

## J-REIT, Does History Repeat Itself?

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The two currently listed JREITs are trading at premium compared to their underlying net asset values (“NAV”). It is estimated that 10 more REITs will commence during the next year to pursue the arbitrage between the public and private real estate markets. In anticipation of being able to securitize at significant premium to cost, commercial real estate has been selling at prices that appear to be well above market.

Assuming that the premium over NAV continues at the same level, all of these planned REITs will be successful. However, is this a reasonable expectation, or is it merely, as our Eiji Enomoto suggested in an earlier topic, a game of Old Maid where eventually the premium will decrease suddenly and someone will be left holding over-priced real estate with no available exit strategy? The UK and US markets provide an interesting history for comparison.

In the UK, where there have been property companies traded publicly for over a 100 years, there has consistently been a discount from NAV to the stock price. In fact, for the period from December 1974 until December 1994, the average variance from NAV was a discount of 22.4% with a range from a discount of 53% to a premium of 29%. Possible factors contributing to the discount from NAV include:

1. **Inside Ownership.** To prevent the likelihood that a fund will be taken over and then liquidated a majority of the stock may be owned by insiders. Inside ownership can reduce the opportunity of profitable arbitrage and thus widen the discount.
2. **Expense Ratios.** Historically, property companies in the UK have received criticism due to allegedly high management expenses. High expense ratios resulting from the fees of the fund manager will result in a lower value compared to if the property was owned directly.
3. **Size.** The NAV is typically calculated by individually appraising the assets of the portfolio. If the portfolio is large it could result in liquidity problems that could result in the aggregate value of the portfolio being less than the summation of its individual assets.
4. **Taxation.** Unlike the US, property companies do not receive any special tax consideration.

In the US, the same condition existed during the 1970's and 1980's as equity property REITs regularly traded at discounts ranging from 10% to 50%. However, during the period from 1993 until 1997, REITs often traded at premiums over 20%. This was triggered by the use of a new definition of cash flow called the Funds From Operations or FFO. The use of this measure rewarded those REITs that were able to increase total cash flow by acquiring more assets. When the flow of capital slowed in 1998 and 1999, the rate of growth of earnings could not be maintained resulting in a drop in market prices to as low as a 20 to 25% discount from NAV.

What paths are the JREITS likely to follow? Will it be a consistent discount from NAV as has been the case in the UK, or will be cyclical as is in the case of the US market? Logic tells us that REITs should sell at a slight premium to NAV to reflect the underlying property value plus the management and debt structure provided by the fund manager. But, as can be seen from the examples in the UK and the US, anything is possible.