

# Heard on the Beach

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July 30, 2010



Green Street Advisors

## Executive Summary

A sea change has occurred over the last decade in how US institutions invest in real estate, as a large percentage of them have shifted from US-centric allocations to a global approach. Done in the name of diversification, many of these investors were, no doubt, taken aback to realize that they were moving out of a market where pricing seemed cheap (i.e. initial yields were high) and into markets where pricing seemed expensive. Fortunately, however, pricing was not what it may have seemed, as total returns on property in at least one of these markets with low yields, the UK, have kept pace with returns in the US.

Despite the concession of a sizable head start, property returns in the UK kept pace for two reasons: 1) NOI growth was markedly higher; and 2) the cap-ex required to achieve that growth was far smaller. Reasons for the variances in the return components range from structural (e.g. UK lease terms are more landlord friendly, free rent is granted in lieu of TT's, etc.) to the nature of the markets (the UK has a heavier proportion of high-barrier, in-fill markets). The comparable returns afford the conclusion that the historic 100-150 bp initial yield gap between these two markets has been about right.

Barring an unforeseen change in the relative performance of either return driver – NOI growth or cap ex – prevailing cap rate spreads should be roughly consistent with their historic averages. Curiously, however, the pricing gap has shrunk in recent years, and this is especially the case in public markets, where implied cap rates in the US, based on current share prices, are nearly identical to those in the UK. The lack of any appreciable yield gap in the public markets may well portend outsized performance by UK REITs.

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RMZ: 699 | DJIA: 10,466 | 10-Year T-Note: 2.90% | Baa Yield: 5.9%

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## *Heard on the Beach*

### *July 30, 2010*

**The remedy for sticker shock.** Every American visitor to Europe knows the feeling: the price of the entrée seems pretty reasonable and then it hits...this meal is going to be really expensive once those pounds/Euros are converted into dollars. The revelation at a gas station on the Continent is even worse, as the same phenomenon is at work – times 4. The high cost of European travel comes as no surprise, but the manner in which prices always seem designed to tease at first glance, can certainly frustrate.

No such scheme is at work in the commercial real estate world, as the first reaction American property investors have when they venture abroad is the opposite: prices *seem* very high. Accustomed as they are to a world where cap rates in the “low 7’s” are the norm, Americans are understandably taken aback by an environment where first-year yields<sup>1</sup> in the “6’s” or even lower are common. The fact that this relationship has existed for decades means that US investors have long faced a choice: stay closer to home where prices seem cheaper, or bite the diversification bullet and take a leap of faith that low yields don’t beget low returns. Faced with that choice, it’s probably no coincidence that US real estate (and REIT) investors are relative newbie’s when it comes to investing in Europe, whereas many of their Old World counterparts are practiced hands at the US game.

However, just as low sticker prices can belie a higher real cost, high “sticker prices”, in the form of low cap rates, do not necessarily mean that real estate is expensive. After all, it is total returns, not initial yields, that investors seek, and a full portrayal of returns in the UK<sup>2</sup> and the US, as well as the components of those returns, is provided in the charts on the following pages. Most surprising is the fact that **even though initial yields have long been meaningfully higher in the US than in the UK, total returns in the two countries have been remarkably similar over the last couple of decades.**

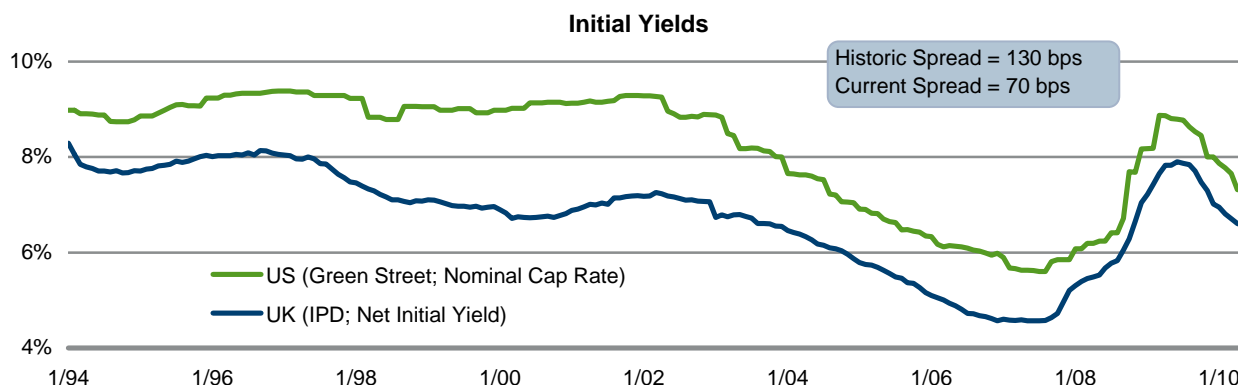
The ability of UK properties to deliver solid relative returns even after spotting the US a big head start (i.e., a higher yield) is attributable to one rather obvious factor and one that is much less so. The one that comes as no surprise is that **same-**

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<sup>1</sup> Cap rate refers to the nominal (pre cap-ex) 12-month-forward NOI yield. Net Initial Yield (NIY) is used herein as the UK equivalent for a cap rate, as this figure most closely mirrors the income component of the UK’s best performance data set (IPD). While cap rate and NIY can be quite different, they are close cousins when it comes to large, well-leased portfolios. Detailed explanations of these terms can be found in our, “Foundation Report: Comparing U.K. and U.S. Property Terms”.

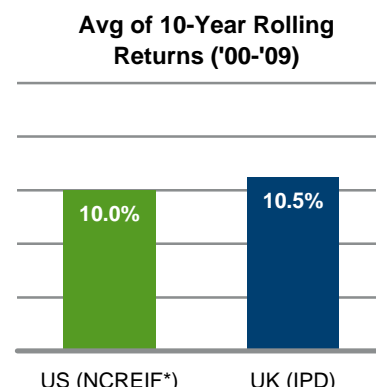
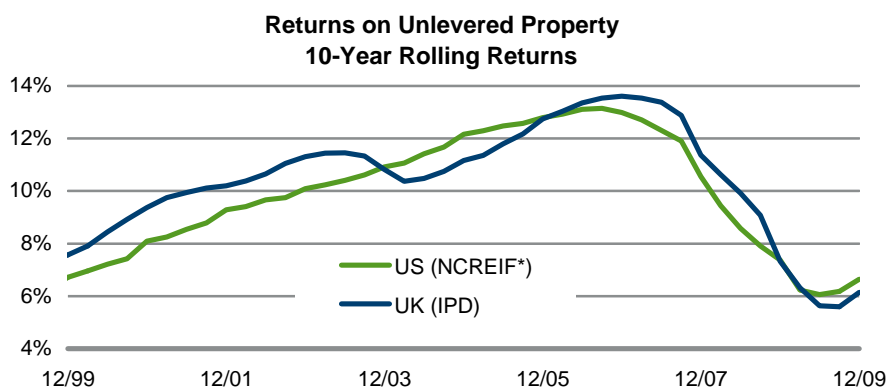
<sup>2</sup> Ideally, this study would include Western Europe, as well as the UK but, to paraphrase Willie Sutton, we study the UK, “because that’s where the (reliable) data is”.

**Sticker Shock** American investors are confronted with a severe case of sticker shock when venturing into most developed countries, as cap rates elsewhere are generally much lower than those in the US. By way of example, cap rates\* in the UK have historically been 100-150 bps lower than those in the US.



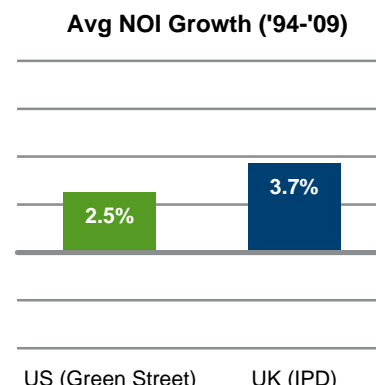
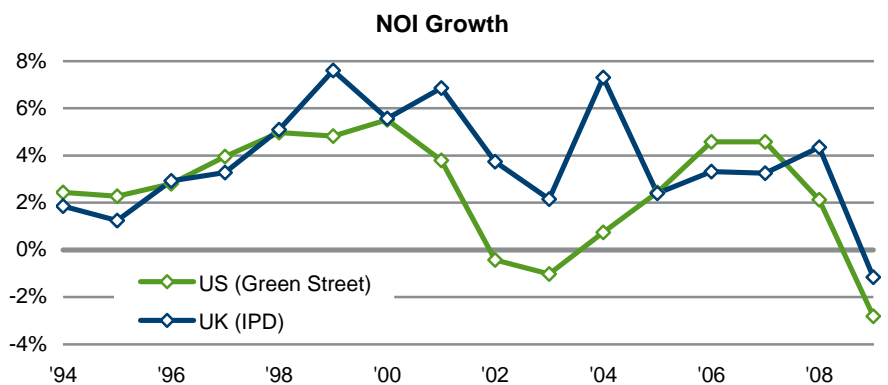
\* As is the case with nominal cap rates in the US, net initial yields in the UK most closely track the income component of the appropriate return series (IPD). Because of that, it serves as the closest proxy for nominal cap rates, especially for large, well-leased portfolios.

**Does that mean the US is cheap?** Probably not. Returns on property in the two markets have been remarkably similar over the last couple of decades. It must be that other differences in the two markets justify the yield differential.

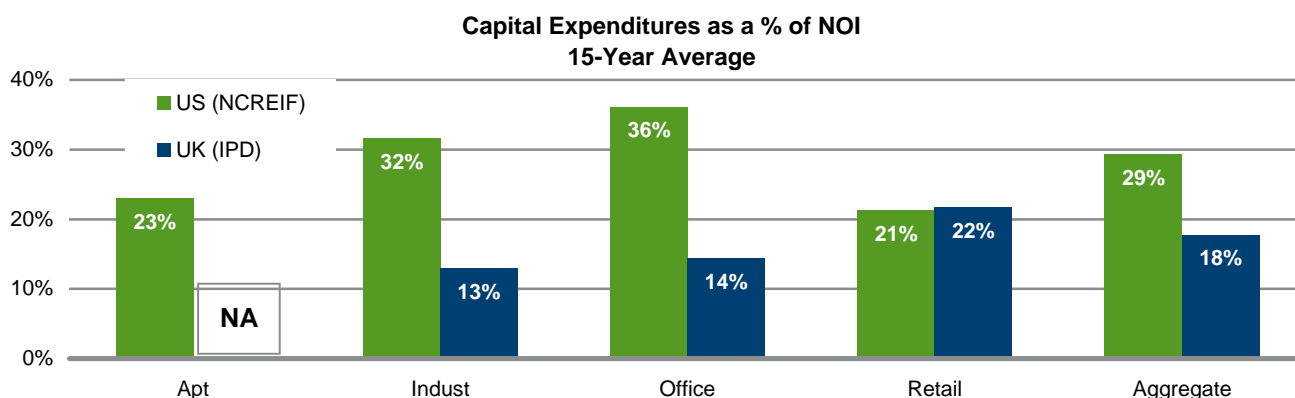


\* NCREIF NPI series is lagged 12 months. Most recent 12 months based on Green Street's Commercial Property Price Index.

**An Obvious Component of Returns** Lower initial UK yields are justified, in part, by better same-store NOI growth. A higher percentage of in-fill locations and more weighting on retail likely explain the better performance.

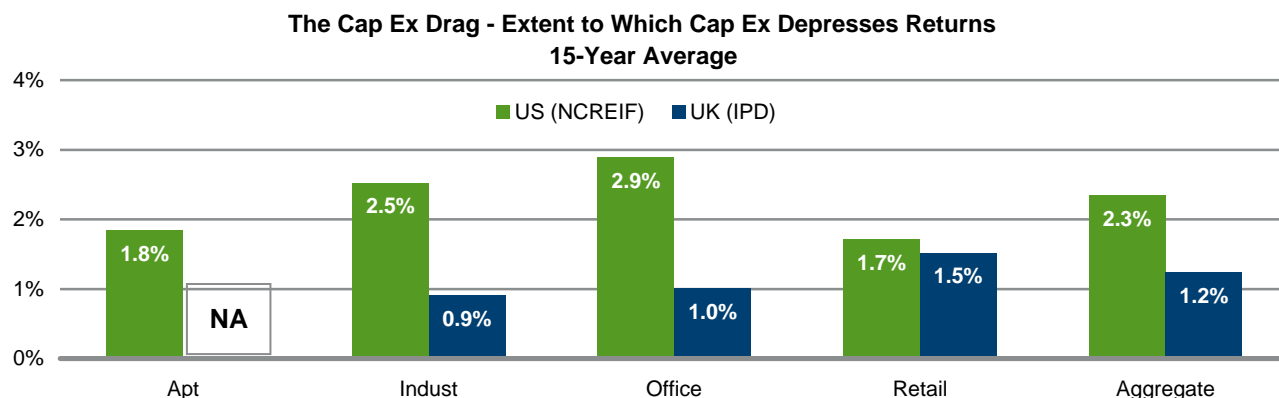


**A Less Obvious Component of Returns** Cap-Ex is a huge, and generally mis-understood, anchor on total returns in the US. It also weighs on returns in the UK, but not as heavily. Different leasing practices in the two markets explain most\* of the difference, as free rent is used in lieu of TIs in the UK (this negatively impacts the UK "cap rate") and tenants generally are required to return space in its original condition upon lease expiration.

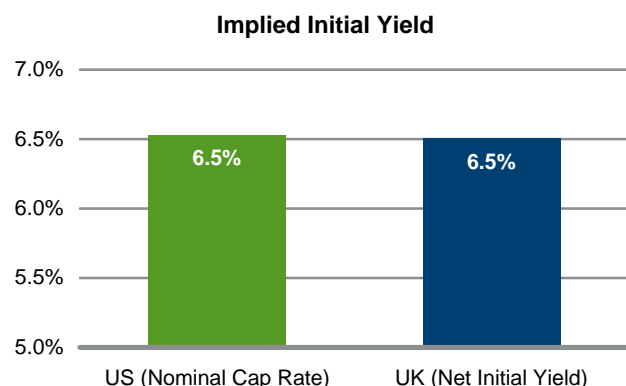
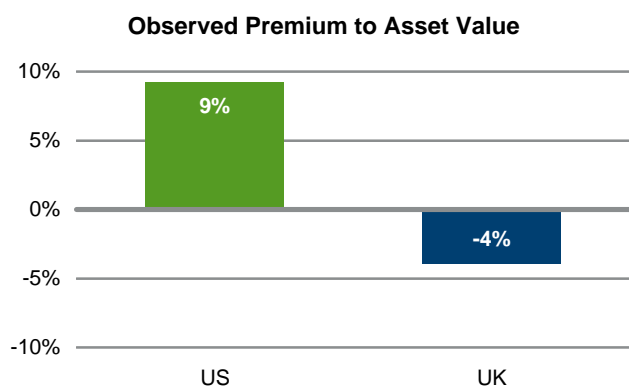


\* Also, the UK figure does not include redevelopments, whereas the US figure does. This results in an understatement of both cap-ex and NOI growth in the UK, relative to the US convention. Despite this definitional noise, after-cap-ex NOI growth is higher in the UK.

**The Crazy Aunt** The cap-ex anchor is so large in the US that it roughly offsets the forward momentum that normal NOI growth would otherwise have on returns. All else equal, the smaller size of the UK anchor justifies an initial yield differential between the two markets on the order of magnitude of about 100 basis points.



**Low Yields = Bargain?** Because NOI growth is better and cap-ex is smaller, UK real estate should trade hands at substantially lower initial yields than US real estate. With UK REITs trading at discounts to asset value, while US REITs are at premiums, it is fair to question whether the similar implied "cap rates" in the public markets are appropriate.



**property NOI growth has been meaningfully better in the UK, enough so to justify at least a 100 bps cap-rate differential.** Bearing in mind that the UK property index (IPD) puts a heavy weight on a global gateway city (London), while the US is much more evenly balanced across high-barrier and low-barrier markets, the historic outperformance is probably no more newsworthy than the fact that NOI growth has been better in New York than in Dallas. While it's not always wise to extrapolate from past performance, higher population densities throughout Western Europe likely mean that investors should be comfortable underwriting relatively high long-term NOI growth in many of those markets.

Capitalized expenditures – the property sector's crazy aunt in the basement that everyone knows is there but no one wants to talk about – serve as the other reason why the yield advantage in the US has not translated into superior performance. Despite the fact that market participants routinely ignore (“we’ll sell the property before incurring them”) and/or underestimate these costs, **capital expenditures in the US have historically equated to 20-35% of NOI. This has served as a 175-300 bp anchor on returns. The historic track record from the UK shows a far smaller (<20%) figure,** with the lower spending likely due to a combination of more landlord-friendly lease terms (fully repairing and insuring leases) and the market practice of granting free rent (which reduces the initial yield) in lieu of tenant improvements.

Over the last twenty years, the similar returns achieved in the UK and the US suggest that markets have done their job well when it comes to the relative pricing of properties. Higher initial yields in the US have been offset by the fact that NOI growth has been better in the UK, even as less capital has been spent to achieve that growth. **Assuming the UK continues to enjoy better NOI growth and lower cap ex – and there is no obvious reason to assume otherwise – a yield gap consistent with the long-term average of 100-150 basis points seems appropriate.**

Curiously, however, the spread between the two has shrunk in recent years to the point where it is now tighter (it's about 70 bps) than this. Even stranger is the fact that the implied cap rates baked into REIT share prices are almost identical between the two markets, as US REITs have markedly outperformed their UK brethren over the past six months. **Against a backdrop of a long history of large cap rate spreads that we now know to have been entirely warranted, today's spreads that are available in the public market seem too narrow. UK REITs may well be poised to outperform their US peers.**

Mike Kirby  
John Lutzius  
Peter Rothmund

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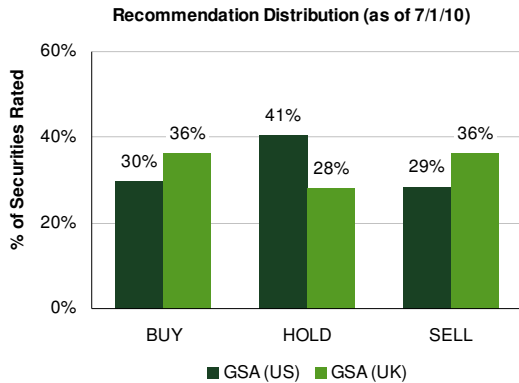
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Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".

**Total Return of Green Street's Recommendations<sup>1,2</sup>**

Year	Buy	Hold	Sell	Universe <sup>3</sup>
2010 YTD	12.2%	5.7%	2.5%	6.5%
2009	58.9%	47.8%	6.0%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
<b>Total Return</b>	<b>4504.6%</b>	<b>392.3%</b>	<b>-35.5%</b>	<b>446.4%</b>
<b>Annualized</b>	<b>24.6%</b>	<b>9.6%</b>	<b>-2.5%</b>	<b>10.2%</b>

Year Ended December 31:

The results shown in the table in the upper right corner are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from this hypothetical performance due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the hypothetical returns assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, can not be used to predict future performance.

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- (2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly". Beginning April 28, 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, are not included in the primary exhibit and therefore not included in the calculation of total return. Beginning March 3, 2003, all Hotel companies are excluded.
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