Real Estate Securities Market Review & Outlook

Global real estate securities posted an increase of 0.4% (USD) during the month of June, comprised of -3.0% in North America, -2.0% in Europe and +3.0% in the Asia Pacific region. Year to date, global real estate securities have posted a gain of 10.6%. Emerging markets continue to maintain a performance lead over developed markets.

Globally, real estate securities are trading at an estimated 16% discount to NAV. Among major markets, listed property companies in Japan are trading at the steepest discounts, on average. Relative dividend yields on listed property shares remain attractive with US REIT yields at approximately 8.0%.

Stage Two

Public real estate securities continue to benefit from improvements in the global capital markets. With more than $30 billion of fresh capital, global publicly traded real estate companies have made a significant first step in strengthening balance sheets. Despite the dilution from new equity issuance, share prices have continued to move higher.

At this juncture, investors have moved off an Armageddon scenario for the overall financial market – real estate stocks included. For months, balance sheets were the near-sole focus of investors. Bankruptcy, covenant breaches and loan defaults were factored in to forecasts. Discounts to even the most conservative net asset value assumptions were violated – real estate companies were trading on survival or option value. In our view, the positive turn in share prices and re-capitalization offers a positive endorsement of the asset class.

At the same time, our optimism is not unbridled. Balance sheet repair and de-leveraging is ongoing. It also stands as the first, not final of several stages in an extended process of recovery. Investor focus will now move to fundamentals, earnings growth and valuation.

Real estate companies derive earnings from longer-term leases. The nature of longer-term leases both dampens – and defers the impact on earnings. Thus far, the material change in economic conditions has held far greater significance on earnings of other businesses.

During a market downturn, volatility rises, correlations increase and tracking error between indices falls. Investors focus less on what stock to buy – rather, the question comes to be whether to hold stocks. For some time, real estate shares traded in tandem with financials – distinction in business models and underlying cash flows held no merit. Longer-term, we believe that differentiation will certainly matter. We anticipate that the transparency and stability of real estate earnings bode well for investor interest and valuations. It is possible that, at least for the near term, the skew of correlations between property stocks and financials will be asymmetric. In other words, high correlations during the market downturn might not necessarily equate to high correlations during an upturn. At this point in the cycle, broad based financial companies likely hold strong near-term potential for expanding valuations on a number of key metrics (i.e. price to book, return on equity and price to earnings).

We recognize that although the public market remains forward looking, the public market has a tendency to over-shoot, both to the downside and upside. In that regard, we remain mindful of relative valuations.

North America

In the United States real estate stocks posted a 2.2% drop in June, underperforming large cap equities, which posted a minor gain, 0.3%. Canadian real estate stocks gained 18.8%, versus a loss of 5.5% for the broader equities market. Over the trailing twelve months, North American property stocks (-43.8%) have underperformed equities (-27.4%) by 16.4%.

Following a wave of secondary offerings earlier in the quarter, the pace of equity issuance has slowed; $5.7 billion, $4.0 billion and $1.9 billion raised in April, May and June, respectively. In addition to decreased volume of deals, recently completed deals have not delivered the same level of price improvement as the earlier offerings. Not that recapitalization activity is complete, but we anticipate that activity will further diminish over the coming months.

For the moment, shares appear range bound, awaiting a significant catalyst. Earnings releases – and more importantly, tenor of management conference calls scheduled for the next several weeks will likely provide incremental news flow dictating market direction.

Sell-side earnings estimates have been trending down. Since the start of the year, 2009 estimates have dropped by approximately 11%. For 2010, estimates have been adjusted down by nearer 16%. Industrial and shopping center companies have been most significantly impacted. At present, expectations are for year-over-year funds from operations to drop by approximately 8% in 2009 and 6% in 2010.

It is worthy to note that earnings adjustments are not only attributable to decelerating fundamentals, but the dilutive impact of recent equity offerings – and in some cases. higher costs of debt service. Further decreases in estimates are likely. We do believe that the public market has priced in much, but not necessarily all, of these adjustments. However, NOI multiples on US property companies have fallen 40% from their peak and are now comparable to historical averages. These multiples, based on depressed earnings expectations, bode well for future capital appreciation when fundamentals start improving.

In the broader market, indicators point towards a different trend. Today, earnings pre-announcements are far less negative than historical levels – in other words, a considerably high level of negative news might already be included in market pricing. Second-half 2009 earnings for the S&P 500 are expected to drop by approximately one-third, year-over-year. For 2010, year-over-year growth is expected to be near 20%. Far-fetched? Not necessarily, Earnings swings of this magnitude have occurred in past cycles. And given the speed of the recent drop, a rapid rise is possible.

Europe

Continental European real estate securities delivered a total return of -3.9% in June, outperforming general equities, which dropped 2.1%. U.K. property shares gained 1.8% versus equities loss of 1.1%. Austria, U.K., Italy, and Finland outperformed European averages. Norway, Sweden, France, Denmark Germany and Spain underperformed. Over the trailing year, real estate equities in Switzerland, Belgium and the Netherlands stand as outperformers. Norway, Luxembourg and Spain remain underperformers.

At this stage of the cycle, public real estate companies have demonstrated one clear advantage over the traditional private real estate model by accessing the public equity markets to reduce balance sheet gearing. While capital raising and rights issuance activity in the public markets appears to have waned, we do believe that much-needed capital transactions will resume following the summer.

The banking sector remains dysfunctional as lenders are likely unable to provide sufficient capital to refinance maturing loans resulting in market dislocation and significant debt shortfalls. Gridlock has emerged in the debt markets. Although banks need cash to boost ailing balance sheets, they will want to avoid write-downs and losses. Government programs are further reducing incentives to sell now at distressed prices by giving implicit future price guarantees above current market pricing.

Furthermore, as bank debt is generally hedged by swaps, particularly in Europe, a prolonged period of low interest rates could significantly reduce borrowing costs, allowing investors to amortise and restructure their liabilities. Yet a financing gap has emerged and will continue to grow. If the crippled CMBS market remerges, it will be significantly smaller and at lower leverage levels, while banks are retreating from real estate and will be unable or unwilling to provide sufficient lending to cover existing borrowing requirements. The real estate industry will need a new injection of capital, either pure equity or gap financing.

Asia

Real estate shares in Asia Pacific posted a 3.0% gain in June, versus a gain of 2.2% for general equities. Among major markets, Japan gained 7.7%, Hong Kong and Singapore each dropped by 0.9% and 3.5%, respectively. Over the trailing year, Japanese property stocks have lost 17.7%; Hong Kong 5.7% and Singapore, 31.1%.

Contrary to trends of decreasing earnings estimates in the U.S. and Europe, expectations have actually been on the rise for property companies in the Asia Pacific region. In particular, results in the residential market continue to surprise to the upside. The residential markets in Hong Kong, China and Singapore have showed particular health. Absorption of existing units has been on the rise, demand has also begun to firm in the mid to high-end of the market. Residential property prices in Singapore were anticipated to fall by approximately 10% through 2010, however, the expectations now call for potential increases. Property investors have showed renewed interest in land for future development.

Capital market transactions continue to reduce concerns about refinancing risks. In China and India, equity offerings have been well received. In June, $1.5 billion of new equity was raised for through both secondary and initial offerings.

Global Outlook

Global property markets are entering into a period of transition. Like a remake of a movie we're all familiar with, we're pretty sure we know how it's going to end – things will get better eventually. What is still unclear is how we're going to get there; the actors are different this time and there are sure to be some unexpected plot twists along the way.

Recent economic data and behavior of the investment markets point to unevenness in the recovery. While economic conditions in Asia are the most positive, we retain a neutral weighting on geographic allocation, due to current stock valuations. We continue to focus on value stocks where we can expect growth at a reasonable price. Company balance sheets are healthier, but still in need of care. Expected dislocation in the debt markets and significant gaps in availability of financing will continue to be an overhang for the direct property markets.

We continue to believe that publicly traded companies will be a compelling investment vehicle for investors looking to capitalize on real estate investment opportunities and the disruption in the capital markets.

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