35 years ago. Until 1990, there was a lack of significant growth, with institutional portfolios being dominated by direct property holdings. The property market recovery in the early 1990s saw institutional investors search for liquidity; a major catalyst to LPT growth with both supply side and demand side appeal. Over this subsequent 15 year period, LPTs have become a mature, sophisticated, highly successfully indirect property investment vehicle, with an outstanding track-record and significant commercial property assets, being available to both general investors and institutional investors. Australian LPTs are the second largest REIT market globally (£53 billion at December 2007), only exceeded in size by the US REIT market (£153 billion at December 2007). The Australian property market is considered to be the world's most transparent property market (JLL, 2006); see Table 9. LPTs are an important ingredient in this high level of property market transparency in Australia.

Importantly, LPTs offer features often not available with direct property, including:

- High liquidity
- High divisibility
- Low entry and exit costs via stockmarket listing
- Proper disclosure re: stockmarket guidelines
- Access to 'trophy' property assets
- Access to quality sector-specific and diversified portfolios
- High yields
- Tax transparency
- Professional fund management skills and expertise
- Efficient market place
- Ability to spread risk
- Non-valuation based performance reporting

3.2 LPT regulatory framework

LPTs are a property investment vehicle listed on the Australian stockmarket. LPTs invest in income-producing properties (eg office, retail, industrial), with the main goal of obtaining rental income. The standard Australian stockmarket regulations and the Managed Investment Act provide the regulatory environment for LPTs.

3. SIGNIFICANCE AND DEVELOPMENT OF AUSTRALIAN LPTs

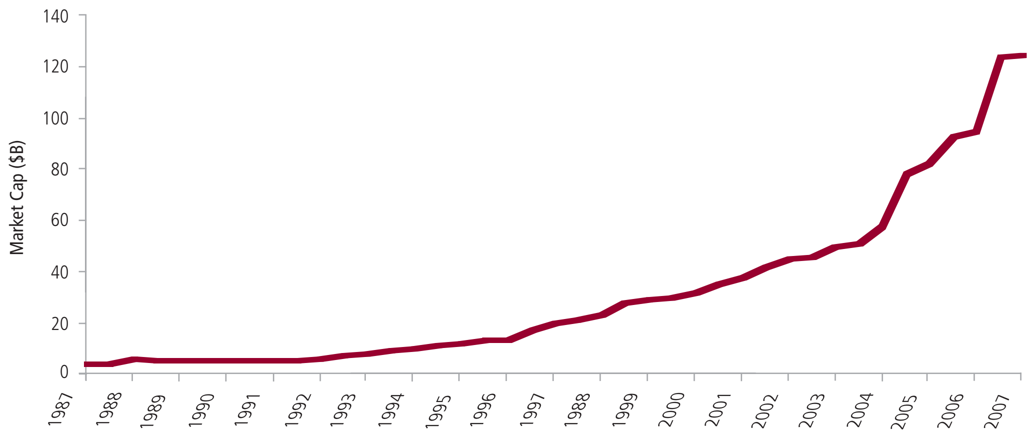
LPTs are tax transparent and do not pay company tax if they distribute 100% of their taxable income (post depreciation) to the LPT shareholders. There are no limits on gearing, with international property investments acceptable. While the traditional LPT structure was for external managers, recent years have seen most LPTs move to an internal management model (via stapled securities) to allow for non-property investment activities, such as property development and other aspects of funds management. Full operational and regulatory details for LPTs compared to other major global REIT markets were given previously in Table 2.

3.3 LPT profile

At December 2007, the LPT sector had total assets of over £62 billion, comprising more than 3,000 institutional-grade properties in diversified and sector-specific portfolios (PIR, 2007a). LPTs currently account for over £52.7 billion in market capitalisation, the third largest sector on the Australian stockmarket, and now represent over 10% of the total Australian stockmarket capitalisation, compared to only 5% of the total Australian stockmarket capitalisation in 2000. LPTs also account for over 85% of property exposure on the Australian stockmarket; significantly above the equivalent global level of 31% (AME Capital, 2008).

Figure 1 shows the growth in LPT market capitalisation since 1987. Significant growth has occurred since 1992, which has seen the LPT market capitalisation grow from only £3 billion to its current level of over £52.7 billion; this sees Australian LPTs as the second largest REIT market in the world, accounting for 15.7% of global REIT market cap (see Table 1). Currently, there are a range of LPTs, including diversified LPTs (38% of LPT sector market cap.), office LPTs (8%), retail LPTs (44%) and industrial LPTs (10%). Unlike US REITs, Australian LPTs do not have residential property in their portfolios.

Figure 1: Growth in Australian LPT market capitalisation: 1987–2007 [1]



Source: Author's compilation

[1] $1 = £ 0.4412 at December 2007

3. SIGNIFICANCE AND DEVELOPMENT OF AUSTRALIAN LPTs

Table 12 presents an overall profile of the leading diversified and sector-specific LPTs in the LPT sector at December 2007. There are 34 LPTs in the top 300 companies on the Australian stockmarket, with 50 LPTs in total at December 2007. The largest LPTs include Westfield (£18.0 billion market cap.), Stockland (£5.4 billion) and GPT (£3.8 billion), with Westfield being the world's largest REIT at nearly double the size of the second largest global REIT (Simon Property Group: £9.8 billion); see Table 2. Other LPTs that are in the leading global REITs are Stockland (#8), GPT (#18), Goodman (#21), Mirvac (#30), DB RREEF (#34) and CFS Retail (#39). This sees Australian LPTs comprising three of the world's top 20 REITs and seven of the world's top 50 REITs (see Table 2).

Some LPTs have in excess of 100 commercial properties in their portfolios (eg DB RREEF, Goodman, Westfield, Macquarie CountryWide, Stockland) via local and international property exposure. Several LPT fund managers have a range of LPTs (eg Macquarie, ING), with the top 10 LPT fund managers accounting for 79% of the LPT market as shown in Table 13.

Table 12: Leading Australian LPTs: December 2007[1]

LPT	Market capitalisation (US$)	Number of properties
Diversified		
Stockland	$12.21bn	192
GPT	$8.48bn	85
Mirvac	$6.16bn	60
DB RREEF	$5.86bn	198
Office		
Macquarie Office	$2.79bn	41
Commonwealth Property	$2.50bn	29
ING Office	$2.04bn	24
Retail		
Westfield	$40.79bn	121
CFS Retail Property	$5.25bn	24
Macquarie CountryWide	$2.18bn	244
Industrial		
Goodman	$8.31bn	543
ING Industrial	$2.77bn	539

Source: UBS (2008), PIR (2007a)

[1] $1 = £ 0.4412 at December 2007

Table 13: Major Australian LPT fund managers: 2007

LPT fund manager	Total assets (US$)	% of total LPTs
Westfield Group	$49.3bn	28.5%
Macquarie Bank	$16.1bn	9.2%
GPT Group	$11.1bn	6.2%
Stockland Trust Management	$10.8bn	6.2%
DB RREEF Funds Management	$9.0bn	5.2%
Colonial First State Global Asset Management	$9.0bn	5.1%
ING Management	$8.5bn	4.9%
Mirvac Group	$8.5bn	4.9%
Centro Properties Group	$8.4bn	4.8%
Goodman Funds Management	$7.7bn	4.4%
Total	**$138.5bn**	**79.1%**

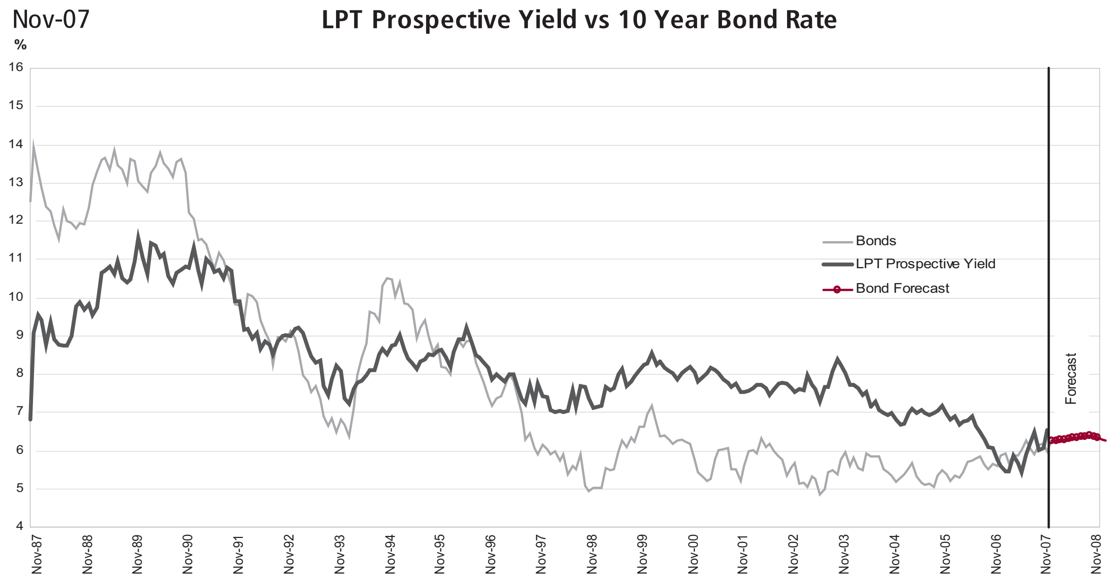
Source: PIR (2007a)

Currently, LPTs account for approximately 7% of institutional asset allocations and over 45% of all institutional-grade property in Australia. As Australia only accounts for 2% of the world's commercial property, this sees Australia as one of the most securitised property markets in the world; with 51% of the property market being securitised (see Table 10). LPT stocks are held by the major institutional investors, with both local and offshore property securities funds having significant levels of LPTs. LPTs are highly liquid stocks, having an average monthly LPT turnover of 9.7% of the total LPT market capitalisation in 2007 (UBS, 2007, 2008); this compares with an average monthly turnover of 3.8% in 1999. International investors (via global property securities funds) have significantly increased their allocations to LPTs, with international investors now accounting for over 22% of LPT holdings. Typical benchmark allocations for Australian LPTs in these global property securities funds are 13%, using the FTSE EPRA/NAREIT Global Real Estate Index.

LPTs have performed strongly compared to the other major asset classes over the last 10 years, with LPT risk levels being significantly below stockmarket risk, reflecting the defensive characteristics of LPTs. Sector-specific LPTs have also typically outperformed the corresponding direct property sector. These LPT performance analysis issues are discussed more fully in the next section of this report.

Typically, LPTs are not highly geared compared to other stocks in Australia, with an average gearing of 35% at November 2007. However, these debt levels have increased significantly in recent years, LPTs had an average of only 15% gearing in 1997. LPTs with international property exposure tend to be more highly geared, compared to those LPTs with domestic property portfolios. The yields for LPTs (currently 6.2%) make them attractive yield-focused investment alternatives to 10-year bonds, although there has been significant yield compression for LPTs in 2005–2007; see Figure 2. The LPT sector also trades at a significant premium to NTA; this is unlike most other securitised property markets and reflects the quality of LPT management and growth prospects.

Figure 2: **Australian LPT yield gap profile**



Source: PIR (2007b)

LPT and stockmarket performance in Australia is correlated (r = 60 over 1985–2007) and it has been shown that there is no long-term market integration between LPTs and the stockmarket. This evidence of market segmentation suggests that there are diversification benefits from including LPTs in an investment portfolio, particularly in conditions of increased stockmarket volatility. Both diversified and sector-specific strategies have been shown to be equally effective for LPT portfolio diversification (Newell and Tan, 2003a), with LPTs also showing evidence of superior property selection and market timing (Peng, 2004). The establishment of an LPT futures market in August 2002 further enhanced the stature of LPTs, with institutions being able to use LPT futures as an effective risk management tool for hedging their LPT exposure (Newell and Tan, 2004).

Another key factor in the development and maturity of the LPT sector has been the establishment of benchmark LPT performance indices on the Australian stockmarket, as well as the production of LPT sub-sector performance indices by UBS for the leaders, office, retail, industrial and diversified LPT sub-sectors since 1993. This has recently been supplemented by additional LPT sub-sector indices by UBS for stapled securities LPTs and international LPTs; reflecting the emergence of these new key LPT sectors in recent years.

The re-badging of Australian LPTs as Australian REITs (or A-REITs) has also been implemented in 2007–2008. This is to make the Australian investment terminology for REITs consistent with that seen in all other REIT markets globally, and has been strongly supported by the property industry in Australia.

Overall, LPTs have been seen to be a world-class indirect property investment vehicle, offering a range of attractive investment features and access to quality commercial property portfolios for both institutional, international and general investors.

3.4 LPT performance analysis

Further evidence of the investment stature of LPTs is shown in Table 14, with the investment performance of LPTs compared to the other major asset classes. Over each of the one, three, five and 10-year holding periods, LPTs were seen to perform strongly, being in the top two performing asset classes in each case, and being the best-performed asset class over the last 10 years. Importantly, over the last 22 years, LPTs were the best-performed sector in 36% of years, only exceeded by shares being the best-performed sector in 41% of years. In particular, LPTs outperformed shares in 55% of years over 1985–2006; as well as LPTs being the best performed asset class in eight of the last 11 years; see Table 15. This strong performance by LPTs reflects the significant growth and maturity of the LPT sector in the last 10 years. Importantly, sector-specific LPTs have also typically out-performed the corresponding direct property sector over these various holding periods; see Table 16.

Table 14: Australian LPT performance analysis: September 2007

Asset class	Average annual total return			
	1Y	3Y	5Y	10Y
Direct property	17.27% (3)	15.72% (3)	13.97% (3)	12.18% (3)
LPTs	20.13% (2)	20.76% (2)	19.29% (2)	14.67% (1)
Shares	33.58% (1)	26.39% (1)	22.45% (1)	13.46% (2)
Bonds	3.12% (4)	4.96% (4)	5.06% (4)	5.59% (4)

Source: IPD/PCA (2007)

Table 15: Major Australian asset rankings: 1985-2006

	Direct property	Shares	Bonds	LPTs
1985	2	**1**	3	4
1986	4	**1**	3	2
1987	**1**	4	2	3
1988	**1**	2	4	3
1989	2	**1**	3	4
1990	3	4	**1**	2
1991	4	**1**	2	3
1992	4	3	**1**	2
1993	4	**1**	3	2
1994	**1**	4	3	2
1995	4	**1**	2	3
1996	4	2	3	**1**
1997	4	2	3	**1**
1998	3	2	4	**1**
1999	2	**1**	3	4
2000	3	4	2	**1**
2001	2	3	4	**1**
2002	2	4	3	**1**
2003	2	**1**	4	3
2004	3	2	4	**1**
2005	2	**1**	4	3
2006	3	2	4	**1**

Source: Author's analysis

Table 16: Australian LPT sub-sector performance analysis: September 2007

Asset class	Average annual total return (%)			
	1Y	3Y	5Y	10Y
Directpropery	17.27%	15.72%	13.97%	12.18%
Office	19.95%	15.21%	11.91%	10.80%
Retail	15.45%	16.34%	15.88%	13.33%
Industrial	13.01%	13.25%	13.34%	13.22%
LPTs	**20.13%**	**20.76%**	**19.29%**	**14.67%**
Office LPTs	19.00%	18.90%	16.00%	11.60%
Retail LPTs	17.60%	20.00%	19.40%	15.90%
Industrial LPTs	15.60%	30.90%	26.00%	18.20%
Diversified LPTs	25.20%	19.40%	19.10%	14.60%
International LPTs	17.30%	18.00%	15.60%	16.30%
Stapled LPTs	21.70%	21.60%	17.60%	14.30%
Shares	33.58%	26.39%	22.45%	13.46%
Bonds	3.12%	4.96%	5.06%	5.59%

Source: IPD/PCA (2007), UBS (2007)

As well as delivering strong total returns, LPTs also have a risk profile significantly less than the risk level of the stockmarket. In particular, over 1985–2006, the LPT risk level of 11.4% was only 63% of the stockmarket risk level of 18.2%, reflecting the defensive nature of LPTs. On a risk-adjusted performance analysis basis, LPTs were the best performed asset class (Sharpe ratio of 0.49), compared to shares (2nd; Sharpe ratio of 0.33), direct property (3rd; Sharpe ratio of 0.27) and bonds (4th; Sharpe ratio of 0.23). The beta for LPTs was 0.40; further reflecting the defensive characteristics of LPTs, compared to the overall stockmarket.

In assessing the portfolio diversification benefits of LPTs, Table 17 presents the inter-asset correlations over 1985–2007. With the correlation between LPTs and the sharemarket being r = 0.60, this reflects some degree of portfolio diversification benefits. Importantly, this correlation between LPTs and shares has decreased significantly in recent years; in particular, the correlation over 1985–92 of r = 0.71 has reduced to r = 0.24 over 1994–2006. This demonstrates enhanced portfolio diversification benefits by LPTs in more recent years. LPTs and direct property were not correlated (r=-0.09) over this period; reflecting their performance being seen as separate and distinct property investment vehicles, with LPTs being seen as a hybrid of direct property and stockmarket performance.

Table 17: Australian LPT portfolio diversification: September 2007

	LPTs	Shares	Direct property	Bonds
LPTs	1.00			
Shares	0.60	1.00		
Direct property	-0.09	0.00	1.00	
Bonds	0.35	0.13	-0.27	1.00

Source: IPD/PCA (2007)

Similarly, it has been shown that the addition of LPTs to a portfolio of shares, bonds and cash sees enhanced risk-adjusted mixed-asset portfolio returns for LPT levels in the portfolio of up to 20% (Newell and Tan, 2003b).

Overall, concerning performance analysis, LPTs have been shown to deliver strong risk-adjusted returns, as well as portfolio diversification benefits. While past performance is not necessarily an indicator of future performance, the results for Australian LPTs present a strong picture regarding the strategic contribution of LPTs to investment portfolios in Australia.

3.5 Recent issues in the strategic development of LPTs

The LPT sector has undergone considerable development and structural change in recent years, including increased levels of international property, increased levels of debt, incorporating property development activities via the use of stapled securities structures, a reduced number of LPTs via significant mergers and acquisitions, and use of emerging property sectors. The potential impact of these structural changes is to increase LPT risk levels and see LPTs as more sensitive to interest rates and less reflective of property market conditions, and reduce the traditional defensive nature of LPTs and their benefits in a portfolio. Importantly, LPTs have also recently seen a changing investor profile; particularly from the rapidly expanding global property securities fund sector.

These changes in the LPT sector have largely focused around the following key issues, all of which have significant strategic implications concerning the future development of LPTs.

3.5.1 Increased levels of international property

With LPTs accounting for over 45% of all institutional-grade property in Australia, the lack of local investment opportunities has seen LPTs seeking international property investments in recent years. Other motivating factors for LPTs seeking international properties in their portfolios have been diversification benefits, growth in investment funds, better returns and lower cost of capital. Beginning with Westfield America in 1996, international property in LPT portfolios now accounts for 39% of LPT total assets, with industry surveys indicating these levels of international property are expected to increase to 50-60% of LPT total assets over the next three years. In 2005, LPT international property acquisitions accounted for 79% of all LPT property acquisitions.

As seen in Table 18, international property has been included in LPT portfolios as stand-alone 100% international LPTs (eg Macquarie DDR, Babcock & Brown Japan Property Trust) or merged with local property (eg Westfield, Macquarie CountryWide, DB RREEF, Macquarie Office). This now sees 60% of LPTs in the ASX200 having international property in their portfolios. The initial focus of this international exposure by LPTs was US retail and US industrial, but this has now further expanded to include European commercial property (eg GPT, Macquarie CountryWide, APN European Retail, Rubicon Europe Trust, Westfield) and Asian commercial property; particularly in Japan (eg Babcock & Brown Japan Property Trust, Rubicon Japan Trust).

Further significant developments into Europe and Asia by LPTs are expected in the future, although current property market uncertainty and tighter conditions in global credit markets may slow these developments in the near future. Evidence of strong performance by the international LPT sector relative to the other LPT sectors over the last 10 years is shown previously in Table 16.

Table 18: Country profile for international LPTs in Australia

LPT	Australian assets	US assets	European assets	Asian assets	NZ assets
100% international portfolio (12 LPTs)					
APN European Retail Trust	-	-	100%	-	-
Babcock & Brown Japan PT	-	-	-	100%	-
Centro Shopping America Trust	-	100%	-	-	-
Galileo Japan Trust	-	-	-	100%	-
Mirvac Industrial Trust	-	100%	-	-	-
Macquarie DDR Trust	-	100%	-	-	-
Mariner American Property Income Trust	-	100%	-	-	-
Reckson NY Property Trust	-	100%	-	-	-
Rubicon America Trust	-	100%	-	-	-
Rubicon Europe Trust Group	-	-	100%	-	-
Rubicon Japan Trust	-	-	-	100%	-
Tishman Speyer Office Fund	-	100%	-	-	-
Merged domestic/international portfolio (12 LPTs)					
Centro Properties Group	67%	30%	-	-	3%
DB RREEF Trust	79%	19%	-	-	2%
GPT	73%	4%	23%	-	-
ING Office Trust	67%	30%	3%	-	-
ING Industrial	85%	-	15%	-	-
ING Community Living	50%	46%	-	-	4%
Macquarie CountryWide	23%	74%	-	-	3%
Macquarie Goodman	93%	-	-	4%	3%
Macquarie Office	40%	60%	-	-	-
Macquarie Leisure	87%	12%	-	-	1%
Stockland Trust Group	95%	-	-	-	5%
Westfield Group	42%	45%	9%	-	4%

Source: Author's compilation

While international property introduces the additional risk factors of currency risk, political risk and economic/investment risk, LPTs have typically used joint venture structures with local market participants, accessed transparent property markets, used skilled management teams and hedged rental income streams for up to 10 years as effective risk management strategies. Other FX risk management strategies used by LPTs include cross-country swaps and off-setting FX borrowings to cover both capital and income risk management of these international property portfolios (Newell and McIntosh, 2007). The addition of international property to the LPT portfolio has been shown to give diversification gains, as well as mixed-asset portfolio benefits (Tan, 2004a, b). Importantly, while LPTs have taken on increased levels of international property in recent years, it has been shown that this has not resulted in increased LPT risk levels (Newell, 2006); further reinforcing the effectiveness of the international property risk management strategies adopted by these LPTs. However, recent tighter conditions in global credit markets has raised concerns towards the end of 2007 for those LPTs with significant international property portfolios requiring refinancing of their maturing debt.

Overall, Australian LPTs have been international leaders in including international property in their portfolios at significant levels over the last 10 years; doing so in an effective manner across a wide country profile of US, Europe and Asia.

3.5.2 Increased levels of debt

Debt levels for LPTs have steadily increased from 10% in 1995 to 35% in 2007. While these debt levels are still low in comparison to US REITs and the overall stockmarket, they are largely attributable to a low interest rate environment and increased international property exposure, with higher gearing used as a natural hedging strategy by LPTs with international property exposure. For example, some 100% international property LPTs have debt levels in excess of 50%; eg Rubicon America, Reckson NY Property, Macquarie DDR. These increased debt levels further heighten the sensitivity of LPTs to future interest rate changes and tighter global credit markets as has been evident in the latter part of 2007. In structuring this debt profile, LPTs have used a range of sophisticated debt products including CMBS, property trust bonds, hybrids and off-balance sheet financing (Chikolwa, 2007).

Importantly, as LPTs are unable to retain capital, LPTs have been highly successful raising additional capital either by new IPOs, rights issues or private placements. This has reflected confidence in the financial markets in the ongoing growth of LPTs, their quality property portfolios and the professional quality of LPT management.

3.5.3 Incorporating property development activities via stapled securities

While the traditional LPT model involved external managers, recent years have seen an increased focus on an internal LPT management structure via stapled securities. This internal management structure has enabled a closer alignment of unit holders and manager interests, no fee leakage and a lower cost of capital, but it has increased LPT exposure to non-property investment risk; in particular, to property development risk. This reduced LPT exposure to rental income has seen this exposure decrease from 96% of income in 2000 to 88% in 2007, with these non-rental income components comprising property development (6.1% of income), funds management (2.8% of income), property management (0.5% of income) and construction (0.4% of income).

Stapled securities now account for over 75% of the LPT market capitalisation, compared to only 29% in 2004. Leading LPTs using this stapled security structure include Westfield, Stockland, GPT, Macquarie Goodman, Mirvac and DB RREEF, with a number of these LPTs engaged in property development (eg Stockland, Westfield).

While stapled securities typically take on more risk due to property development risk and higher leverage ratios, stapled securities have been shown to outperform externally managed LPTs on a risk-adjusted basis (Tan, 2004c), with property development being an important value-adding dimension in LPT performance (Tan, 2004d). Importantly, industry surveys have indicated that industry participants consider stapled security returns outweigh the extra risk, and property development is being seen as the most effective future growth strategy to optimise returns. Similarly, LPT fund managers do not consider the risk will increase substantially, due to the generally low levels of property development activity undertaken in the overall LPT portfolio. Evidence of strong performance by the stapled securities LPT sector relative to the other LPT sectors over the last 10 years is shown previously in Table 16.

This stapled securities structure for LPTs has seen a number of LPTs further develop their fund management activities by establishing significant unlisted wholesale property funds. This has been an effective strategy for accessing the significant growth in pension funds in Australia (over £450 billion in 2007) and the increased appetite for property by these pension funds in their investment portfolios. Examples of these wholesale property funds include the GPT Wholesale Office Fund and Goodman Australia Industrial Property Fund (Newell, 2007a, b).

While LPTs have increasingly adopted this internal management structure in recent years, it has been shown that this has not resulted in increased LPT risk levels in the stapled securities LPT sector (Newell, 2006). This has largely been attributable to managing the extent of the property development activities compared to the lower risk delivered by the stable rental income component from the portfolio of LPT investment properties; with rental income still accounting for 88% of the LPT income stream.

3.5.4 Changing LPT investor profile

LPTs have seen significant changes in their investor profile since 2002. This has reflected increased offshore investor interest from the rapid growth in the global property securities fund sector. In 2007, there were 250 global property securities funds with over US$81 billion in assets under management, including over 51 global REIT funds with assets of over US$21 billion (see Tables 6 and 7). With the strong previous performance of LPTs and a typical portfolio benchmark weight for LPTs of approximately 13% in these global property securities funds, this has seen these international funds recently take on increased significance in the LPT investor profile. In comparison, other benchmark allocations by these global property securities funds include US (37%), UK (8%), Hong Kong (12%) and Japan (13%).

Table 19 presents the LPT investor profile over 2002–2006. The significant change over this five-year period was the increase in the level of LPTs in the offshore funds, having increased from only 5% to 22%. This was also accompanied by a significant increase in allocation by the local property securities funds, having increased from 15% to 25%. The lesser significance of LPTs in general equities funds is also evident, having decreased from 45% to 28%. Given the bottom-up stock selection strategy used by these global property securities funds and their global mandate, the current uncertainty in the LPT market is likely to see many global property securities funds be underweight in their fund's LPT exposure.

Table 19: LPT investor profile: 2002–2006

Investor fund type	2002	2003	2004	2005	2006
Equities	45%	46%	40%	35%	28%
Offshore	5%	9%	10%	15%	22%
Property securities	15%	20%	25%	25%	25%
Retail	35%	25%	25%	25%	25%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Data provided to author by UBS

3.5.5 Reduced number of LPTs via mergers and acquisitions

Recent years have seen considerable consolidation in the LPT sector via merger and acquisition activity, strategy largely implemented to build funds under management for LPTs and increase their international competitiveness. This has also seen LPTs strategically develop their property portfolios by acquiring existing property portfolios, rather than to incrementally increase their property portfolio via individual property acquisitions. This has seen the LPT sector grow significantly, but the number of LPTs reduce significantly.

Recent examples of this LPT consolidation via mergers and acquisitions include:

- DB RREEF; formed from Deutsche Office, Deutsche Industrial and Deutsche Diversified
- Westfield; formed from Westfield, Westfield America and Westfield Holdings.

This consolidation now sees a significant contribution by a smaller number of large LPTs to the LPT sector market capitalisation, with the top five LPTs (Westfield, Stockland, GPT, Goodman and Mirvac) accounting for 68% of the LPT index (see previous Table 12). Each of these top five LPTs have a market capitalisation in excess of £2.5 billion, with 16 LPTs having a market capitalisation of more than £440 million. With considerable liquidity evident in the LPT sector, the potential impact with this consolidation is for LPTs to behave more like stocks than previously. This consolidation has been offset to some degree by the recent establishment of smaller LPTs, with 16 LPTs now listed on the ASX but not included in the benchmark ASX300.

3.5.6 Emerging property sectors

LPTs traditionally focused on core portfolios of office, retail and industrial property. However, recent years have seen a movement by LPTs into new property sectors, including leisure (eg Macquarie Leisure), retirement (eg ING Community Living), pubs (eg ALE Property Group), self-storage (eg Valad), healthcare (eg ING Healthcare) and childcare (eg Australian Education Trust). Table 20 gives details of the emerging property sector LPTs at December 2007, with a number of these emerging property sector LPTs included in the benchmark ASX300 (eg Macquarie Leisure, ING Community Living). The structure has normally been achieved as a stand-alone LPT structure, with one LPT (Valad) integrating an emerging sector (self-storage) into its broader LPT portfolio.

This growth in emerging property sector LPTs has reflected the mismatch between available funds and the shortage of core property assets in Australia, and LPTs having considered higher risk value-added property by seeking enhanced returns available from the emerging property sectors. The ageing demographic in Australia has also been a catalyst for the retirement and healthcare sectors being included in these emerging sector LPT portfolios. These emerging sector LPTs have higher risk, but significantly out-performed the traditional LPT sectors on a risk-adjusted basis over 2002–2005, as well as providing portfolio diversification benefits (Newell and Peng, 2006). Table 21 gives the performance of selected emerging sector LPTs at September 2007.

Table 20: **Emerging property sector LPTs: December 2007**

Leisure/entertainment:	
Macquarie Leisure	ALE Property
ING Entertainment	MTM Entertainment
MFS Living & Leisure	Tourism & Leisure
Retirement:	
ING Community Living	
Healthcare:	
ING Healthcare	
Childcare:	
Australian Education Trust	
Agriculture:	
Challenger Wine Trust	Coonawarra Australia
Cheviot Kirribilly Vineyard	
Self-storage:	
Valad Property Group	

Source: Author's compilation

Table 21: **Emerging sector LPT performance: September 2007**

LPT	Average annual total returns			
	6M	1Y	3Y	5Y
Macquarie Leisure	14.8%	37.1%	44.1%	52.2%
ING Community Living	4.1%	23.1%	19.5%	NA
ALE Property	9.3%	33.9%	45.9%	NA
ING Entertainment	10.0%	19.8%	14.0%	NA
Australian Trust	4.9%	20.8%	NA	NA
Challenger Wine	-5.3%	-11.6%	2.5%	8.0%
LPT sector	7.7%	20.0%	20.7%	19.3%

3.5.7 Yield compression

2006–07 has seen increasing bond yields and yield compression in the LPT sector; see previous Figure 2. This yield compression in the property market has seen it become more difficult for LPTs to acquire properties at attractive yields, with LPTs only accounting for 23% of recent commercial property purchases in Australia; compared to unlisted wholesale property funds (41% of recent acquisitions) which have a stronger focus on total returns rather than yield. This has seen the significant growth in the unlisted wholesale property fund sector in Australia; now being over £26 billion in property assets (Newell, 2007a, b).

3.5.8 Private equity investors

As has also been seen for US REITs, 2007 has seen an increasing role by private equity investors acquiring major LPTs in Australia for their quality property portfolios. This has seen Investa (£2.5 billion portfolio of 34 commercial properties) recently acquired by Morgan Stanley, and Multiplex (£1.4 billion portfolio of 25 commercial properties) acquired by Brookfield. Increased private equity interest in LPTs is expected, but this may be softened by the recent increased cost of debt and tighter credit market conditions.

3.5.9 Other recent developments

Other recent developments that have impacted on the LPT sector include:

- introduction of performance-based fee structures by most LPTs; in some cases, with significant out-performance of benchmarks, this has presented pressures on net income levels available for distribution to shareholders with deferred fee structures having to be introduced in some instances.
- significant international leadership role by LPTs regarding sustainable commercial property (eg Investa, Stockland, GPT, Mirvac), with LPTs being included in the various international sustainability performance benchmarks including the FTSE4Good Index, Dow Jones World Sustainability Index, Global 100 Index and Carbon Disclosure Project Climate Leadership Index.
- introduction of LPT futures as an effective LPT risk management strategy by institutional investors (Newell and Tan, 2004).

Overall, these recent major developments and structural changes in the LPT sector can have a potential impact on LPT risk levels, and hence their portfolio diversification benefits. Importantly, effective risk management strategies have been adopted by most LPTs and not reduced the overall attractiveness of LPTs as an asset class.

3.6 Changing LPT and property landscape in 2007

Australian LPTs have not been immune to the downturn in major global REIT markets in 2007 (see Table 5), which has resulted from property market uncertainty and a tightening of global credit markets. Table 22 shows LPT sector/sub-sector performance in 2007 over the last three months, six months and 12 months. This particularly highlights the significant impact on the LPT sector in the last quarter of 2007 (-13.0% return), with this impact also being evident across all LPT sub-sectors. This has seen LPTs significantly under-perform the overall Australian stockmarket (16.2% return) in 2007.

Table 22: LPT performance: December 2007

LPT sector		Returns	
	3M	6M	1Y
LPTs	-13.0%	-8.5%	-8.4%
Office LPTs	-10.5%	-11.4%	1.1%
Retail LPTs	-15.1%	-10.0%	-12.3%
Industrial LPTs	-24.1%	-18.4%	-23.0%
Diversified LPTs	-7.4%	-2.5%	-1.1%
International LPTs	-7.7%	-1.2%	-2.0%
Stapled LPTs	-13.6%	-8.8%	-8.5%
Shares	-2.7%	2.9%	16.2%
Bonds	0.7%	2.5%	4.0%

Source: UBS (2008)

This increased cost and reduced availability of credit has had a significant impact on LPTs seeking to refinance maturing debt; particularly those LPTs which were highly geared and with high US property exposure. For example, Centro which is the second largest retail property owner in Australia has recently experienced difficulties in refinancing £1 billion in maturing short-term debt, following a recent extensive US retail acquisition strategy (eg £2.5bn acquisition of New Plan Excel Realty Trust). This has led to trading in Centro being suspended and redemptions frozen on a number of Centro's unlisted property funds. This has also seen Centro become a potential acquisition target for both local and international property investors. Given the approximately 40% level of international property in LPT portfolios, several of which are 100% international with US or UK/ European properties (see Table 18), and the typically higher level of gearing in these 100% international LPTs, this has raised concerns over future rental growth, declining property values and future earnings pressure on several LPTs, as well as concerns over their currency risk exposure. This has already seen a number of global property securities funds reduce their allocation to LPTs to be significantly under-weight compared to the 13% FTSE EPRA/NAREIT benchmark allocation.

The current situation sees increased concerns regarding LPT risk factors; particularly for LPTs with high levels of US property and high levels of gearing; as well as for LPTs engaged in property development. While these LPT risk factors have been managed effectively previously, risk management strategies by LPTs will take on increased importance to accommodate this current property market uncertainty and the tighter global credit markets.

3.7 Summary

LPTs in Australia are an important property investment vehicle, offering features such as liquidity, transparency, high yields and access to quality property assets. Table 23 provides a timeline for significant milestones in the development of LPTs.

Table 23: LPT timeline

1970	LPTs introduced in Australia
1970-90	Lack of significant growth; institutional portfolios dominated by direct property holdings
1989-91	Major property market downturn
1992	Property market recovery; institutional search for liquidity Catalyst to LPT growth; both supply and demand side appeal Market cap for LPTs reaches $7bn (£3bn) Focus on office, retail and industrial property LPT gearing at 10% External manager as preferred LPT model
1996	First international property LPT @ Westfield America
1997	Significant LPT yield gap established; retained until 2007
1999	LPT gearing at 20%
2000	Increased popularity for stapled security/internal management model
2002	Increased M&A activity; smaller number of large LPTs Increased levels of international property in LPTs; initially US properties
2003	Market cap for LPTs reaches $50bn (£22bn) Incorporation of emerging property sectors into LPTs
2006	Market cap for LPTs reaches $100bn (£44bn) Expanding international focus to Europe and Asia; particularly Japan Yield compression
2007	LPT gearing at 37% Market cap for LPTs reaches $130bn (£57bn) International property in LPTs reaches 39% A-REIT terminology increases acceptance instead of LPT terminology Concerns in LPT sector over tightening of global credit markets for re- financing debt Increased role by private equity investors in acquiring LPTs

Importantly, LPTs in Australia have been seen as a well-performing asset class, with strong defensive characteristics (eg low risk) in a portfolio, particularly in a volatile stockmarket environment. Recent structural changes and developments in the LPT sector have also seen increased international investment, increased levels of debt, incorporating property development activities via stapled securities LPTs, a reduced number of LPTs via significant mergers and acquisitions and the inclusion of emerging property sectors in LPT portfolios, as well as a changing investor profile. The latter half of 2007 has presented concerns and challenges for the LPT sector in Australia; particularly with the re-pricing of risk in global markets and some LPTs experiencing difficulties in effectively accessing the global credit markets for re-financing debt. These features could potentially impact on the future risk profile of LPTs and their strategic contributions to portfolios. Despite these concerns, LPTs have quality property portfolios, quality professional managers and long-term stable returns in the world's most transparent property market; with the future outlook being generally positive.

With the development of REITs in the UK currently in progress, the track-record, investment strategies and characteristics of LPTs in Australia provides an excellent opportunity to reflect on this international experience with a long-standing, mature and sophisticated LPT/REIT market to identify potential implications for UK REITs such that they can be strategically developed as an effective property investment vehicle in the UK in the future. This is discussed in the following section of this report.

4. IMPLICATIONS FOR THE FUTURE DEVELOPMENT OF UK REITs

Given the maturity, structure, track record and market growth of LPTs in Australia, it is important to reflect on the factors that have seen Australian LPTs being highly successful and identify possible implications for the future strategic development of UK REITs as an effective property investment vehicle in the UK and internationally. A key issue to recognise is that the success story for LPTs did not occur overnight; it took many years to develop to its current status. Established in 1970, LPTs did not capture a significant place in the property investment vehicle landscape until the early 1990s. This has seen LPTs with an effective 15-year track record.

These LPT success factors can be broadly classified as:

- quality investment grade properties in portfolios
- high yield via tax transparency
- investor choice via diversified and sector-specific portfolios
- market cycle timing
- gearing levels
- use of internal manager via stapled security structure
- incorporating international property
- incorporating emerging property sectors
- access to capital
- performance analysis and monitoring
- effective growth strategies
- product demand from both institutional and retail investors
- property industry understanding
- professional property fund managers

with these LPT success factors discussed below.

4.1 Quality investment grade properties in portfolio

Quality investment-grade properties characterise the LPT portfolios; for both their local and international portfolios, as well as there being significant LPT market depth. With most UK REITs established as conversions from leading UK property companies in 2007, this sees the quality portfolios of these leading property companies as major elements in these UK REIT portfolios. This is reflected in the UK REIT market quickly becoming the 4th largest global REIT market with 18 REITs, and five UK REITs being in the top 50 global REITs; namely Land Securities (#4), British Land (#12), Liberty International (#16), Hammerson (#26) and Segro (#42).

4.2 High yield via tax transparency

As seen previously in Figure 2, LPTs have historically offered high yields with a significant yield gap over 10-year bonds since June 1996. While this yield gap has reduced since 2006, LPT yields are still attractive (6.2%) and above those seen in most other global REIT markets. The UK REIT yield gap is currently negative (3.25% versus 4.5%); similarly for REITs in France. In contrast, several of the recently established REIT markets in Asia have significant yield gaps (eg Japan and Hong Kong), as do Belgium and Netherlands.

4.3 Investor choice via diversified and sector-specific portfolios

62% of LPTs are sector-specific; hence investors have choice regarding exposure to a specific property sector instead of using a diversified LPT. Importantly, 71% of UK REITs are also sector-specific, offering UK REIT investors the choice of property exposure via sector-specific or diversified REITs.

4.4 Market cycle timing

LPTs took on more importance in the early 1990s in Australia as there was a recovering property market and institutional investors sought liquidity in their property portfolios. These concurrent supply and demand side factors proved to be a major catalyst for LPT growth. With 2007 seeing considerable uncertainty in the property market and tightening credit markets, it was not an optimal time to launch a new REIT market. An improving property market in the future will see a more suitable market context for the ongoing development of UK REITs.

4.5 Gearing levels

While LPTs have no formal limit on their gearing levels, LPTs have low gearing levels compared to other stockmarket entities. However, recent years have seen LPT gearing levels increase significantly; particularly for LPTs with international property portfolios. Several LPTs currently experiencing refinancing difficulties were more highly geared, due to their international property exposure (eg US) strategy. If UK REITs are to expand the level of international property in their portfolios, this issue of gearing needs to be considered as an element in the overall REIT risk management strategy.

4.6 Use of internal manager via stapled security structure

Most LPTs have moved from the traditional external manager model to an internal manager model via a stapled security structure. This has seen LPTs able to engage in property development and other aspects of funds management (eg unlisted wholesale property funds). A key factor in this success has been the continued significant levels of rental income (88%) contributing to the LPT income stream, with non-rental income components mainly comprising property development (6.1%) and funds management (2.8%). Many LPTs acknowledge that incorporating property development activities is the most effective future growth strategy, with the expected enhanced returns outweighing the extra risk. Importantly, LPTs have kept the property development contribution in perspective, with a continued strong focus on significant levels of rental income. This is compatible with the UK REIT model which allows both property development and external/internal managers.

4.7 Incorporating international property

LPTs have 39% international property in their portfolios; particularly in the more transparent US and European property markets and increasingly in Japan. UK REITs are also able to include international property. Key issues for UK REITs to consider are:

- quarantining this international property exposure in a 100% international REIT or integrating this international property exposure with the domestic property portfolio
- currency risk management strategies for both income risk management and capital risk management
- using joint venture arrangements with local market participants to enhance local property expertise and knowledge
- use of fractional interests in the international properties; typically more than a 50% ownership structure for the property via a joint venture with a local player to retain management control of the international property asset
- ensuring members of the UK REIT property team have international professional property expertise and experience in areas such as risk management and JVs

While some LPTs with significant US property exposure are currently experiencing difficulties with refinancing in a tight global credit market, effective risk management strategies should see the effective integration of international property into UK REIT property portfolios.

4.8 Incorporating emerging property sectors

LPTs have recently successfully established emerging property sector LPTs in the areas of leisure, retirement, healthcare, childcare, self-storage and agriculture; in most cases, as stand-alone LPTs. Several UK REITs are already involved in these emerging sectors; this includes Big Yellow (self-storage) and Primary Health Properties (healthcare). In moving into these emerging property sectors, it is important to recognise that these new property sectors have some key differences to the traditional property sectors in UK REIT portfolios. These differences include:

- operating business being linked with the property assets
- difficulties predicting cashflows
- lack of consistent and long-term performance measures
- small size of these niche markets
- lack of UK REIT experience with these new property sectors
- variety of business models re: operating business elements

They clearly highlight the risk management issues that need to be addressed by UK REITs moving into this emerging property markets sector; particularly concerning the use of a joint venture partner with experience in the operating business. Importantly, these new property sectors have been shown to be strongly performed in Australia and are taking on increased importance in these portfolios. Some of these new property sectors have higher risk than the traditional property sectors due to this extra dimension of business risk and this needs to be factored into appropriate risk management strategies by UK REITs.

4.9 Access to capital

As LPTs are required to distribute 100% of their net income to retain their tax transparent status, LPTs generally do not have access to retained earnings for new acquisitions, compared to property companies. This sees LPTs using the capital markets for additional capital, including new IPO launches, rights issues and private placements.

Similarly, on the debt side, LPTs have increased their access to CMBS and LPT bonds. The quality of the LPT property portfolio is a key criteria in accessing this funding and ensuring a high credit rating for the CMBS or LPT bond. While there is a current tight global credit market, LPTs have typically been highly successful in raising additional capital, due to the quality of their property portfolios and future growth prospects.

With UK REITs required to distribute 90% of their net income, this issue of access to capital is also an issue for expanding UK REIT property portfolios.

4.10 Performance analysis and monitoring

Given the significance of the LPT sector, LPTs have extensive performance analysis, with LPT sector/sub-sector indices available since 1993 (UBS, 2008); this being essential to assess the risk-adjusted performance of the LPT sector and to benchmark LPT performance against the other major asset classes. Such UK REIT sector/sub-sector indices are also required; particularly given the significant level of sector-specific UK REITs and the increasing market depth in these UK REIT sub-sectors. These indices would be a useful complement to the existing IPD UK direct property indices to enable the effective performance comparison of UK indirect and direct property; as well as for global property investors to enable more rigorous investment performance evaluations.

4.11 Effective growth strategies

Strong economic growth, strong property market fundamentals, improved business confidence, shortage of new supply and expected rental growth have been key factors in a supportive environment for the previous growth of LPTs. However, a number of specific factors will also impact on the ongoing growth of UK REITs; with these factors also having been evident in the LPT market. These include:

- limited ability to deliver yield and high distribution growth via individual acquisitions; particularly with competition from unlisted funds
- smaller UK REITs will likely experience M&A pressure as larger UK REITs and private equity funds seek to acquire full property portfolios rather than individual properties to achieve significant growth; this will most likely result in further consolidation of REITs in the UK
- smaller UK REITs will have limited growth potential as they lack a property development pipeline to grow their portfolio by acquiring stabilised yield-producing properties from the parent company
- longer-term performance information will highlight separation of over/under-performers in the UK REIT sector; further highlighting M&A pressure
- increasing interest rates and the current tightening of global credit will impact on UK REIT performance; similarly with the current repricing of risk in the capital markets; this will highlight the quality of their property portfolios and the calibre of their UK REIT professional management
- yield compression has been evident recently; this has placed pressure on UK REITs to acquire properties at competitive yields; particularly with competition from unlisted property funds who are total return focused.

4.12 Product demand from investors

LPTs have seen strong ongoing demand from both institutional and retail investors; in particular, more recently from the offshore global property securities funds. For UK REITs, given that most are conversions from existing UK property companies, the transition to REITs has seen investors hopefully recognising this re-badging, rather than seeing it as a totally new property investment vehicle. This is further complemented by the well-known and respected stature of REITs in many other countries (eg Australia, US) and should see wide acceptance of UK REITs by retail investors particularly as these are mainly conversions rather than new UK REIT products. In the future, new UK REIT IPOs may need more effective marketing to retail investors; particularly given the difficulties in 2007 in the initial year for UK REITs in an uncertain UK property market. Overall, a better understanding of UK REITs by investors will likely see increased investor demand. Similarly, given the stature and understanding of the UK property companies by the major institutional investors, a high degree of institutional investor acceptance of UK REITs can be expected, with the benchmark weighting for the UK for global property securities funds currently being 8% as per the EPRA/NAREIT Global Real Estate Index.

4.13 Property industry understanding

Given their property investment stature, UK REITs will interact at all levels of the UK property industry; particularly covering the areas of property investment, valuation and property management. As such, property professionals in the UK need a full appreciation of the significance, stature and role of UK REITs. In the UK, this has been actively facilitated by IPF and BPF; as well as EPRA extending this agenda to the broader European REIT context. In Australia, this LPT agenda has been very effectively led by the Property Council of Australia, as the major advocacy group for the Australian property industry. Given the initial difficulties with UK REITs in 2007, this advocacy for UK REITs by IPF and BPF needs to be further emphasised to ensure all players are aware of the property investment benefits of UK REITs.

4.14 Professional property fund managers

For LPTs, the quality of the property portfolio and the quality of the professional property fund management team are seen as the two essential ingredients for a successful LPT. In many cases, the quality of the professional fund management team figures prominently in the rating given by rating agencies, and advisory LPT rating groups and investment advisers (eg Property Investment Research, UBS).

With UK REITs largely being the conversion of UK property companies, this has seen an extensive level of property expertise, skills and experience already built in at all levels of the professional management of UK REITs. This includes asset management, property portfolio management and property fund management for UK REITs.

Addressing the various issues listed above will add considerably to the ongoing stature, integrity, performance and risk management strategies implemented by UK REITs. While 2007 has been a difficult year for UK REITs, REITs are now seen as a globally accepted property investment vehicle for quality property exposure in a liquid format, with outstanding reputations in many countries and developing reputations in the more recently introduced markets in Europe and Asia.

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