

# Unlocking the Potentials: Listed Property v Direct Property

For institutional investors only

June 2024

The case for having listed property as a part of real asset portfolios should be considered on the basis of longer term returns, liquidity and ability to offer a strong inflationary hedge. In this paper, we examine these elements and highlight the investment opportunity in listed property as a complement to real asset portfolios.

## Property characteristics

There are three main routes for investors to gain exposure to real estate: **listed property (Real Estate Investment Trusts (REITs))**, **private property (unlisted property funds) and/or direct investment**. There are some nuanced differences between these options primarily related to liquidity, cost and asset type. The key characteristics are:

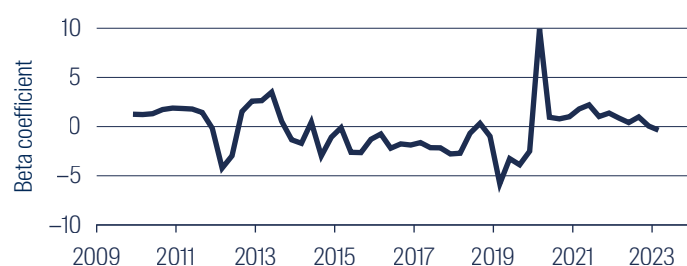
### Private property and direct investment

- Lower correlation with equities and REITs in the short term, but higher correlation to REITs in the long term
- Valuations based on net asset value rather than the stock market
- Very little demonstration of an inflationary hedge in recent times
- Liquidity:
  - Closed end private property funds: Inflexible and illiquid, with liquidity windows pressured during downturns as assets need to be sold to realise investments
  - Direct investment: Inflexible and illiquid, as the asset or joint venture interest needs to be sold to raise liquidity
- Typically invested in traditional property types such as office, industrial and retail, with office and retail being more exposed to disruption
- Very high transaction costs for direct investment and high fees for exit on private property funds
- Performance fees can be excessive

## Listed property

- Liquid alternative to direct property investment, REITs are listed on equity markets
- Natural inflation hedge with stable cash flows and pricing power
- Flexibility to move into different real estate sectors and regions
- Less volatile than equities but more volatile than direct property funds (see Chart 1). It's important to note that the long term trend beta is near 1. For long term investors, listed property offers the luxury of liquidity with a similar return profile. The rarer cyclical volatile events do create large pricing anomalies offering active investors excess return opportunities
- Assets within the REIT universe provide access to alternative property sectors such as data centres, healthcare, residential, life science and self-storage facilities (see Chart 2)
- De minimis transaction costs

**Chart 1: 1 year rolling beta listed property versus direct property**



Disclaimer: First Sentier Global Property Securities Strategy vs INREV Global Real Estate Fund Index. All data in USD. Past performance is not indicative of future performance. Source: Factset and inrev.org. 31<sup>st</sup> December 2023.

**Chart 2: Asset types of listed property and direct property**

Listed property	Private property
<ul style="list-style-type: none"> <li>• Medical Office Buildings</li> <li>• Private Hospitals</li> <li>• Seniors Housing Assets</li> <li>• Life Science Assets</li> <li>• Apartments for Rent</li> <li>• Detached Housing for Rent</li> <li>• Land Lease Communities</li> <li>• Student Accommodation</li> <li>• Hotels and Leisure Assets</li> <li>• Logistical Centres</li> <li>• Industrial Warehousing</li> <li>• Data Centres</li> <li>• Self-Storage Facilities</li> <li>• Shopping Malls</li> <li>• Retail Shopping Centres</li> <li>• Suburban Office Buildings</li> <li>• CBD Office Buildings</li> </ul>	<ul style="list-style-type: none"> <li>• CBD Office Buildings</li> <li>• Suburban Office Buildings</li> <li>• Shopping Malls</li> <li>• Retail Shopping Centres</li> <li>• Logistical Centres</li> <li>• Industrial Warehousing</li> <li>• Student Accommodation</li> </ul>

## Listed property

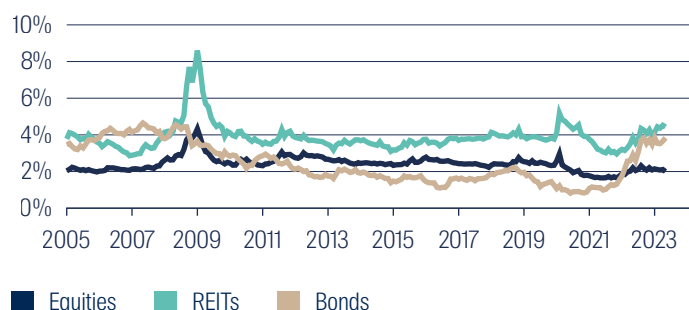
With listed property offering investor liquid exposure to high quality assets across various property subsectors, there are several other core characteristics of listed property that reinforce the aim to deliver resilient cash flows together with long-term capital appreciation:

### Dependable cash flow

We believe REITs generate stable cash flows as their revenues come from contracted rental income streams across a diverse range of property types. The listed property universe includes asset types such as biotech laboratories, data centres, student accommodation, residential assets, self-storage facilities and logistics warehouses, which offer exposure to structural growth themes. These assets are usually less economically sensitive and their operating fundamentals are driven by factors such as societal change, technology adoption, data consumption

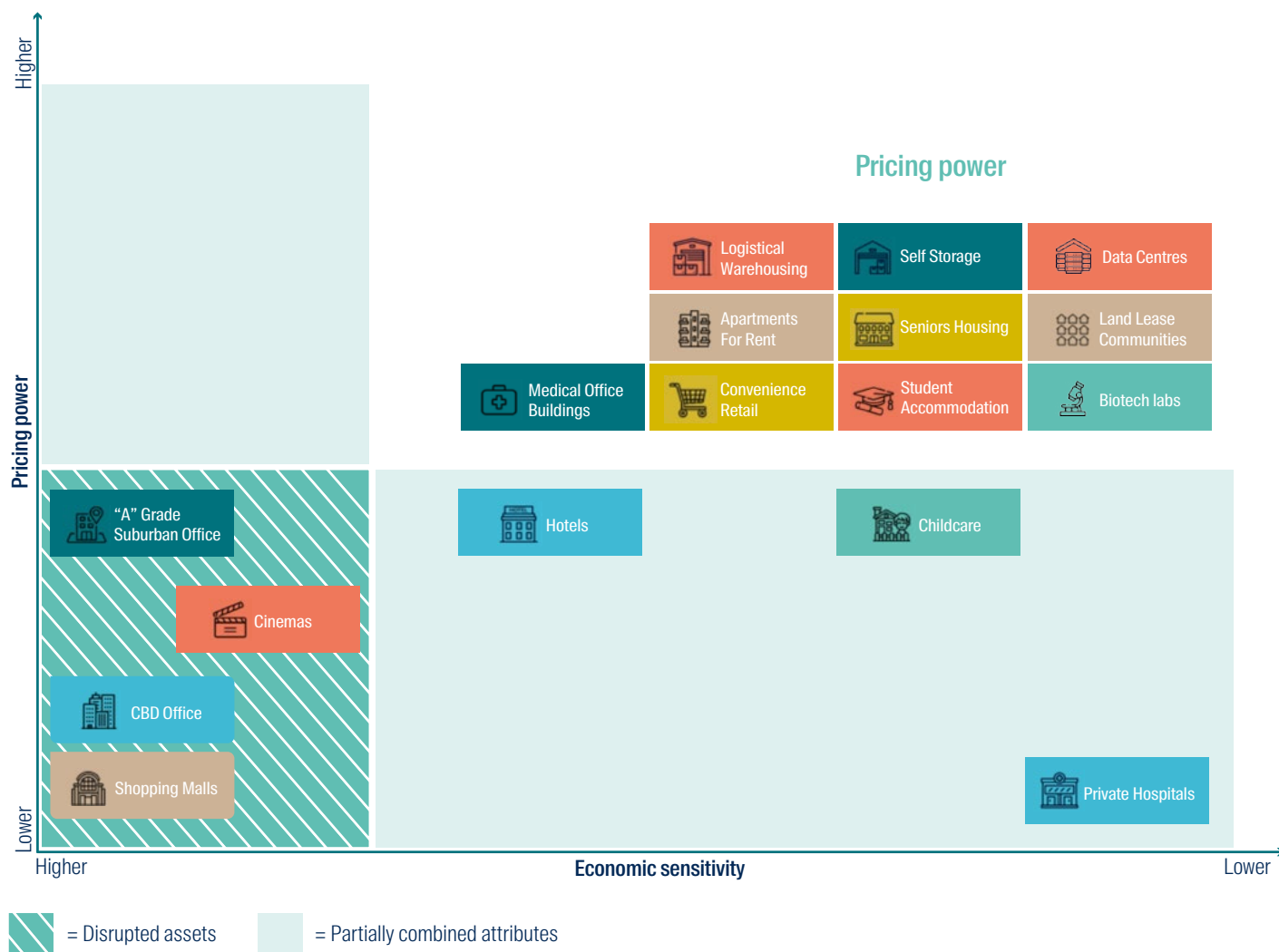
growth and demographic shifts etc. The stable cash flows allow REITs to consistently provide attractive dividends to shareholders throughout economic cycles. Chart 3 demonstrates that global REITs have historically offered higher dividend yields compared to global bonds and equities.

Many property types offer an inflation hedge to investors. Some property types have rental contracts with built-in clauses that automatically increase rents annually. These clauses can be fixed (typically around 2-3%), or tied to a published inflation rate, or a combination of both, which may take pricing floors or caps into consideration. In the short term, these lease clauses help pass higher landlord costs to tenants. However, for the inflationary hedge to be sustainable, the property must have pricing power. Without pricing power, the inflationary hedge may not be sustainable and could lead to tenant default and/or material falls in rents at the end of the lease. Assets that can maintain 'pricing power' (see Chart 4) are able to pass through inflationary pressures to tenants, providing a natural sustainable inflationary hedge that drives revenue growth. Rising inflation also increases the replacement cost of property assets and increases barriers-to-entry, reducing supply. This limited supply further supports market rental growth and property valuations.

**Chart 3: Dividend yield**

Disclaimer: Data as at 31 March 2024. Global REITs as represented by the FTSE EPRA Nareit Developed Index. Global Equities as represented by the MSCI World index. Global Bonds as represented by Bloomberg Global Aggregate Bond Index. All data is in USD.

Chart 4: Pricing power within listed property universe by asset type



Source: First Sentier Investors, for illustrative purposes only.

As shown in Chart 4, the majority of the listed property sector assets are positioned in the top right quadrant. These assets exhibit strong pricing power, which drives the inflationary hedge with low economic sensitivity.

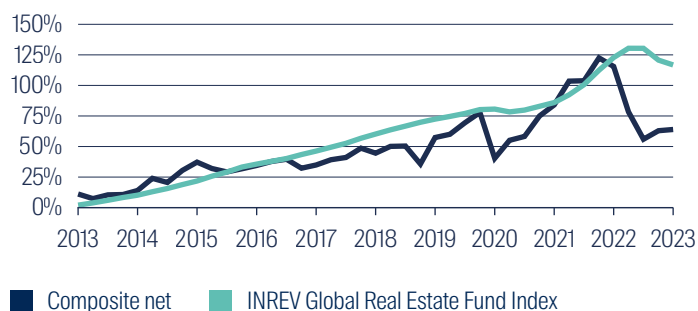
### Understanding liquidity

For private investing, liquidity has been a core issue, especially during periods of volatility when Private Real Estate Funds have 'gated', preventing or delaying investor redemptions. For direct investment, capital market conditions may cause direct property markets to freeze, preventing asset sales.

In contrast, for listed property, whilst volatility may cause implied stock prices to fall below net asset values, liquidity is also available which allows for more efficient asset allocation. Volatility provides the flexibility to move between property segments, which may

have different supply and demand dynamics. The appealing valuations in listed property also make a compelling argument, particularly for active management.

Chart 5 demonstrates that listed property and direct property have delivered similar long term returns until central banks began tightening monetary policy and increasing interest rates. The direct property valuation lag effect is very evident here, whereas listed property was revalued with immediacy. This lag effect in direct property valuation can create significant pricing dislocations in the short and medium term, as is the case today. We believe a further decline is expected in direct property valuations, listed property offers a distinct pricing anomaly with much higher total return expectations over the medium term.

**Chart 5: Listed Property vs Direct Property performance (10 Years)**

Disclaimer: Metrics are for the First Sentier Global Property Securities Strategy (USD) and the INREV Global Real Estate Fund Index. The First Sentier Global Property Securities Strategy is net of fees and the INREV Global Real Estate Fund Index is net of fees (assumption is 40 basis points). Past performance is not indicative of future performance. Data as at 31 December 2023.

**Chart 6: First Sentier Global Property Securities Strategy Net Asset Value**

Disclaimer: Metrics are for the First Sentier Global Property Securities Strategy (OEIC). NAV (Net Asset Value) is our assessed value of property assets owned plus the value of other businesses operated. Past performance is not indicative of future performance. Data as at 31 March 2024. Source: First Sentier Investors.

## Conclusion

With investors having the ability to gain exposure to real assets via differing avenues, the decision to choose one over another can be challenging. It is clear that both listed and direct property have historically delivered similar returns over the longer term, which makes a strong case for owning both as they complement each other. However, in our view, listed property is expected to offer higher returns over the medium term given the current pricing anomalies. There is also an argument for listed property to deliver higher returns over the longer term, given its sector make up primarily invested in alternative property types with a stronger inflationary hedge. Essentially, liquidity should not be overlooked – it isn't important until it is. Combining higher return expectations and liquidity makes a compelling case for including listed property as an important part of real assets portfolios.

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