REITS, Australian, and German Property Shares

by

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INTRODUCTION

The internationalisation of the capital markets and the consequential reaction of European investors appears to be one of the main topics in European real estate investment today. What are the main reasons for the growing internationalisation in Europe?

Firstly, the introduction of the Euro eliminated currency risks. After having been being restricted to investments in their respective home countries, investors now consider European investment alternatives. The change of mentality that comes along with this new development also encourages investors to invest in overseas markets. Even for investors outside the Euro zone, it simplifies matters considerably that one can concentrate on just one currency parity.

Secondly, in the German market property shares have been neglected for a long time by the capital and financial markets. For more than 50 years the real estate markets have been subject to substantial tax incentives. Since supply and demand in the German real estate market concentrated on tax-oriented forms of direct investment, property shares have not managed to play a significant role in the German market. As real estate specific tax benefits have been gradually reduced in recent years, investors have begun to discover property shares as a new and attractive form of investment.

In this article the authors examine three investment markets: Australia, Germany and the USA, further they compare the most important real estate investment vehicle of each market. The US Real Estate Investment Trusts (REITs) have been for a long time the prototype of an instrument with the aid of which the investor can set up his portfolio with percentage point accuracy since there exists an adequate supply for every property type and region. The equivalent from an investor's perspective is the Australian Listed Property Trust (LPT). The only real estate investment opportunity listed at German stock exchanges is the German Property Share (GPS).
In the following these three investment vehicles shall be compared with each other. For that purpose the authors use seven criteria and analyze each instrument applying these criteria.

HISTORY

REITs were created with the passing of the Real Estate Investment Trust Act by Congress in 1960 but for more than 30 years they played a minor role in real estate investment. In the beginning, REITs were constrained because they were only permitted to own real estate, not to operate or to manage it. The investment market did not readily accept this arrangement. During those years, provisions of the tax code also distorted prices on the real estate market as real estate investment tax became shelter-oriented. By using high debt levels and aggressive depreciation schedules, a taxpayer could claim interest and depreciation deductions that significantly reduced his or her taxable income. The Tax Reform Act of 1986 changed the real estate investment landscape in two important ways. At first, the Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This meant that real estate investment had to be economic and income-oriented. Second, as part of the Act, Congress bolstered REITs. The Act permitted REITs not only to own, but also to operate and manage most types of income-producing commercial properties. REIT industry analysts often classify REITs according to one of three investment approaches: Equity REITs own real estate. Their revenues derive principally from rent. REIT industry investments in property ownership have increased steadily over the last 38 years.[1] Mortgage REITs loan money to real estate owners. Their revenues stem principally from interests on their mortgage loans. Some mortgage REITs also invest in residuals of mortgage-based securities. Hybrid REITs combine the investment strategies of both equity REITs and mortgage REITs. Some REITs invest in a variety of property types: shopping centers, apartments, warehouses, office buildings, hotels, etc. Other REITs concentrate on one property type only, such as shopping centers or factory outlet stores. Health care REITs specialize in health care facilities: hospitals, including intensive care, rehabilitation and psychiatric, medical office buildings, nursing homes, as well as congregated and assisted living centers.

Activity in the Australian LPT sector began after an economic collapse had a disastrous impact on unlisted property trusts in the mid 1990s. Most of the new activity emanated from restructured and revalued previously unlisted property trusts which were then listed at the Australian Stock Exchange. In addition, investors withdrew capital from unlisted property trusts and invested in the listed property market that was dominated by trusts initially established by property development companies to serve as a source of financing. The LPT market can be divided in diversified and specific trusts. Trusts seeking to avoid cyclical fluctuations in their unit prices may diversify their portfolio by owning properties in several categories. Specialization takes place in retail, office, industrial, commercial or leisure and tourism properties in a variety of locations.

[1] This is the comparable form that corresponds best with Australian LPTs and German Property Shares.

The majority of GPSs stem historically from the discontinuation and liquidation of the corporations' original business operations. The remaining property portfolio was the starting point for the new property company. German real estate corporations originate from such business as breweries, textile companies and mining companies. For the sake of simplicity three types of real estate business types can be roughly distinguished: real estate investment, real estate development, real estate services. The fields differ greatly in the type and structure of sales, costs, and risk incurred. So far, there are no exclusive service or development corporations to be found on the market, rather companies are either investment types or they combine different types within one corporate shell.

LEGAL FORM

All three investment opportunities represent regular share certificates issued by a legal entity. Australian LPTs and US REITs can considered counterparts. REITs and the LPTs both feature a tax-exempt status. In order for a corporation or trust to qualify as a REIT or an LPT it must comply with certain provisions within their respective Tax Laws. REITs can be modelled as corporations, business trusts, or associations whereas the Australian vehicle is limited to the legal form of a trust.

In the past, German legislation has been postulating funds as the model investment instrument for real estate. Consequently, promotion of Property Shares has been conducted rather timidly in the past time and capital was invested in funds which are neither listed nor does there a secondary market exist. Property Shares are the only listed real estate securities in Germany but it cannot be considered as the exact equivalent to REITs or LPTs. Specific requirements regarding dividend policy, ownership structure, and compulsory disclosure, as well as tax benefits do not apply for the German investment vehicle. German Property Companies have the legal form of a corporation. Consequently they are only subject only to German Stock Corporation Law which is in the case of real estate not different from that of any other corporation.

NUMBER, CAPITALISATION, AND DIVERSIFICATION

Since 1986, the vast majority of REITs has been listed at the stock exchange.[2] Non-listed existing partnerships which own real estate can pursue an IPO in the special form of an Umbrella Partnership REIT (UPREIT) since 1992. Compared to their Australian and German counterparts the total market capitalization of REITs is immense amounting to US$ 138 billions.[3] Only the Equity-REITs represent a capitalization of almost US$ 134 billions (97% of all REITs). This equals about one percent of the total US market

[2] This article analyzes only the listed REITs and does not regard the dozens of not listed REITs.
[3] REIT data refers to 31/12/2000.

capitalization. In the U.S., there are some 300 REITs. About two-thirds of these are traded at the national stock exchanges: 155 at the New York Stock Exchange, 30 at the American Stock Exchange, and 13 at the NASDAQ National Market System. Their assets total over US$ 250 billions. The average size as to their market capitalization, which is indicated through NAREIT Index is US$ 734,4 millions. The number of small REITs is comparably low which could indicate that a market concentration has already taken place. The market is dominated by specialized, mostly commercial REITs. The market share of diversified REITs ranges below 10%.

The US REITs must comply with the provision of the Internal Revenue Code to qualify for the tax-exempt status. Two of these regulations have a direct effect on liquidity. Firstly, the REIT has to have a minimum of 100 shareholders. Secondly, no more than 50 percent of the shares can be held by five or fewer individuals during the second half of each taxable year. This regulation leads to an increased liquidity compared to GPSs.

The Australian Listed Property Trusts reach a market capitalization of about US$ 20 billions. Their weight in relation to the total market capitalization is higher than in the U.S. as they amount to almost 6% percent stake of the market.[4] The liquidity in the sector has improved across the board during the last years. Levels of shares held by managers to maintain a controlling influence are very low.

In Australia, there are now 42 LPTs, not taking some smaller hotel trusts into account. Their assets total over US$ 26,6 billions. The average size as per market capitalization of US$ 459,2 millions has been growing steadily over the years. There are also a large number of trusts in the sub US$ 100 millions. The tendency to enlarge their size is accelerated by an institutional demand for liquidity and lower costs of capital. The structure of investment offered within the LPT sector is dominated by diversified (circa 36%) and commercial real estate (circa 34%), which add to ca. 70% of the index.

In contrast to the majority of US REITs, the tradability of existing German real estate corporations appears restricted due to the comparatively low market capitalization amounting to a little more than US$ 12 billions.[5] This also represents one percent of the German market capitalization. Furthermore, many companies are characterized by a relatively small free-float which still represents the historic roots of privately owned property management firms.

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[4] LPT data refers to 30/09/2000.

[5] GSP data refers to 31/12/2000.

In Germany, at present, time there are 57 listed property companies. The average size according to market capitalization, indicated through DIMAX Index, amounts to US$ 216,47 millions. Diversified real estate companies add up to circa 60% of the DIMAX Index value. Specialised companies focus mainly on residential property (circa 34%). The first specialised company in shopping centers is Deutsche Euroshop AG. This niche player went public in January 2001 and represents 4,31% of the DIMAX Index.
A distinctive characteristic of the German market that is dominated by a small number of very large corporations. After the acquisition of 68,7% of the shares of RSE by WCM and the plan to consolidate RSE as a subsidiary of WCM, was announced at the end of August 2000, the two largest corporations of the DIMAX (WCM and IVG) account for 58% of the index weight (57,4% of the market capitalization). Moreover these two are interconnected through equity stakes.
In addition to the top three corporations, which are characterized by a high capitalization and a homogenous investor structure, there exists on the one hand a small number of corporations with high capitalization and a diversified investor structure, like DBVI AG and on the other hand the investor is confronted with a large number of corporations with low capitalization and a homogenous investor structure.

TAX ASPECTS

Securitized real estate in the analyzed forms is influenced to a not neglectable degree by tax regulations. Therefore, the three instruments also have to be compared with each other regarding their tax aspects.

The US REITs are granted an special tax exempt status. This refers to the US specific double taxation on the corporate and individual level. On the corporate level a REIT can evade taxation on dividends paid to the shareholders. To retain this status a REIT has to fulfil certain requirements from the second year of its taxation on. A REIT does not have to pay corporate tax as long as

- 75% of the company's assets are composed of real estate held for the long term,
- 75% of the company's income is derived from real estate,
- a maximum of 50% of the shares is held by maximal five individuals like mentioned above, and

- the company pays out at least 90% of its taxable income to shareholders.[6]

The last criterion makes a REIT a clearly income-oriented investment instrument. Consequently, the 1986 tax reform in the US could not diminish the attractiveness of REITs. The REIT Simplification Act of 1997 did not alter the basic structure of the real estate securities and instead it stabilized their existence by mainly simplifying border cases of regulation.

Australia offers a similar tax advantage for LPTs. The trust structure allows to distribute pre-tax profits to investors. Although the trusts are regarded as separate entities for tax purposes, they are not taxable if the beneficiaries (investors) are entitled to the entire taxable income of the trust. The beneficiaries themselves are subject to tax on their proportionate share of the trust's taxable income which includes both income and capital gains. The latter are generated through the disposal of a trust asset. Then at the investor level there exists the possibility to offset any capital gains distributed by the trust against any other capital losses incurred by the investor. This seems especially enticing since the Australian government has introduced rules which confine the margin for trusts to deduct current and prior year losses. Australia's tax laws allow trusts only to retain income that is tax free under the legislation. Consequently, when calculating their taxable income, trusts, as non tax paying entities, cannot profit from tax deductions such as depreciation.

GPSs are devoid of a comparative incentive for the real estate owning company. On the other hand, the German tax system already includes a general rule which allows to deduct the corporate tax, paid on distributed dividends from the private income tax on the dividend. But as this is not a specific law that applies to Listed Property Companies they cannot profit from a comparative advantage when being compared to other investment options. Depreciation, on the other hand, plays an important role in investment decisions in German real estate. In the aftermath of the German reunification depreciation schemes for renovation were generously introduced by the federal government as special incentive to invest in the former communist Germany. By now, all of them have expired.

MANAGEMENT AND TRANSPARENCY

REIT's investments are determined by its board of directors or trustees. Directors are elected by, and responsible to, the shareholders. In turn, the directors appoint the

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[6] The REIT Modernization Act, effective for taxable years beginning after 2000, has returned the REIT distribution requirement from 95% to the 90% level currently also applicable to mutual funds. This level already applied to REITs from 1960 to 1980.

management personnel. REIT’s management is periodically reviewed by the REIT's board of directors. REITs can be either internally managed or externally advised. Stock exchange rules or state law typically requires that the majority of directors is independent from management.
Many REITs show a significant share of inside ownership in their companies to align the interests of both management and shareholders. At current the average equity ownership position is a 12.5 percent, giving an incentive to the management to ensure good performance.
REIT's performance is monitored on a regular basis by the directors of the REIT as well as independent auditors. Also financial analysts play an important role in analyzing the performance of REIT management and they enhance the transparency for investors. In addition, the vast majority of analysts applies an industry-wide standard measure, funds from operations, to analyze REIT operating performance.

LPTs organisational structure is similar to that of REITs. A board of directors performs the same functions as in REITs. LPTs are managed by Trust Responsible Entities (or managers) which can be fund managers or large corporations. The manager of the trust does not own properties (except for personal investment purposes). The properties are owned by the unitholders and then are held in trusts on their behalf by the Manager. The Manager of an LPT is, in effect, a contracted employee of unitholders and can be removed by a majority vote of unitholders. Management fees vary but tend to approximate 0.5% per annum of the gross value of the assets of the Trust (4.2% p.a. of gross income). In addition, the Manager may be entitled to the property management fees.
In order to protect investors Australian laws require a minimum level of disclosure of information. There are some LPTs whose level of disclosure is regarded as strong. The amount of publicly available information of others is still slight although in the past months a clear trend manifest itself and people start paying attention to this topic. The challenge is to obtain a uniformity of disclosure since only a similar level of consistent data can add to simplify investment decisions especially for small investors.

Regulated by the German Stock Corporation Law, the management of German Property Companies consists of a management board and a supervisory board. The latter is elected by the shareholders and nominates the members of the operative board of management. According to German law members of the supervisory board must not be persons from the management board. That means that in contrast to REITs not even the minority of directors can be involved with the management. Thus theoretically all the directors scrutinize the performance of the company intensively. In practice, however, since they often participate in numerous supervisory boards real control suffers from time constraint. Financial analysts also observe these companies but German Property Companies are not yet as intensely covered by analysts as REITs since they do not have a comparable history. Moreover analysts and the public are not as alert because there has not taken place a a stigmatisation comparable to the REIT crisis in 1974. But coverage augments and the demand for Property Shares rises with a growing German shareholder culture in recent years.

The valuation of real estate corporations is inhibited according to German accounting standards. Valuing real estate operations promptly is not foreseen by these standards. Balance sheets accordingly post book values which are below the market value and the actual substance of the company. As a result compulsory disclosure of real estate specific information can be regarded as limited. Furthermore, the low transparency of company information policy does not improve this situation. The highly aggregated information allows, if at all, only a partial appraisal of land or valuation of real estate projects. Moreover only a handful of companies publish their market values in the appendix of the balance sheet.

As a consequence many German real estate corporations are traded at a significant discount to their net asset value (NAV). Deutsche Bank Research estimates the discount of two of the top three companies IVG and RSE at -15% and -28% respectively. For the companies concerned, this can result in severe problems when they plan a secondary offering, since the issue premium, and thus the injection of new funds is reduced.

In Australia, the situation is diametrical. Although decreasing in recent times major trusts are still traded at a price to net tangible assets (NTA) premium averaging approximately 9.5%.

Comparable to Germany most REITs trade below their NAV. The retail REITs are traded at a 20% discount versus 5-10% for office sectors. Prices of specialty REITs are estimated to range 15% below their underlying net asset value. The average apartment REIT is dealt at a 9% discount. This leads to the same problems as mentioned above. Taking the capital-raising costs into account, the average apartment REIT share price would have to rise 11 to 14% before raising new equity would be non-dilutive to the net asset value.

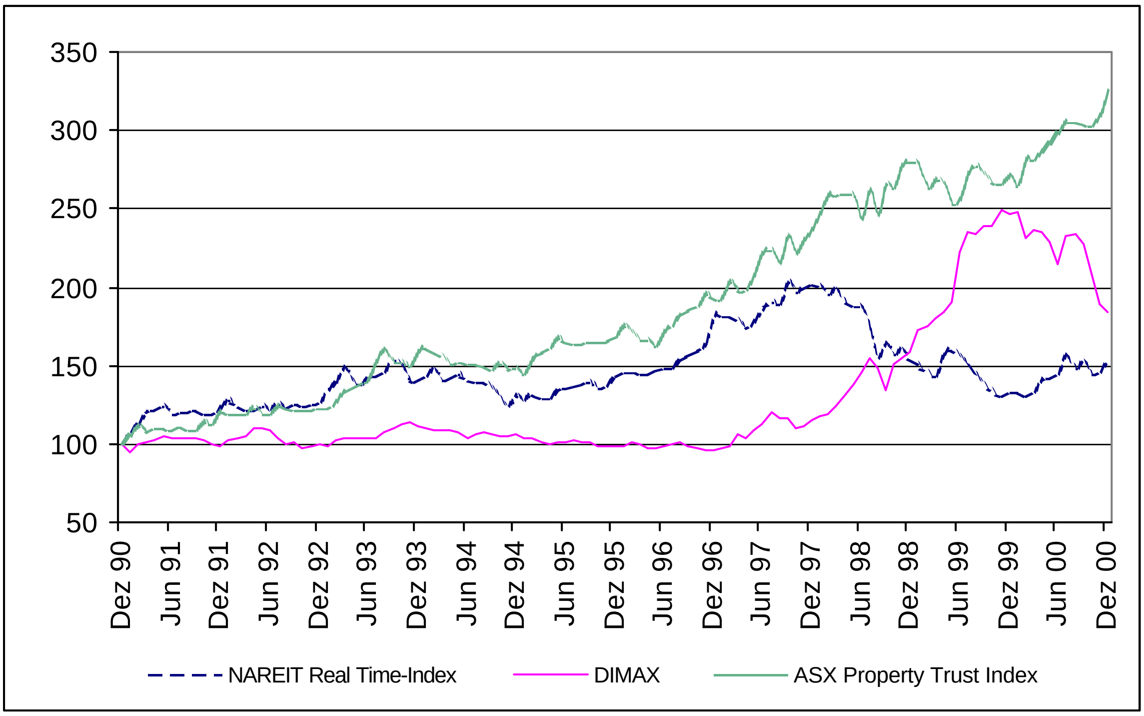
INDICES AS BENCHMARKS FOR PERFORMANCE

The performance of these three real estate investment vehicles can be measured by the respective indexes. On the US market the National Association of Real Estate Investment Trusts publishes the NAREIT Real-Time Index. It is a weighted performance index and the only REIT index to include all 198 REITs that are currently traded at the New York Stock Exchange, the NASDAQ, and the American Stock Exchange.

The Australian Property Trust Accumulation Index is a weighted performance index which is published by the Australian Stock Exchange. Over the last 3 years a few listed companies with property portfolios have been added to the index although it is still dominated by listed property trusts.

The German DIMAX is a weighted performance index currently comprising of 57 companies. To qualify for the index, listed real estate companies must at least generate 75% of their revenue from real estate. This includes trading, letting and leasing, service project development or advisory activities. The index weight is determined by the market capitalization of the individual companies.

To compare the performance of the three national real estate investment vehicles over the past ten years these three indexes are set against each other in the following graph. The respective indices have been indexed at 100 on Dec. 31, 1990.



Source: JP Morgan, Ellwanger & Geiger

The Tax Reform Act of 1986 reduced the potential of real estate investment to generate tax shelter opportunities and strengthened REITs. The Act permitted REITs not only to own, but also to operate and manage, most types of income-producing commercial properties. By 1990, the combined impact of the savings and loan crisis on the one hand and the Tax Reform Act on the other hand, as well as the phenomenon of overbuilding during the 1980s led to a depression in the real estate industry. Against this backdrop, many private real estate companies decided that the best way to access capital was through the public marketplace using REITs. Throughout the 1990s the REIT market had been showing growth. The growing REIT market was heavily affected by the financial crisis that erupted in Japan and Russia in 1998. REIT stock prices plunged by double-digit amounts and have not yet fully recovered. Perhaps this can show a future perspective of increasing liquidity also for non-US markets. Given the discounted valuations on the basis of which many US REITs and GPSs continue to be traded, more acquisitions are likely to take place which will lead to further consolidations of the respective markets. Effective in 2001, the REITs Modernization Act will enhance the competitiveness of REITs in comparison to other US investment vehicles and they will probably foster the growth of this segment.

The LPT market has shown continuous growth. The beginning of the 1990s was characterized by the listing of previously unlisted property trusts. Towards the end of 1993 the Australian economy started to recover from recession and property markets underwent a accelerated growth with a following stagnation. In contrary to the REIT market, LPTs profited form the Asian crisis. Huge sums of capital were invested into the LPT sector driving the index to its all time high at the end of 1998. The continuation of mergers in the listed property trust sector emphasises the desire of trusts to increase their capital base, consolidate their core activities, and generate size advantages.

The young market has grown continuously. This development can be illustrated by the market capitalization of real estate corporations. In 1998 the companies of the E&G DIMAX, the GPS index, had a capitalization of 7.1 billion Euro. Two years later it had grown to 17.3 billion Euro. At the same, time seven new companies were incorporated into the index so that the index now comprises of 57 companies. The increase in capitalization as well as the decrease of capitalization in the year 2000, however, was mainly due to the large rise of the share price of WCM. By now, the German market is a lot more liquid than five years ago. Moreover, the capitalization will increase further in the near future since many new real estate corporations are in the process of arranging IPOs. This development will be further stimulated by the fact that several larger industrial holdings are considering listing their real estate subsidiaries at the stock exchange.

CONCLUSION

The market for US REITs is the most developed one due to its high transparency, liquidity, and market capitalization. It features the highest specialization and therefore it offers best chances for investors to diversify. Therefore it grants the best options for an exact match for virtually any individual portfolio.

From the legal and the tax perspective Australian Listed Property Trusts are similar to US REITs. Nonetheless they are characterized by a lower transparency when it comes to passing on information to investors and to management control. Their size and their degrees of specialization are not as high as that of their US counterparts but it is clearly higher that of the German market.

The German instrument is fundamentally different from US REITs and Australian LPTs: It does not provide for a combination of tax shelter and listed security. The average size of the property companies is the smallest of the three countries. Specialization is still very low and in its beginning. Hence, the GPS is a less flexible investment instrument for portfolio diversification. Due to the lack of legal uniqueness of the GPS the real estate sector of the securities market is not uniform. It does not yet represent a homogenous asset class yet instead analysts rather tend to compare real estate companies with non-real estate related corporations than with other Property Company peers. This also leads to the problem that analysts hardly use real estate specific analysis tools so far. But since the emergence of the property share in the late eighties and the growing interest of the German population in listed securities as investment option the Property Share shows an auspicious development.