Perpetual Private

Real Estate: Unlisted vs Listed

May 2023

Introduction

Property has been a popular asset class in Australia for decades. It has the potential to generate stable income as well as capital gains; it receives favourable tax treatment; and it is a tangible asset that investors can see and touch. This provides a sense of security and control that may not be present with other types of investment.

However, it is difficult to achieve a suitable level of diversification when owning properties directly as it requires substantial amounts of capital, particularly when investing in assets such as commercial office towers or industrial warehouses. In Australia, whilst many investors will own residential property directly, most investors will access commercial and industrial real estate via a pooled vehicle or fund. This could be via their superannuation funds or a specialist real estate fund.

One type of vehicle is a listed Real Estate Investment Trust (REIT), which pools investors' capital and owns the real estate assets on behalf of investors, with units in the REIT traded on an exchange. Another way to access real estate is via an unlisted trust or syndicate – which is a similar pooled vehicle, however interests in the trust or syndicate are not traded on an exchange and can only be redeemed if there is sufficient cash in the fund (through income or the sale of assets) or if there is another investor wanting to purchase them.

Both listed and unlisted funds have advantages and disadvantages, and their performance can be impacted differently by changes in economic conditions. For example, we have seen significant divergence in the performance of the two investment types over the last 12-18 months, which has raised questions on the different structures given the underlying assets are basically the same across both approaches.

This paper aims to explore the differences between listed and unlisted property investments, their underlying assets, their management, and their performance in different economic environments. We also aim to provide our own insights into the current state of the broader property market and our outlook for the asset class moving forward.

What is Listed vs Unlisted Real Estate?

Listed property investments generally refer to units of REITs, which are bought and sold on an exchange, such as the ASX, in the same way you would buy shares in a company. Given the investment vehicles are listed on an exchange, investors are free to buy and sell their units whenever they see fit which provides a high degree of liquidity. Investors may receive regular dividends derived from the rental income of the properties owned by the REIT and can also benefit from capital gains if the value of the units increase. Listed property investments provide a simple way for investors to access a large property portfolio diversified across a range of geographies and property types.

Unlisted property investments refer to direct property ownership or investment in unlisted property funds. Unlisted property funds are managed by a fund manager who pools together funds from investors to buy and sell assets. Investment in unlisted real estate generally requires a much larger initial investment, and fund managers often stipulate long investment holding periods whereby investors will be unable, or will incur additional fees, to redeem their investment. Similarly to listed real estate, investors may receive regular distributions derived from the rental income charged on the properties and can earn capital gains if the underlying assets appreciate in value or through completion of property development projects. Unlisted real estate funds can offer access to more specialised areas of the property market and managers may have greater control over the investment strategy and management of the underlying property. As seen in figure 2 below, despite listed real estate outperforming during certain periods, unlisted funds can provide better returns over the long term, ultimately rewarding investors for the burden of locking-up capital for an extended time period.

TABLE 1: The pros & cons

	Listed	Unlisted
Pros	• Liquidity • Diversification across geographies/property types • Accessibility • Lower fees	• Higher potential returns • More control over assets • Less correlation with equities and bonds supporting better portfolio risk and return outcomes.
Cons	• Greater correlation with equities • Australian REIT index is concentrated • More exposed to swings in investor sentiment	• Illiquid • Complex investment strategies • Less transparency • Higher fees

Why do they perform differently?

Listed property trades daily on a stock exchange, meaning investors are buying and selling securities based on their own valuation of the underlying assets, which may also incorporate future expectations of economic conditions. As a result, any change in their expectations of interest rates or regulations (as an example) will be quickly accounted for by investors and reflected in the traded price of the REIT.

Our approach to valuation

We review the valuations of the assets in our unlisted property portfolio with our fund managers on a quarterly basis and look to test whether we see fair value or not. We continue to believe that the economic assumptions applied to our portfolio are in line with market.

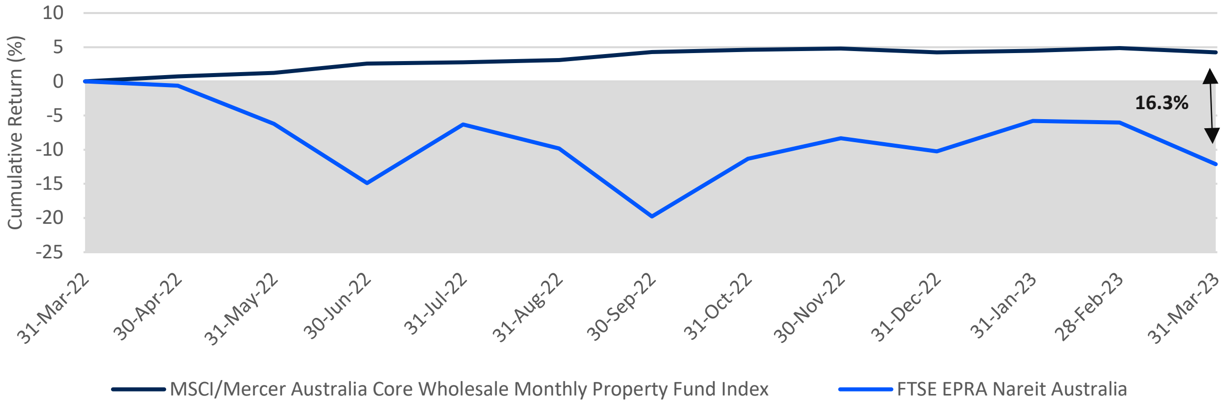
This is in contrast to unlisted property where the underlying assets are valued by independent professional valuers on an infrequent basis, usually quarterly or annually. The economic assumptions used by the independent valuer may differ to those of listed market investors, leading to divergent opinions on the current price of the assets, and hence different return outcomes for investors. Unlisted assets may also be valued based on comparable transactions, where the valuer uses the sale price of similar properties sold recently as the basis of their valuation. In times of economic distress like we have experienced recently, there are generally less transactions occurring due to heightened volatility and the elevated cost of financing. This can lead to further dispersion in valuation between listed and unlisted real estate.

These differing valuation methodologies can lead to significant short-term differences in returns as listed markets incorporate economic data into their future expectations faster than unlisted markets. As seen in figure 1 below, we have seen significant dispersion in returns between unlisted and listed real estate over the last 12 months. Elevated interest rates in response to high inflation have caused declines in listed real estate over the last 12 months and returns from unlisted real estate have softened recently.

Why do higher interest rates lower property values?

Higher interest rates mean property owners and developers will be paying more interest on loans resulting in less net income from rental payments, which decreases the value of owning real estate. The increased interest payments may be offset by increased rental income, although increases to rent will generally lag increases to interest rates.

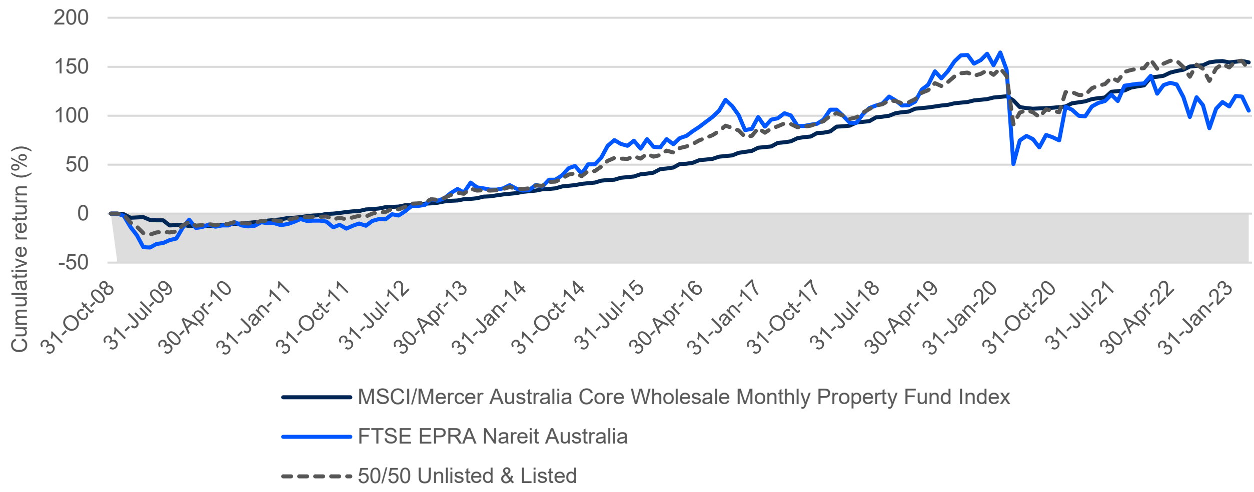
FIGURE 1: Short term returns



Source: Factset, Perpetual Private, May 2023. Past Performance is not indicative of future performance.

There are other fundamental differences between the two investment types that drive different return outcomes for investors. The greater liquidity of REITs exposes them at times to short-term sentiment driven price momentum from changes in economic conditions, leading them to exhibit elevated volatility. It is not uncommon for unlisted and listed returns to differ markedly over shorter time horizons, despite the underlying assets being similar in aggregate. As seen in figure 2, although the two investment types trend in the same direction, listed property exhibits much more volatility but tends to revert to unlisted property returns over time.

FIGURE 2: Long term returns*



Source: Factset, Perpetual Private, May 2023. Past Performance is not indicative of future performance.
*Shaded areas represent periods where listed property underperformed or was flat, while unlisted property was positive or saw slight drawdowns.

As an example, we believe that the decline in listed real estate in 2022 was not solely due to elevated interest rates, but that it was also a result of negative investor sentiment caused by concerns of an impending recession and poor performance of equities. As a result, the listed real estate market has weakened beyond what can be attributed to interest rates alone. This increased exposure to market sentiment also contributes to higher correlation with stocks, which can erode some of the diversification benefits of investing in property. From June 2007 to March 2023, Australian listed property[1] and Australian shares[2] had a correlation of 0.77, as opposed to -0.04 for unlisted property[3]. Australian unlisted property was also less correlated than listed property with domestic fixed income[4] and international equities[5] over the same period.

Does real estate protect against inflation?

Real estate investment, whether listed or unlisted, can provide a partial hedge against inflation through contractual step ups in rental income built into most tenant agreements of around 3 – 4% per annum, depending on the sector, the amount of loans or leverage applied and the location of the asset. However as previously mentioned, higher inflation often precedes higher interest rates which increases debt repayments, offsetting the extra rental income. Ultimately, it is this interplay between elevated rental income and larger debt repayments which has the largest influence on returns for property investors over the short to medium term. The link to CPI isn't as clear in real estate, as it is for say infrastructure, which we have a larger allocation to in our Growth Opportunities portfolio, where we also invest in other unlisted asset classes such as private equity, infrastructure and hedge fund strategies.

[1] As defined by the FTSE EPRA Nareit Australia Index

[2] As defined by the S&P/ASX 200 Index

[3] As defined by the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index

[4] As defined by the Bloomberg AusBond Composite (0+Y) Index

[5] As defined by the MSCI AC World Index

What about blending the two?

A blended approach can help investors benefit from the potentially increased returns and lower volatility of unlisted real estate, without committing their whole allocation to an illiquid investment vehicle. As seen in figure 2 above, spreading your real estate allocation evenly over the two investment types provides a smoother return path than a solely listed allocation while giving investors greater liquidity and achieving a similar return to unlisted property over the investment horizon.

At Perpetual Private, we incorporate unlisted property as part of our Growth Opportunities portfolio. We believe a varied unlisted exposure can provide significant benefits to a diversified investment strategy and may improve risk/return outcomes over time.

How do we allocate to Real Estate in our portfolios?

For a balanced risk profile investor, we recommend a 6% allocation to listed real estate which is evenly split between global and Australian real estate. For unlisted property, we recommend a 10% allocation to our Growth Opportunities fund which targets a 20% unlisted property allocation, equating to 2% of the client's overall portfolio.

Outlook: Will unlisted property sell-off like listed?

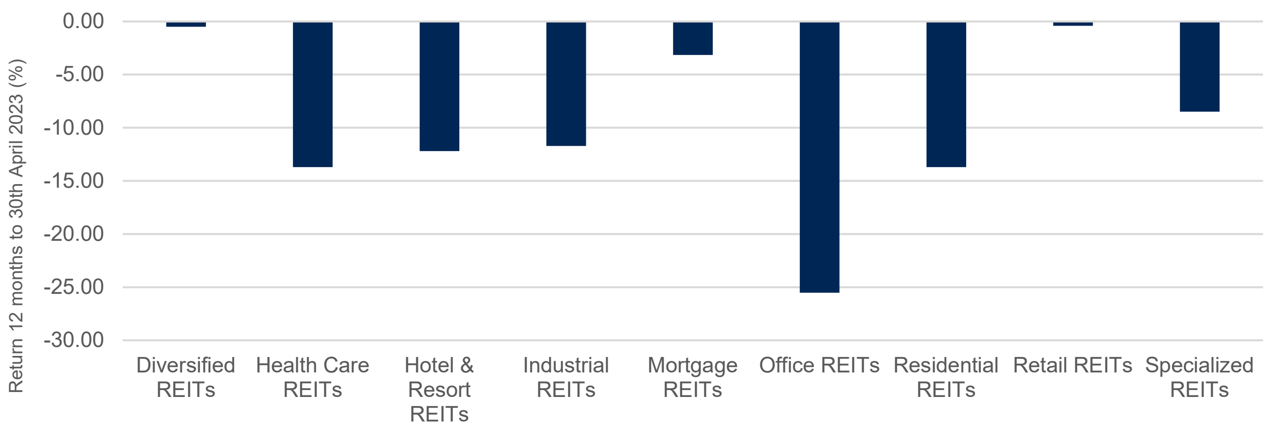
The differences in valuations between listed and unlisted real assets seen over the last 12 months are significant and it is likely that prices will converge through a combination of a devaluation of unlisted assets and potentially a rally in listed property. As seen in figure 2 above, there have been periods in the past where listed real estate has traded at a large discount to unlisted real estate which exhibited more mild drawdowns.

We view the path of inflation, and subsequent interest rates as having the largest impact on the direction of listed and unlisted real estate valuations. If inflation remains higher for longer, the sustained higher interest rates will likely increase pressure on the valuations of unlisted assets, especially if unlisted property managers are forced to sell their assets to meet liquidity requirements. If inflation continues its downward trend and central banks lower interest rates in the back half of 2023 or early 2024, listed real assets may converge up toward unlisted asset valuations.

What sub-sectors of unlisted property are most at risk?

As detailed above, listed real estate valuations factor in new economic data faster than unlisted property. Property can be further sub-divided into sectors, reflecting the type of property held by a REIT – this could be office or industrial, but also be somewhat specialist in nature, such as health care or hotels. It can be helpful to analyse how different sectors of listed property have performed recently to provide some insights into what the market may expect for unlisted property valuations. However, price swings in unlisted property have historically been far lower in magnitude than those observed in listed property. As seen in figure 3 below, whilst all sectors have posted negative returns over the 12 months to 30th April 2023, there has been large dispersion between sectors in performance.

FIGURE 3: International REIT[6] sub sector performance



Source: Factset, Perpetual Private, May 2023. Past Performance is not indicative of future performance.

[6] MSCI World REIT sub sector indices

Our unlisted office property exposure

Unlisted office property is circa 5% of our alternatives program and we remain comfortable with our exposure. We believe our managers are well diversified and own high-quality assets in areas with strong demand.

Office property has been the largest detractor of performance on the back of less demand for office space as companies implement work from home policies, resulting in fewer people in the office and less need for office space. The office sub sector is also more exposed to the economic cycle given demand for office space generally declines when business confidence is low and recession fears increase. This would imply unlisted office property may be at the greatest risk of price declines over the short-to-medium term, however historically we would not expect price declines of the same magnitude as those reflected in listed markets.

Conclusion

Both listed and unlisted property investments can play an important role in a diversified investment portfolio, providing exposure to tangible assets that offer the potential for long-term capital appreciation and stable income streams. Investors should carefully consider the pros and cons in terms of accessibility, diversification, liquidity, transparency, and control over the underlying assets of each investment type and conduct thorough due diligence before making any investment decision. The impact of changes in economic conditions on the relative performance of these funds may also differ, with unlisted property funds potentially offering greater insulation from these risks.

If you have any questions in relation to any of the content in this article, please reach out to your financial adviser or get in touch with us via the contact details below.

More information

Contact your financial adviser or call:

1800 631 381

perpetualprivate@perpetual.com.au

perpetual.com.au/advice

Author

Jai Sartori

Investment Associate, Perpetual Private

Jai Sartori is an Investment Associate who specialises in the communication of investment ideas and offerings. He is also a CFA level III candidate.