Journal of
Property
Finance
6,2

Major property investor attitudes to property securitization

Graeme Newell
School of Land Economy, University of Western Sydney, Australia, and
Allan Fife
Grant Samuel Property Services, Australia

Introduction

Illiquidity, indivisibility and lack of flexibility are the traditional criticisms of direct property investment, compared to equities and gilts. In recent years, this has been accentuated in most property markets with a decreased demand for property investment and an increase in the completion value of property projects[1]. With landmark office buildings often having completion values in excess of £150 million, few property investors have the investment capacity to own effectively such significant office buildings on their own, as a high level of portfolio concentration in a single property asset is regarded as an imprudent investment strategy.

These concerns have been the catalyst for a range of property investment vehicles which have been developed in recent years in many countries to try to improve the liquidity of the property market[2]. Property securitization or the ability to divide a single property asset effectively into smaller more readily tradeable interests has been the focus of these "liquidity" developments in the UK, USA and Australia. Property securitization is expected to offer a number of attractive property investment benefits[1,3], including:

- improved tradeability and liquidity;
- ability to invest in high quality assets of a value that would otherwise be beyond normal prudent investment criteria;
- ability for investors to achieve better investment mix by diversifying risk in terms of geographic spread and property type;
- greater investment flexibility, with ability to react more quickly to changes in market conditions;
- partial disposal of an asset while retaining significant management benefits;
- ability for investment managers to reduce costs through economies of scale and specialization;
- enabling investors to develop strategic links with other institutional property investors;

Journal of Property Finance,
Vol. 6 No. 2, 1995, pp. 8-19.

- enabling institutions to reweight property sector exposure, while retaining management control;
- prestige of investing in “trophy” property assets;
- possible reduction in differentiation between fund managers on basis of quantum of funds; and
- redirection of attention to investment performance.

Potential disadvantages of property securitization include thin trading of shares/units, lack of established trading markets, price volatility and lack of directional control over management of the property asset.

While the specific property securitization investment vehicle that is applicable is clearly dependent on the different legal structures, tax regimes and economic circumstances that prevail, the emergence of improved exit options via the use of securitization has seen property securitization receive considerable attention in the financial sector as a viable option for both large and small investors. To date, given the state of most property markets, much of this attention has been supply-driven rather than demand-driven[1].

However, with the increased use of financial engineering and derivative products in the finance sector, the expectation is for growth in the range of new and innovative financial instruments relating to property[4]. Similarly, factors likely to see increased usage of securitized property vehicles in the next few years[4] include:

- greater caution by fund managers with direct property;
- property management difficulties with major landmark buildings;
- emergence of smaller specialist fund managers and specialized investment funds;
- specialist management skills needed for hotels and tourism properties;
- growth in indexed funds and need for responsive portfolio reweightings; and
- diversification difficulties concerning premium property.

These developments in property securitization will clearly have an ongoing significant impact for the levels of both direct and indirect property among institutional investors. The purpose of this article is to present the results of two surveys of major property investors in Australia to examine investor attitudes to property securitization.

Status of property securitization

Property securitization has enjoyed differing levels of success in the UK, USA and Australia in recent years.

In the UK, property securitization has had limited success. While a range of vehicles have been proposed, including single asset property company (SAPCOs), single property ownership trust (SPOTs), property income certificate (PINCs) and authorized property unit trust (APUTs), they have generally not been viable because of adverse market conditions and lack of tax transparency[2]. Efforts to establish a property futures market have also been unsuccessful[5]. This has seen most indirect property investment achieved via the traditional base of UK property companies. More recently, the first issue of property index certificates (PICs) by BZW in June 1994 has attracted attention as a property index derivative product[6]. The longer term success of the PIC product is yet to be assessed, particularly given that it is guaranteed to underperform the underlying property assets and lacks an established trading market.

In addition to the UK, other attempts in various countries at establishing property futures contracts have also been unsuccessful. These include Hong Kong (using the Hang Seng property sector index) in 1991 and the USA (using Salomon Brothers' property derivative product called property asset cash transfer (PACT)) in 1991. Other major US investment banks such as Goldman Sachs, Merril Lynch and Morgan Stanley have developed similar proprietary contracts but have not implemented these property derivative products[1].

In the USA, real estate investment trusts (REITs) and limited partnerships are the major forms of property securitization. While experiencing major problems in the 1970s and early 1980s, REITs have enjoyed a major investment upsurge in the 1990s[7]. This is largely attributable to improved management structures and tax reform benefits via the Tax Reform Act of 1986.

This strong REIT performance in the 1990s has also been achieved without significant recovery in the US property markets. Importantly, property securitization via REITs has filled the vacuum left by the flight of the traditional direct property investors from the US property markets. In December 1993, the market capitalization for REITs was US$32 billion (including equity, mortgage, hybrid and health REITs), of which US$26 billion was equity REITs[8].

Recent REIT performance (1993) was characterized by the following significant achievements[8, 9]:

- equity REIT market capitalization increased by 118 per cent (from US$12 billion to US$26 billion);
- equity REIT total returns were 18.7 per cent, compared to 10.1 per cent for the S and P 500; with REIT performance outstripping overall equity market performance for the third consecutive year;
- ten REITs had market capitalizations in excess of US$500 million (e.g. New Plan (US$1.1 billion), Weingarten (US$1 billion) and Vornado (US$.9 billion), with a further 40 having market capitalizations in excess of US$200 million);
- REITs accounted for 8.4 per cent (47 of 560) of initial public offerings (IPOs) and 21.9 per cent of IPO capital raised;

- 80 REIT offerings raised US$11 billion of equity for the real estate industry, of which REIT IPOs raised US$8.5 billion (77 per cent of equity raised); and
- institutional investors showed a high degree of interest in REITs, accounting for 59 per cent of the US$8.5 billion in REIT IPO market capitalization.

1994 saw some slowing in this strong investor demand for REITs, attributable to a saturated REIT market and rising interest rates. Forty-two REIT IPOs raised US$6.7 billion, with most of this activity in the first half of 1994[10, 11]. Despite this reduced performance in 1994, REITs continued to outperform the equity market, with total returns of 2.6 per cent compared to 1.3 per cent for the S and P 500.

Projections are for REIT investment to reach up to US$80 billion over the next few years, with this promising outlook attributable to its enhanced liquidity for the US property investment market. Clearly REITs have achieved the necessary size, investor breadth and management depth to attract the necessary substantive investor audience needed for property securitization[12].

In Australia, the major forms of property securitization have been listed property trusts, unlisted property trusts, property securities trusts and single property vehicles. Listed property trusts have generally been the most successful securitization vehicle, largely attributable to their tax transparency and the ongoing acceptance among investors of the property trust structure. This role has been reinforced in recent years, with listed property trusts having over AUS$12.4 billion in assets at June 1994 and accounting for 4.5 per cent of Australian equity market capitalization, having increased significantly from only AUS$ 2.6 billion in 1986[13]. Listed property trusts have acquired landmark CBD office buildings and retail centres in Sydney, Melbourne and other Australian capital cities and currently account for approximately 15 per cent of the Australian commercial property investment market. Several listed property trusts have over AUS$500 million in market capitalization, including Westfield ($1.8 billion), General Property Trust ($1.4 billion), Stockland ($863 million) and Schroder ($513 million). The current property portfolio mix for listed property trusts is retail (58 per cent), office (35 per cent), industrial (5 per cent) and other (2 per cent).

The total return performance of listed property trusts has exceeded that of direct property over various investment timeframes[14], including:

- December 1984-June 1994: property trusts (12.8 per cent p.a.), direct property (10.5 per cent p.a.)
- June 1993 -June 1994: property trusts (9.8 per cent p.a.), direct property (8.0 per cent p.a.).

Over the period of the recent Australian commercial property downturn (December 1989-June 1994), listed property trust total return performance (74.9

per cent) significantly outperformed direct property (–5.2 per cent), as well as significantly outperforming the stock market (46.1 per cent).

The more recent reduced performance of listed property trusts (–5.2 per cent) in the second half of 1994 has been characterized by increasing interest rates and an increased supply of property trust units via new fund raising. Currently (December 1994), 82 per cent of listed property trusts are trading at a discount to NTA.

Importantly, institutional investors have been major supporters of listed property trusts, with listed property trusts currently accounting for 40 per cent of institutional property exposure compared to only 20 per cent of institutional property exposure in the mid to late 1980s[15]. The current institutional strategy is to utilize listed property trusts to balance or fine-tune property portfolios, thus enabling responsive portfolio adjustments for asset allocation[15].

Similarly, listed property trusts have responded in meeting changing investor needs, with current trends including sector specific trusts (e.g. retail, industrial), small levels of debt, decreased management fees, higher levels of disclosure, increased size and minimal cash holdings[15].

While the overall performance of listed property trusts in Australia has been strong, unlisted property trusts have reduced markedly in significance in the last five years. This has seen unlisted property trusts fall from a peak asset value of AUS$8.9 billion in June 1990 to only AUS$1.8 billion in June 1994[13]. Many unlisted property trusts have recently listed in efforts to enhance their liquidity and investor attractiveness, and to meet new compliance requirements.

Survey methods and respondent profiles

The first of two surveys was designed to obtain information on major property investor attitudes to property securitization and was conducted in October 1991 in Australia. The survey addressed key issues concerning property securitization, including:

- existing portfolio of securitized property;
- preferred vehicles for property securitization;
- advantages and disadvantages of property securitization; and
- future investment strategies concerning property securitization.

Given the relative newness of the concept of property securitization in Australia and the limited range of alternative investment structures presently in use, it was expected that the larger property investors would be able to provide a more informed response to this survey. Accordingly, the survey was sent to 60 selected major property investors in Australia, including insurance companies, pension funds, funds managers, property companies and property trusts. Thirty-seven usable replies were received, giving a survey response rate of 64 per cent. These respondents were able to provide an informed response concerning property securitization, given that they constituted the major property investors in Australia and accounted for a total property portfolio in excess of £10 billion. Of the survey respondents, 95 per cent had invested in at least one form of property securitization in recent years and currently held securitized property. The respondent profile by value of property portfolios is shown in Table I.

The second survey was designed to obtain detailed information about property securitization and was conducted in July 1992 in Australia. Ten major institutional property investors were selected, all of whom had participated in the first survey. These respondents were among the largest property investors in Australia, having over £9 billion in property from a total investment portfolio of over £46 billion. Structured in-depth personal interviews were conducted with the senior property executive in each of these ten organizations, with the interviews each taking approximately 75 minutes.

The key issues addressed in this second survey included:

- procedures used to access/decide on property securitization;
- preferred securitization structures;
- property derivatives; and
- strategic investment considerations.

While time has elapsed since these surveys, they are the first substantive surveys in this area and provide an important reference point or benchmark as to how investor attitudes may change in the future, particularly given the factors listed previously[4] that are likely to see increased usage of securitized property vehicles in the next few years.

Results and discussion: first survey

Types of securitized property

For the purposes of the first survey of property investors, securitized property was defined as any one of the following five classes of investment:

(1) shares in single asset property companies, where the shares held by the respondent are less than 100 per cent of those units on issue;

(2) units in listed property trusts;

Value £	Percentage of respondents
>£500million	24
£25-million-£500million	17
£125million-£250million	14
£50million-£125million	29
<£50million	16

Table I. Value of property portfolios held by respondents

(3) units in unlisted property trusts;

(4) units in private property trusts holding single or multiple properties where the holding of the respondent is less than 100 per cent of those units on issue;

(5) units in limited or ordinary partnerships where the respondent partnership interest is less than 100 per cent.

Existing securitized property portfolio of respondents

Of survey respondents, 95 per cent currently hold securitized property. Of the above five property securitization options, the existing range of securitized property held by the respondents is shown in Table II. Listed property trusts were the most predominant, being held by 43 per cent of respondents and accounting for 33 per cent of property securitization options held. Overall, the unit trust format (i.e. listed, unlisted and private) accounted for 76 per cent of securitization options held by respondents. Only 11 per cent of respondents utilized units in property partnerships as a securitization option.

The percentage of the respondents' total property portfolio held as securitized property varied considerably. Of respondents, 35 per cent held less than 10 per cent of their total property portfolio as securitized property. The greatest concentration (38 per cent of respondents) held between 10-50 per cent of their total property portfolio as securitized property. Fourteen per cent of respondents held over 75 per cent of their total property portfolio as securitized property. Overall there was no significant association between differences in either size of property portfolio or weighting in property and the concentration of property investments held as securitized property.

Preferred class of property securitization

There were variations in the most preferred type of property securitization among respondents. The most preferred option was listed property trusts (35 per cent of respondents), followed by unlisted property trusts (19 per cent) and private trusts (19 per cent). The least preferred options were single asset property companies (15 per cent) and partnership forms (12 per cent), which

Type of securitized property	Percentage of respondents with specific type of property securitization
Single asset company	20
Listed property trust	43
Unlisted property trust	31
Private trust	23
Partnership	11

Table II.
Existing types of securitized property held in respondents' portfolios

largely reflected the tax implications of corporations and the liability implications of partnerships.

Preference for listed property trusts was more evident among those with higher levels of property securitization in their portfolios. There was also a greater propensity to prefer listed property trusts among respondents with lower property portfolio weightings.

Advantages of property securitization

The most significant advantages of property securitization among respondents were found to be:

- access to higher value assets (47 per cent of respondents);
- investment spread (32 per cent);
- liquidity of investment (12 per cent);
- management cost efficiencies (2 per cent).

Access to higher value assets was clearly seen as the major advantage of property securitization, with this being particularly evident among funds with lower weightings in property. For those with higher property weightings (exceeding 30 per cent), greater priority was given to investment spread than accessing higher value assets. The often cited advantage of investment liquidity was only found to be of most importance to 12 per cent of respondents. This is significant, as liquidity is one of the key advantages traditionally cited for property securitization.

Disadvantages of property securitization

The most significant disadvantages of property securitization among respondents were found to be:

- lack of directional control (48 per cent of respondents)
- potential illiquidity (38 per cent)
- higher cost/lower return (8 per cent).

The concerns over liquidity are to some degree at conflict with the perceived advantages of liquidity for property securitization and clearly reflect the potential lack of an established secondary trading market.

Lack of control over the direction of the investment and potential illiquidity (due to the lack of secondary market) dominated the responses. The concern over lack of control was more evident among respondents with smaller weightings in property. There were only marginal differences by investor property weightings concerning illiquidity problems for property securitization.

Diversification benefits

Of respondents, 76 per cent would or do consider the enhancement of their property portfolio's geographic spread using securitized property. The desire to achieve geographic diversification was more evident among the larger funds (portfolios exceeding £250 million), with 80 per cent in favour, than for the smaller funds (65 per cent in favour).

Of respondents, 66 per cent would or do consider varying property type portfolio weightings using securitized property investments. This desire to use securitized property for property type reweighting was more evident among funds with a higher securitized property exposure.

Level of investment control

The level of investment control sought by respondents over securitized property investments was:

- full control: 48 per cent;
- control commensurate with size of securitized interest: 37 per cent;
- no control: 6 per cent.

It is clear from these responses that some element of control, covering investment policy, reporting, borrowing and management, is required by investors in securitized property. Importantly, this is not the usual intent of promoters of such securitized property investment vehicles.

Impact of liquidity

Only 26 per cent of respondents were influenced by the issue of liquidity in establishing the level of control sought. This remained constant across both investor size and property portfolio weighting.

Respondents nominated the following degrees of liquidity anticipated from securitized property investment:

- greater than direct whole property interest: 38 per cent;
- same as direct whole property interest: 24 per cent;
- less than direct whole property interest: 38 per cent.

Those respondents with higher portfolio weightings in property (>30 per cent) did not have the same high liquidity expectations exhibited by those with lower property weightings. There was general recognition that in the event that liquidity exceeded that of the direct property, then it would be at a pricing premium, equating to a discount on sale or premium on entry to the investment.

Investment intentions

Of respondents, 78 per cent indicated that they would make further securitized property investments in the next few years. Respondents currently with a higher percentage of their property portfolio as securitized property were more likely to invest in securitized property in the future. Similarly smaller institutions (less than £125 million total investment portfolios) were generally less likely to invest in securitized property in the future. This result for smaller institutions is interesting, as it would be expected that smaller institutions in the future would have more need of indirect access to higher value properties than the larger institutions. This result is likely to reflect the increased strategic focus on indirect property as a complement to direct property by the larger institutional investors to avoid the significant overexposure to direct property seen in Australia in the early 1990s.

Results and discussion: second survey

The second survey was undertaken to investigate issues which emerged from analysis of first survey responses. It considered particularly the investment behaviour of different investor types and the extent to which investors embraced alternative investment mediums.

Investment approval process

The process of investment authorization for all respondents depended largely on the extent to which investment authority was delegated. All respondents had at least three stages of investment authorization, with the most frequent (40 per cent) being four stages. One organization had seven stages in the authorization process. Those respondents with the fewest authorization stages had clearly defined investment ratios and strictly applied investment criteria to which proposed investments would be matched and also predetermined.

Securitization investment structure considerations

The primary considerations when respondents were assessing property securitization were liquidity, risk minimization and compatibility. The higher importance on liquidity issues in this survey is an interesting contrast to the previous survey in which liquidity was seen to be of less importance than accessing higher value assets and achieving investment spread.

Unit trusts (90 per cent) were the most frequently used securitization option reflecting their features of tax transparency and intra-portfolio flexibility. While not used as frequently, 70 per cent of respondents indicated that partnerships were worthy of further consideration, although 20 per cent would exclude them from consideration as viable property securitization vehicles for their organization.

Property derivatives

The survey sought to establish respondent familiarity with the international availability and potential domestic use of property derivatives, and the methods considered most viable for the Australian investment environment.

Of respondents, 80 per cent had considered the use of property derivatives. Interest was motivated primarily by a desire to achieve a greater level of portfolio liquidity. While respondents were aware that no property derivatives were available in Australia, two respondents had actively considered the use of index-linked options in the USA in order to achieve a relatively liquid exposure to that market. The other advantages of property derivatives, including being an effective hedging mechanism, allowing “short” property exposure and providing specific property interest with respect to duration and property type[16], were not mentioned specifically by respondents.

Respondents stressed a reluctance to be involved in options contracts utilizing appraisal-based property indices. Other respondent comments related to:

- a willingness to participate in the development of property derivative products in conjunction with other major institutional investors;
- the need for a rating system for property income streams, particularly if they are to provide the yield basis for property derivatives;
- the suitability of property derivatives in providing immediate investment spread;
- the "awkwardness" or intimidation of handling such financial instruments within property investment departments;
- property derivatives having more financial than property characteristics.

Conclusions

This study has clearly demonstrated the strong support for property securitization and that a range of property holding structures are appropriate to different circumstances and must be fitted into different regulatory frameworks, tax regimes and ownership arrangements. Many previous assumptions and expectations regarding property securitization have also been supported by these two surveys. These include:

- the principal benefit of property securitization being the ability to access physical property assets which would otherwise be beyond prudent investment levels;
- the desire for investment liquidity and the use of securitized property as an effective portfolio management tool to obtain geographic and property type diversification and allocation benefits; and
- unit trusts were the preferred method of securitized property investment, with listed property trusts being the preferred trust format.

While investment liquidity has been assumed to be a key advantage for property securitization, these surveys have shown that other factors, such as accessing higher value assets and achieving investment spread, are as important to investors as the desire for liquidity.

The future substantive developments in this area of property securitization will have an ongoing significant impact for both direct and indirect property investment, as many institutional investors continue to use indirect property to complement their levels of direct property.

References

1. Fife, A., "Real estate co-ownership in Australia", unpublished MSc Thesis, University of Western Sydney, 1993.
2. Adams, A. and Venmore-Rowland, P., "Proposed property investment vehicles: will they work?", *Journal of Property Valuation and Investment*, Vol. 9 No. 4, 1991, pp. 287-94.
3. Maxwell, M., "Breathing life into property markets", *Journal of Australian Securities Institute*, September 1991, pp. 9-13.
4. Rees, D., "Property securitization: the wave of the future", T*he Valuer and Land Economist*, Vol. 32 No. 4, 1994, pp. 277-82.
5. Baum, A., "Property futures", *Journal of Property Valuation and Investment,* Vol. 9 No. 3, 1991, pp. 235-40.
6. Baum, A., "Property index certificates – will they perform?", *Building Owner and Manager*, February 1995, pp. 12-13.
7. Jennings, R., "Resurgence of REITs", *Journal of Property Finance,* Vol. 4, 1993, pp. 13-19.
8. Salomon Brothers, "Real estate investment trusts – the 1993 REIT explosion in perspective", *Salomon Brothers Real Estate Research Report*, January 1994, New York, NY.
9. Lehman Brothers, "Lehman brothers report", *Lehman Brothers Research Report,* March 1994, New York, NY.
10. Salomon Brothers, "REIT 1994 year-end review", *Salomon Brothers Real Estate Research Report,* January 1995, New York, NY.
11. Lehman Brothers, "Commercial real estate quarterly", *Lehman Brothers Real Estate Research* Report, January 1995, New York, NY.
12. Gorlow, R., Parr, D. and Taylor, L., "The securitization of institutional real estate investments", *Real Estate Review*, Spring 1993, pp. 22-8.
13. Reserve Bank of Australia, *RBA Bulletin*, January 1995, Sydney.
14. BOMA, "BOMA Index Chartbook: CBD office series", *Building Owner and Manager*, June 1994, Sydney.
15. Brenchley, H., "Property trusts in the 1990's", *Proceedings of AIC Conference*, December 1994, Sydney.
16. Harrington, A. and Bennett, L., "Buying or selling property? The derivative alternative", *Building Owner and Manager*, September 1993, pp.32-3.