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Chapter 1

Introduction

In our global economy in which the race for more and better is progressing at a record pace, real estate plays a dominant role. Office towers house large multinational conglomerates and facilitate their daily business, while retail centers offer tradesman optimal locations in the competitive craft of serving their customers. Our homes are our castles in which we can retreat during our spare time and hospital buildings are designed such that our recovery towards economic participation is as efficient as possible. The built environment that has developed over the years and which surrounds us in daily life has capitalized into the largest asset category of our modern economy. In an attempt to quantify the sheer magnitude of the real estate industry within the United States economy Miles and Tolleson (1997) reported an estimated total value of 12.4 trillion US dollars¹, compared to a corresponding 1997 GDP of 7.8 trillion². Although the importance of real estate has been apparent for as long as man has settled down, its value has fluctuated significantly through time. Being part of the overall economic system the value of real estate has been sensitive to the continuous interaction of supply and demand. The cycles in which real estate values tend to move are hard to predict and differ across nations and real estate categories. The combination of economic magnitude and financial volatility turn real estate into an economic factor that can stimulate and hamper economic prosperity both on a micro and macro level. A recent example of the importance of the real estate industry within our modern economy is given by the Asian crisis. Renaud, Zheng and Koeberle (2001) explain how the Thai real estate boom turned into a bubble, which contributed to a domestic financial crisis whose cost were amplified by a currency crisis. This domestic distress was triggered by the immature, local real estate industry and eventually precipitated a global financial crisis with historical proportions.

¹ This real estate value aggregates the value of commercial real estate (3,774 \$B) and the total value of owner-occupied housing and land (8,623 \$B).

² The GDP number originates from the OECD-statistics and is denoted in prices of 1995.

The uncertainty that accompanies real estate value has disturbed risk-averse homeowners but at the same time has attracted outside investors who are keen on realizing the profits that can result from these value fluctuations. By separating the ownership and the use of real estate it is possible to offer risk-averse tenants the virtues of occupying a real estate object and at the same time distribute the financial uncertainties regarding the real estate value to prudent investors who possess the skills to contemplate such financial risks. This separation of ownership and use, which transforms real estate objects into investment opportunities, is not novel. Already at times of the Roman Empire some houses have been used as investment objects being occupied by tenants, which is illustrated by Cicero's distinction between houses that served as homes and houses that generated money³. Although real estate has capitalized enormously since the early days, the scale and setting of real estate investments remained relatively small and simple until the end of the 19th century.

Great sums of money have been earned in real estate, but investments were primarily undertaken by local royalty and churches, limiting the supply of financial resources severely. Purchasing a real estate object has always required a significant amount of money, which was available only to the happy few. In order to alleviate this capital requirement individual investors initiated 'partnerships' in which they combined their individual funds, skills and dedication. Through participation in these partnerships individual investors obtained access to the returns that were concealed in the real estate industry. This growing involvement of outside investors has professionalized the real estate industry by making sure that the financial resources that are being implicated are used both prudently and efficiently.

Since typical partnerships contain only a few partners, individuals still need to possess small fortunes in order to participate in these type of investments collaborations. The next and final stage of the real estate investment evolution was achieved when partnerships evolved into larger organizations that started to issue securities to the general public. The proceeds of such security issuances were employed for expanding their real estate investment activities, offering security holders their fair share of the resulting profits in return. At first these securities were issued directly to investors, but eventually in 1850 the German Concordia Bau und Boden AG⁴ was the first European real estate company to list its shares on a public stock exchange stimulating the development of a new investment category, the listed real estate market. Initially most of these pioneers

³ A more detailed discussion of financial assets and markets during the classical antiquity is provided by: Janssens, W., 1992, *Financiële markten en bankiers in de klassieke oudheid*, *Revue de la banque*, no 1, januari, pp 7-16.

⁴ Details on firm specifics and dates are offered by the Global Property Research's Annual Handbooks.

were involved in a vast variety of activities ranging from construction machinery to heating systems, but gradually their scope narrowed towards pure real estate investment management. The concept of transforming illiquid assets into tradable securities, securitization, has opened up the real estate investment market to the general public. Real estate securities offer investors the opportunity to invest their financial savings in a collection of well-diversified and professionally managed real estate assets from around the world, through low costs transactions on liquid and public stock exchanges. At the same time this securitization offers the real estate industry a new supply of financial resources facilitating a stable development of the industry.

1.1 Purpose

The concept of facilitating the growth and development of a company by involving private investors through the issuance of tradable securities stems back to 1602. The first public listed company (Plc) was the *Verenigde Oost-Indische Compagnie*⁵ (VOC), a Dutch trade association located in Amsterdam. During its origination in 1602 the VOC offered citizens of the Dutch Republic the opportunity to participate in this new enterprise. The individual participations differed significantly in size but were all formalized through an 'actie', a share, which nominated the investment. In this way the VOC obtained sufficient funds to build a fleet of sailing ships with which it could wander the oceans and initiate international trade of which the proceeds were divided among its participants, the stockholders. Before 1602 Dutch citizens could only profit from the virtues of international trade by buying a ship and sailing themselves, which off course was not always a feasible alternative.

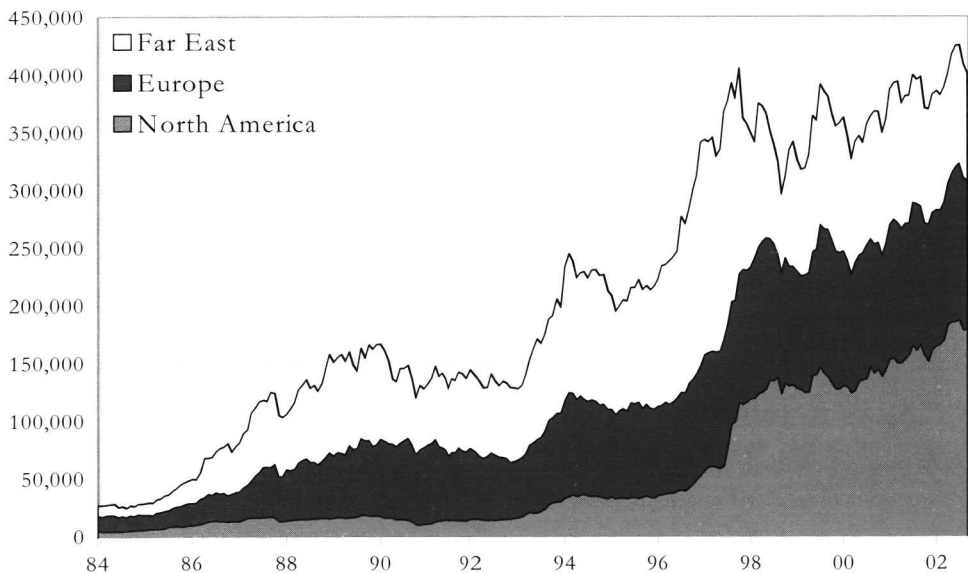
During the 400 years that have passed since the first VOC-shares have been issued, numerous corporations from different industries across the world have followed this example and issued stocks to outside investors. Nowadays the national stock exchanges contain listings of companies of all industries enabling investors, professional and private, to invest in the future potential of each single sector by constructing portfolios of listed securities.

Compared to other industries, however, the securitization of real estate evolved relatively late and slow and is still progressing today as can be seen from Figure 1.1. Before the

⁵ For more specifics on the trade of VOC-shares I would like to suggest: Gastra, F.S., The Amsterdam Capital Market and the Dutch East India Company, in: H. Diederiks and D. Reeder (red.), 1996, Cities of Finance, KNAW-Series, Amsterdam and Israel, J.I., Dutch Primacy in World Trade 1585-1740, Oxford, 1989.

1980s property shares were rare and the securitization of the industry was still in its early stage. The European listed property market is the oldest, but during most of the early twentieth century this market consisted of only a handful of British companies like for example Brixton Estates Plc., which was founded in 1924 and which first listed its shares on the London stock exchange in 1935. By 1984 the global listed property markets still contained as little as 107 different companies⁶ and it is this lack of diversity of companies, which hampered the popularity of these indirect real estate investments among investors. During the last two decades real estate securitization has really taken off, expanding swiftly and maturing into a 350 billion US dollar asset category, the listed real estate market, which is attractive for private and professional investors and suited for academic research. By the turn of the millennium the listed property market consisted of 405 companies worldwide, with an average market capitalization of 884 million US dollars.

Figure 1.1: Capitalization of the global listed property markets in million US dollars.



⁶ The number of listed property companies is based on the Global Property Research Securities Universe, which includes all publicly listed property investment and property investment/development companies in the world with a market capitalization of more than 50 million US dollars.

Norman, Sirmans and Benjamin (1995) offer interesting statistics on historic real estate returns, which illustrate why real estate should be part of a well-balanced investment portfolio. Real estate's low correlation with other asset categories give access to significant diversification benefits, a result which can be derived directly from Markowitz's (1952) Modern Portfolio Theory. At the same time real estate objects are associated with low trading liquidities and require considerable amounts of financial resources and professional management expertise. The securitization of real estate equity alleviates some of these drawbacks, hence increasing the appeal for investors to include real estate in their investment strategy. Eichholtz and Koedijk (1996) illustrate the characteristics of real estate securities and describe the development of international listed property markets. But besides alleviating real estate from some of its traditional drawbacks, the securitization process also changes the return characteristics of these real estate investments. Securitized real estate vehicles combine the real estate economics of the underlying property portfolios with the financial economics that are at work at stock exchanges. In order to understand the performance of real estate securities one needs to be aware of: the effects of informational asymmetries, capital structure implications and risk perceptions of the investor audience. Most of these issues are well-documented by the corporate finance literature, insights which should be incorporated into the analysis of real estate stock performance. By the same token these real estate stock markets also present new opportunities to test and improve financial theory by offering a unique laboratory of observations. As Jan Tinbergen (1975) once stated: "The difference between ideology and science, is that science continues to test itself using all available observations, while ideology seems unconcerned about observations".

In my study I will analyze real estate securitization and performance by combining financial theory, real estate economics, and as many observations as possible in order to provide new knowledge on existing dilemmas and to test and improve available theories. I will search for answers on questions like: do real estate initial public offerings perform abnormally? Are real estate stock returns still related to the returns on real estate? And are strategic choices regarding corporate focus translated into the performance of real estate stocks? I will try to augment existing knowledge by raising new questions, by providing new international evidence and by applying new methodology. My results ought to be useful for a wide audience, ranging from financial academics and real estate professionals to the interested layman.

1.2 Outline

This dissertation includes studies on issues that relate to real estate's transformation into tradable securities and the performance of these securities on international stock exchanges. These studies have been clustered into three parts. Part one is on real estate securitization and performance and includes chapters two through five. Part two focuses on corporate strategies of listed real estate companies and includes chapters six and seven. Part three concludes my dissertation and includes chapter eight.

In part one I study motives for and the functioning of real estate securitization from a financial economic perspective. In chapter two I analyze the ownership and performance of real estate in non-real estate corporations. While some companies are keen on leasing the real estate assets that are required for running their business, others tend to own and manage their property. In this chapter I will analyze whether this difference affects the companies' stock performance. I use an international sample of 5,109 companies, covering twenty industries and nine countries. First I analyze the sample on the persistence of consistent patterns in corporate real estate ownership levels across industries and across national borders. Then I proceed with a study of both the risk and return profiles of the individual companies and combine these results with the previous outcomes on ownership levels in order to detect the presence of a relationship between both entities.

Corporate real estate ownership can be substituted by lease contracts, which offer firms more flexibility and require less long-term capital investments. In chapter three I analyze the development of real estate companies, which offer this real estate lease alternative. In effect I study real estate's venue to the stock market, the securitization event, by analyzing the performance of initial public offerings (IPOs) of real estate companies. By closely studying the price behavior of 54 European property companies during their debut on the national stock exchange I gather new insights on the IPO-puzzle. The rise in stock prices on the initial day of trading which turns into relatively poor performance during the first year after the issuance has been well documented by the corporate finance literature. For the IPOs in my sample I document a modest mean initial day abnormal return of 2.55% and a mean first year abnormal buy-and-hold return of -0.55%. Furthermore I document interesting cross-sectional variations in these performance observations, which are explained best by Rock's winner's curse theory.

Chapter four continues my analysis on real estate securitization by examining the market reactions on the announcement of additional debt and equity offerings from listed real estate companies, seasoned real estate securitization. According to modern capital structure theory we may expect the market to react negatively to the announcements of share issues because of negative tax-considerations and pessimistic signals that may underlie such announcements. Collecting information on issue-announcements from property companies across Europe enables me to construct a unique sample. Since corporate tax rates still differ across European countries it is possible to test the explanatory power of these tax considerations in a laboratory situation. The results indeed show the most negative price reactions for countries with the highest corporate tax rates, while issuances of new debt were associated with a mildly positive stock movement.

Finally I will conclude part one by studying the similarities and differences in returns on real estate assets and the corresponding returns on real estate stocks in chapter five. In order to find out whether real estate stocks still behave consistent with the fluctuations in underlying real estate values I compare historic data on both markets for the US, UK and Canada. This analysis illustrates how property shares have performed over the years and proves that the securitized real estate market tends to behave like a mixture between stock and real estate markets.

The second part of my dissertation is concerned with the implications of management strategies on the stock performance of international listed real estate companies. In chapter six I evaluate the effect of strategic combinations of typical real estate investment activities with participations in property development projects within one listed firm. The real estate market is infamous for its lack of transparency and its informational inefficiency, obtaining access to the best real estate investment deals in town is very complicated. Some real estate professionals therefore claim that by actively participating in property construction projects, firms can create their own investment opportunities and circumvent the dependence on others when it comes to expanding their investment portfolio. At the same time real estate development projects are known for their high intensity of planning and involves a complete new set of risks and uncertainties, ranging from myopic planning errors to costly delays. This situation has created a controversy on whether the combination of both type of activities creates synergies or agency costs. By exploiting an international data sample of listed property companies I test both views on this matter and document that both the return and systematic market risks are highest for firms that are involved the most in property construction projects. After controlling for

this extra risk most of the initial cross-sectional outperformance evaporates indicating that the shift in returns is accompanied by a proportional rise in the underlying risk.

Chapter seven focuses on a second strategic consideration which is debated both in corporate board rooms and during academic gatherings. The question whether managers should focus their corporate resources and personal expertise on excelling in one local property sector or across different sectors around the world? Until the 1980s both academics and professionals were convinced that creating diversified conglomerates offered the best chances on financial success. Since the early eighties this view has changed and lean companies with clear and specialized strategies were promoted by both worlds. The clear and bulky portfolio structure of real estate investment companies offer a unique opportunity for an accurate empirical analysis on this matter of corporate diversification strategies. After analyzing both the United States and the most important European listed property markets I conclude that companies that focus their portfolio in one property type and in few geographical regions have performed best over the last 15 years. Especially regarding geographical spread I document a significant difference in the corresponding stock returns. At the same time I document that the idiosyncratic risk of companies tends to rise with the level of corporate focus, which corroborates with modern portfolio theory.

Part three completes my study by offering the summary of the main findings and conclusions in chapter eight. By combining the insights from the previous chapters I hope to offer a set of stylized facts and conclusions regarding real estate securitization and the underlying corporate strategies