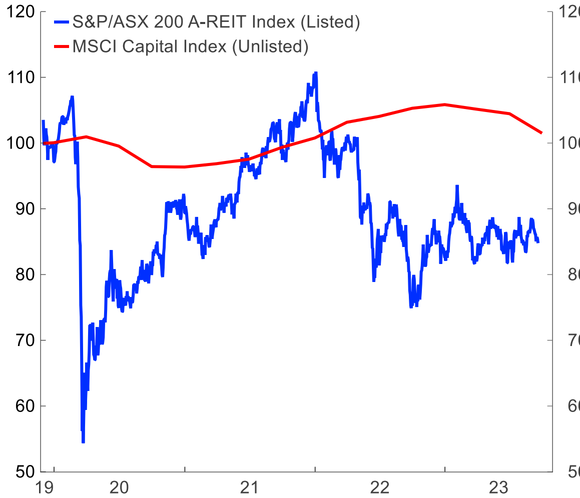
Thursday, 28 September 2023

Commercial Property Insights

Listed vs Unlisted – Canary in a Coalmine?

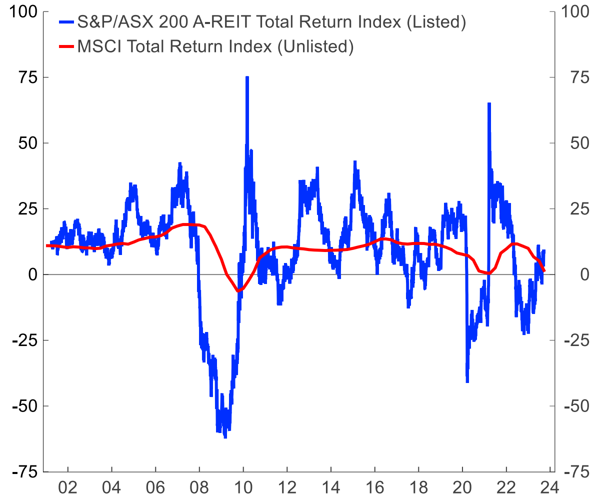
- **Transformational changes to the way we live, work, and do business due to the pandemic are impacting commercial property supply-and-demand dynamics. Many shifts are expected to be enduring, contributing to longer-term impacts, including on expected returns.**
- **Expectations that interest rates may be higher for longer are also placing pressure on valuations.**
- **Office valuations are under strain as vacancies spiked during COVID and remain elevated. Retail is also facing challenges which differ across locations. Industrial property demand is likely to remain strong in an environment of stretched supply, supporting valuations and returns.**
- **Listed Australian Real Estate Investment Trusts (A-REITs) have experienced material declines in prices, reflecting challenging market conditions. Unlisted valuations are yet to experience meaningful falls; however, this doesn't necessarily imply they are superior investments.**
- **Academic evidence suggests that unlisted real estate investments are unlikely to be inherently less risky than listed REITs. While short-term deviations exist, longer-term risk-adjusted returns have been historically similar in the US market, after accounting for underlying differences such as exposures to different market segments and leverage.**
- **This suggests that an illiquidity premium may not exist or is lower than investors may expect in the long run. A-REITs and unlisted property assets are both likely to be impacted by the challenges facing the sector, but the speed in which valuations change will vary.**
- **There are many factors impacting asset allocation decisions, including the listed versus unlisted choice. Investors should be clear on the risks they are taking, even if those risks are not overtly obvious. Chasing an illiquidity premium for its own sake should not be a deciding factor.**

Australian Commercial Property
Index: Dec 19 = 100



Sources: MSCI, Bloomberg, Macrobond

Australian Commercial Property
Total Return, Annual % Change



Sources: MSCI, Bloomberg, Macrobond

Many commercial property investors have seen the value of their investments fall in recent quarters as the challenges facing the sector since COVID hit are being increasingly reflected in underlying asset values.

These challenges have had the greatest impact on commercial office properties. Retail properties, such as shopping centres, have also been impacted, although outcomes are more mixed. Industrial properties have bucked the trend – growth has slowed more recently but values remain robust owing to continued strong demand and a healthier longer-term outlook.

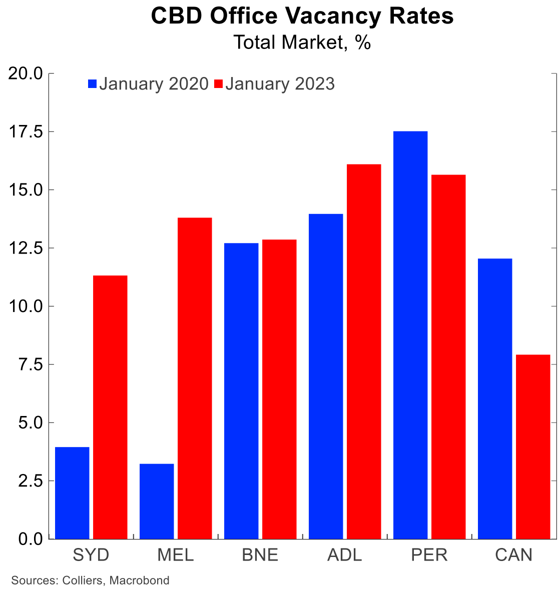
Transformational changes due to the pandemic

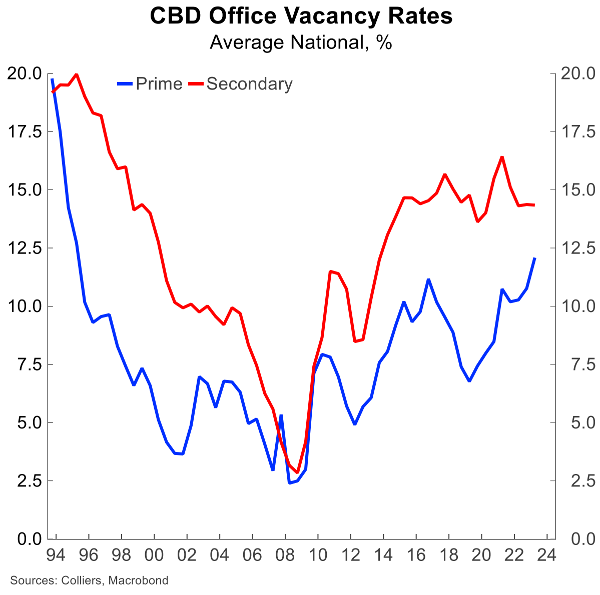
<u>Office</u>

The pandemic had a transformational impact on working patterns across the world. CBDs were suddenly deserted as office workers traded the meeting room for the living room. Prime CBD office vacancy rates spiked to double digits and secondary CBD office vacancy rates also increased.

Since lockdowns lifted, companies have encouraged workers to return to the office and CBD foot traffic has increased substantially. The pandemic has also led to changes in businesses' approach to leasing new office space. The rise in remote working reduced demand for space from some businesses. Other businesses have increased their use of collaboration spaces for periods where people are in the office working together. At the same time, supply in Sydney and Melbourne had been increasing in response to low vacancy rates in the period before the pandemic. Overall, the net effect has been that demand for new leasing space has not kept pace with supply, resulting in rising office vacancy rates, particularly in Sydney and Melbourne. Indeed, vacancy rates across Sydney, Melbourne and Adelaide have not yet declined from the highs hit since the pandemic began. Vacancy rates in Brisbane, Canberra, and Perth have pulled back slightly from their respective post-COVID peaks.

Nationally, office vacancy rates remain elevated across both prime and secondary properties, placing downward pressure on valuations. Prime vacancies are at the highest levels since the 1990s recession, while secondary vacancies have remained elevated for several years. However, vacancy rates are still well below the highs of around 20% hit during the 1990s recession.





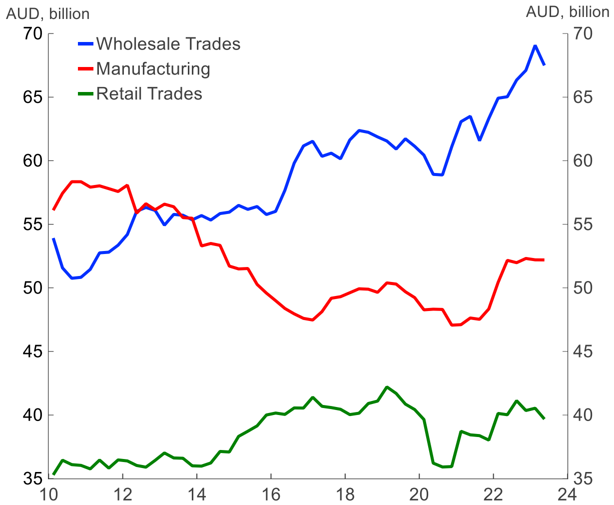
While some trends will continue to revert, many aspects of the working-from-home movement are here to stay. Most companies are settling on hybrid approaches, with workers often spending around 2-3 days per week in the office and the rest at home. These changes are likely to have permanent impacts on demand for office space and expected returns for owners.

Tenants are also seeking higher quality office space, as evidenced by demand for top tier properties being more robust compared to lower tiers. The net effect is that office vacancy rates are unlikely to fully retrace their pandemic spikes in the near term.

<u>Industrial</u>

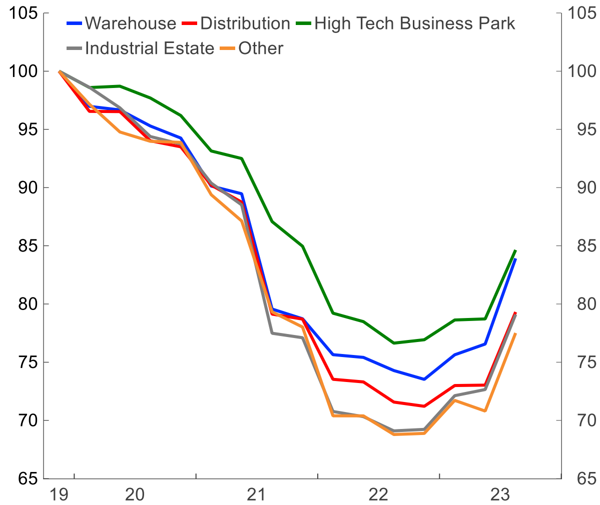
Industrial properties have performed very strongly since COVID hit and the outlook remains positive, particularly relative to other types of commercial property. A change in shopping patterns reflecting the large shift to online and the increased need for fulfilment centres being located closer to customers increased demand for industrial spaces. Supply-chain disruptions also had large impacts on business practices, including increased onshoring and greater inventory levels being held in line with the shift from 'just in time' to 'just in case' inventory management.

Inventory Levels
Chain Volume Measures



Sources: ABS; Macrobond

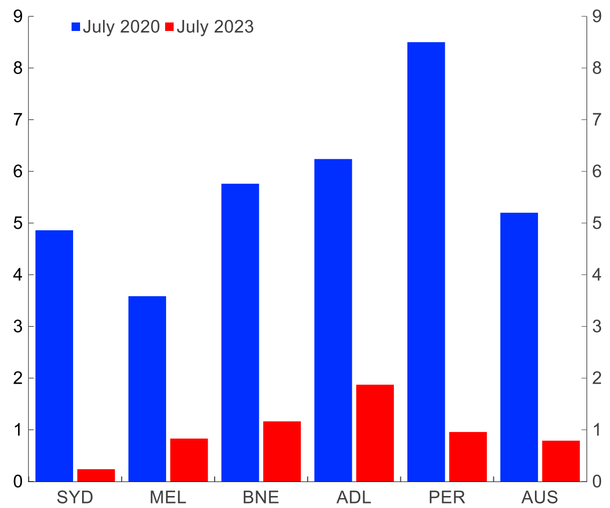
Unlisted Industrial Cap Rates
Index: Dec 19 = 100



Sources: MSCI, Macrobond

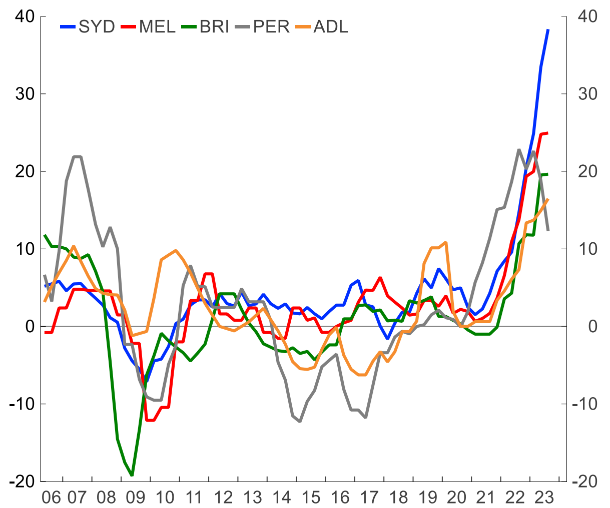
Inventory levels across the wholesale sector rose to record highs in recent quarters, partly reflecting this shift to holding greater amounts of stock. Manufacturing inventories have also risen to around the highest levels in almost a decade. Inventories across the retail sector have not risen as sharply as the wholesale sector but have returned to near pre-pandemic levels.

Industrial Vacancy Rates
Total Market, %



Sources: Colliers, Macrobond

Industrial Net Face Rent
Prime, Annual % Change



Sources: Colliers, Macrobond

Demand growing faster than supply contributed to rising rents. The rapid increase in rents attracted investors who drove prices up at a faster pace than rents, resulting in yields falling to record lows.

Some cooling of demand from scorching hot levels has occurred and more is expected given the normalisation of supply-chains and stabilisation of inventories, as consumer spending also slows.

Additionally, the economy is expected to slow materially as higher interest rates bite, impacting leasing demand. However, despite these headwinds, leasing demand is expected to remain robust, and vacancy rates, which currently average below 1% nationally, are expected to remain low, supporting rental growth and valuations.

As was expected given rising interest rates, yields have moved higher and valuations are plateauing. Despite this, the sector is likely to remain in strong demand and returns are likely to be robust compared to other commercial property segments.

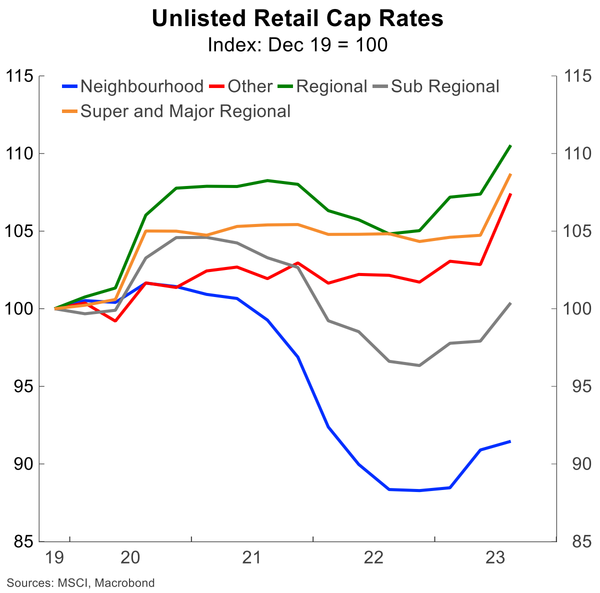
Overall, the picture is more reflective of moving from 'red hot' to 'hot', rather than 'hot' to 'cold'.

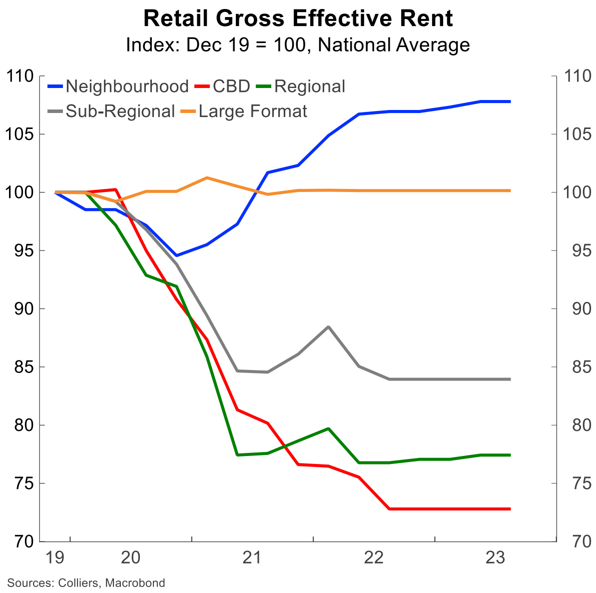
Retail

Retail properties, such as shopping centres, were also affected by the seismic shift in worker travel and shopping patterns, including the surge in online shopping. However, there have been more divergent trends across retail centres. Retail spaces in CBDs struggled as foot traffic plummeted. On the flip side, smaller retail spaces in suburban areas benefited from people spending more time around their local area – such as neighbourhood retail, which represent local centres of up to 35 shops and less than 10,000 square metres.

These patterns are likely to reverse somewhat as people continue to return to the office and we find a new equilibrium. However, some aspects of these trends are likely to be enduring, such as increased online shopping, impacting longer-term supply and demand dynamics for retail properties across regions.

These patterns can be seen through changes in rents and cap rates. Cap rates are inversely related to valuations (i.e. lower cap rates imply higher valuations, all else equal).





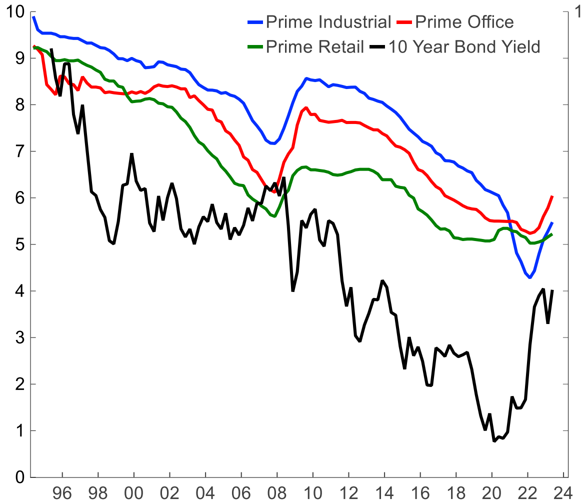
'Higher-for-longer' interest rate environment

Rising short- and long-term interest rates and the market's increasing acceptance that rates are likely to be higher for longer is another key factor affecting the commercial property outlook.

Higher risk-free yields, in the form of higher long-term government bond yields, change investor incentives. When risk-free 10-year Australian government bonds yield over 4% investors are faced with a more difficult decision around whether to allocate to commercial property or other assets.

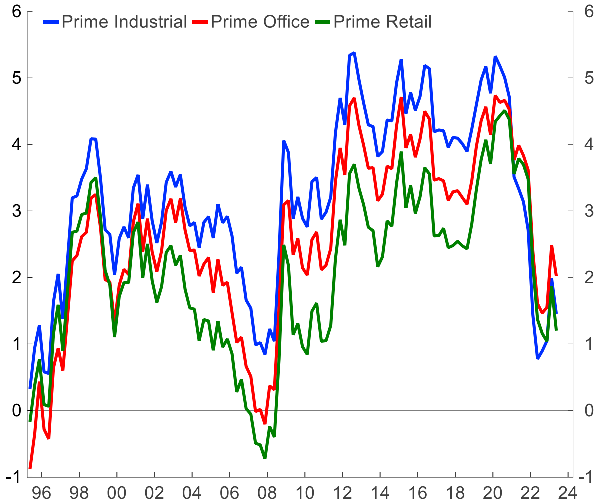
The spreads between commercial property yields and the 10-year Australian government bond yield have compressed materially since COVID hit. Industrial property spreads bottomed at levels not seen since the late 1990s. Office spreads fell to the lowest since the GFC and retail spreads dropped to levels not seen since around 2010. While spreads have since lifted, they remain very low compared to history. This suggests the risk premium of commercial property over risk-free government bonds has reduced in recent years and that the expected return at current prices may be lower compared to history. As a result, going forward, some investors may choose to invest in government bonds instead. As this process plays out, there is downward pressure on commercial property valuations and upward pressure on commercial property yields and expected returns.

Commercial Property & Bond Yields
Australia-wide, %



Sources: Colliers, Westpac Property, RBA, Macrobond

Commercial Property Bond Yield Spead
Australia-wide, %



Sources: Colliers, Westpac Property, RBA, Macrobond

This process takes time to play out, but the longer rates remain elevated, the more downward pressure valuations are likely to be placed under.

Asset pricing fundamentals

Fundamentally, the present value of any asset can be boiled down into the sum of expected future cash flows, discounted by an appropriate discount rate.

This discount rate accounts for a range of factors, including:

- the real risk-free interest rate,
- expected inflation,
- an inflation risk premium to account for the uncertainty around expected inflation, and
- a risk premium to reflect the systematic (or undiversifiable) risk of the asset.

Importantly, unsystematic risks (i.e. specific to an individual asset/sector) can be diversified away so investors don't earn a risk premium from exposing themselves to those risks.

As central banks moved policy rates higher to combat surging inflation, asset values adjusted. They adjusted for a range of reasons, not only because interest rates were increasing.

For example, market expectations around expected future cash flows changed. Expected future cash flows were reduced for many risky assets, particularly those more exposed to the economic cycle, such as cyclical companies. However, cash flow expectations for assets less exposed to the business cycle were relatively less impacted, such as defensive companies.

Not only did cash flow expectations change, so did the factors affecting discount rates.

Increases in central bank policy rates flowed through to real risk-free interest rates. Additionally, the surge in inflation led to investors pricing in a higher expected rate of inflation in the future. Added to this, as the path and expected volatility of inflation became more uncertain due to a range of underlying drivers, the inflation risk premium increased.

Finally, the risk premium around certain assets also changed, with riskier assets being more impacted than less risky assets.

The discount rate accounts for different factors depending on the asset class. For example, bonds are exposed to fewer risks than equities as bond payments are fixed or priced as a spread over a benchmark floating rate, are legal obligations for the borrower, and have a known time horizon. As a result, the discount rate reflects fewer risks which investors are being compensated for and will typically be lower for bonds than equities. Said another way, equities are typically riskier, have a higher discount rate, and higher expected return than bonds.

These factors all contributed to higher discount rates, placing downward pressure on asset prices.

However, not all asset values adjust at the same speed. Bonds, such as government bonds, adjust near instantly to changes in actual and expected monetary policy. Equities, including listed real estate investment trusts (REITs), also adjust rapidly to changes.

But illiquid assets, such as unlisted commercial property, residential property, private equity, and unlisted infrastructure, adjust slowly to changes in monetary policy or economic conditions.

Why is that? Are unlisted assets providing something more compared to listed alternatives?

Indeed, at first blush, the unlisted commercial property space in Australia appears to have weathered the storm of rapid and coordinated increases in policy rates better than listed Australian REITs (A-REITs). But the sands have been shifting and the future is uncertain.

Listed vs unlisted commercial property – the canary in the coalmine?

Investors who allocate to commercial property have a range of options they can choose from to get exposure to the sector. They can purchase a commercial property directly. However, this requires significant outlays of capital and limits most retail investors to smaller investments, such as a corner shopfront or small industrial space. There is also less access to leverage for commercial property investments relative to residential properties, reducing buying power.

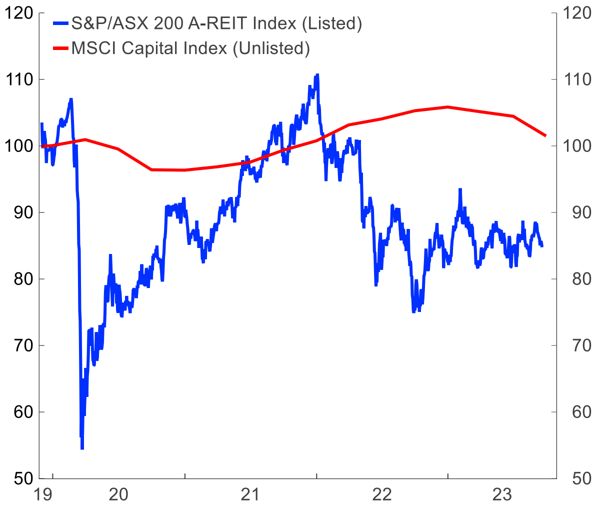
Other than investing directly, investors can combine their funds and invest via pooled investment vehicles, such as a property investment fund, of which there are listed and unlisted alternatives. One of the key differences is that for listed funds, shares in the fund are actively traded on the ASX so investors can easily sell their shares to another investor in the secondary market. For unlisted funds, investors typically redeem their investment from the fund manager and there may be limitations on how and when this can be done, particularly during periods of market stress.

For diversification benefits, investors can allocate to multiple funds. In the listed space, investors can allocate to funds that track the entire A-REIT space to increase their diversification. Conversely, in the unlisted space, investors need to allocate to individual funds rather than being able to track an underlying index, such as the returns drawn from the quarterly Property Council of Australia/MSCI Australia All Property Digest (MSCI) – which is used in this report. As a result, investors cannot practically replicate the performance of the unlisted index (minus fees), while they can easily replicate the performance of the A-REIT index (minus fees). This is an important consideration because investors allocating to unlisted assets typically take on a greater amount of unsystematic risk – some of which could be diversified away if they were able to spread their investments across all funds. This leads to a greater dispersion of outcomes for investors compared to the index.

Importantly, the listed or unlisted nature of the fund reflects the structure of the pooled vehicle. It is possible for the underlying assets to be very similar across different vehicles. Therefore, a reasonable expectation may be that the performance of these two categories should be the same over time and driven by the performance of the underlying investments. But is it?

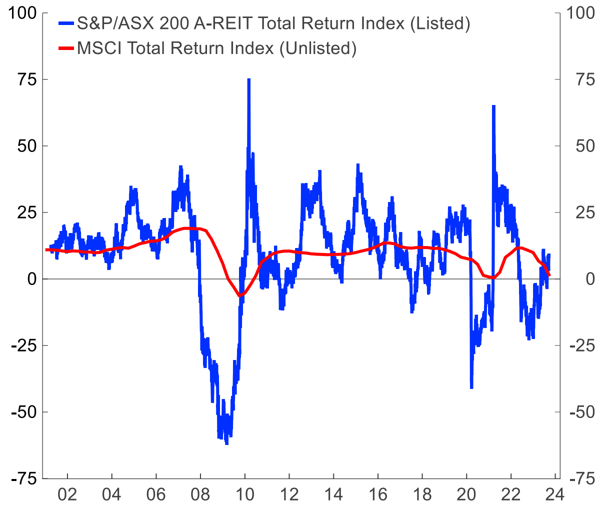
<u>Historical performance: Capital and total returns</u>

Australian Commercial Property
Index: Dec 19 = 100



Sources: MSCI, Bloomberg, Macrobond

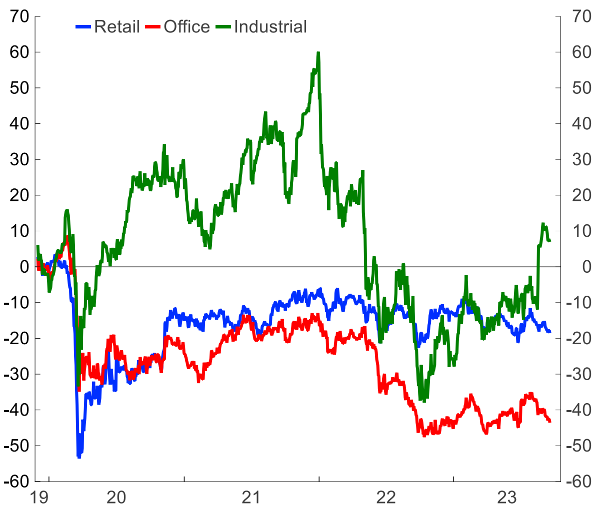
Australian Commercial Property
Total Return, Annual % Change



Sources: MSCI, Bloomberg, Macrobond

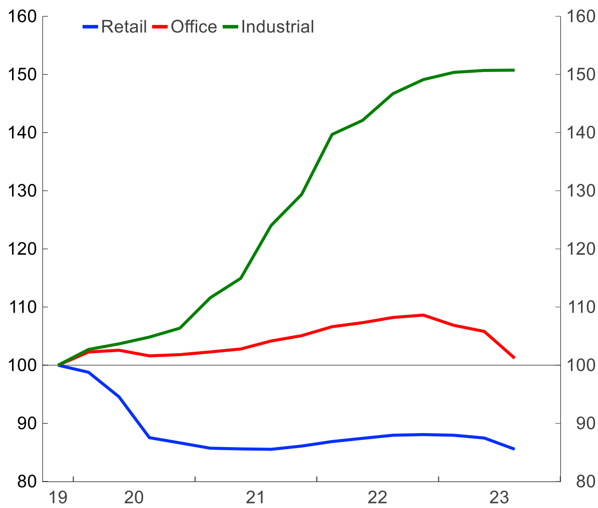
A-REIT values were hard hit during the pandemic and plunged almost 50% from pre-pandemic levels. On the other hand, unlisted property valuations barely budged – only slipping around 5%. Following the initial shock, A-REITs recovered their losses and were trading around 10% above their pre-pandemic levels in January 2022. They also rose to be above unlisted valuations. However, since then, valuations have fallen as the commercial property sector has come under pressure. A-REIT valuations are currently around 15% below pre-pandemic levels. In contrast, unlisted valuations remain just above pre-pandemic levels.

Australian Commercial Property Values
Listed minus Unlisted Index: Dec 19 = 100



Sources: MSCI, Bloomberg, Macrobond

Unlisted Commercial Property Values
Index: Dec 19 = 100



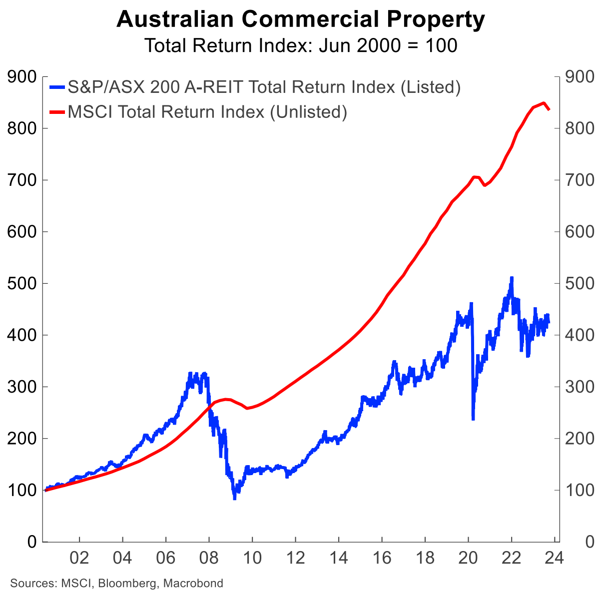
Sources: MSCI, Macrobond

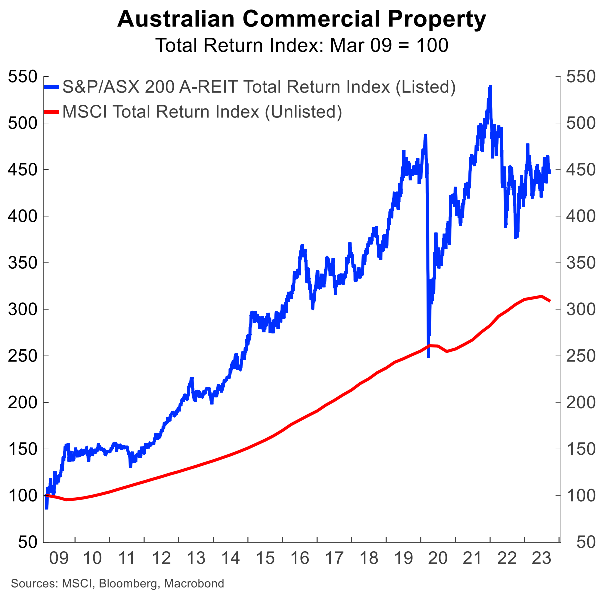
However, cracks are starting to appear across the unlisted sector and valuations have begun to be downgraded in recent quarters. Historically, returns across the listed sector tend to lead the unlisted sector. However, they are considerably more volatile. Differences in capital values and returns across the listed versus the unlisted space since the pandemic are greatest for office. In comparison, differences across industrial and retail properties are more modest.

Importantly, valuation and total return differences are quite sensitive to the starting point chosen. Specifically, the listed sector was hard-hit by the GFC – much more so than the unlisted sector. One of the key reasons was the level of leverage (or gearing) within listed funds prior to the GFC and the impact large price falls had on their gearing ratios. In order to restore these ratios, many listed funds issued new capital to investors. This led to more shares on issue, diluting the shares of existing investors and resulting in capital valuations not fully recovering their GFC plunge. Even today, many years after the GFC, the recovery is incomplete.

Unlisted funds also faced challenges during this period. Many unlisted funds froze redemptions to stop capital outflows and reduce the realisation of losses. This locked investors into the fund, effectively crystalising the illiquidity risk that exists across unlisted investments.

Due to these nuances, listed values have considerably underperformed the unlisted sector when measuring performance across the full period of available data (from 2000) or from just before the GFC. However, the listed sector has outperformed since March 2009, which coincided with the bottom of the post-GFC period and a recovery in valuations and returns. The listed sector also outperformed the unlisted sector in the lead up to the GFC. Effectively, the GFC period explains the difference in performance over the entire time horizon.

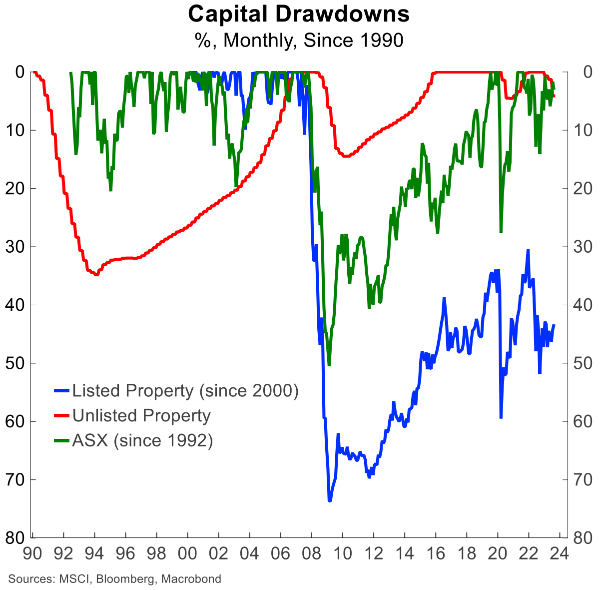


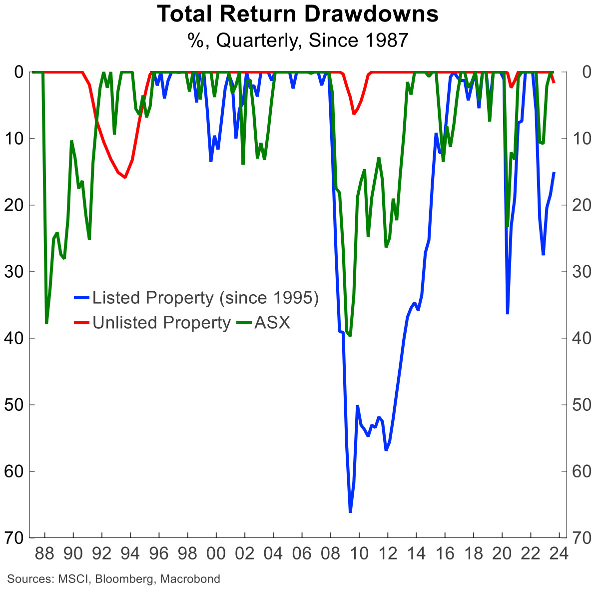


<u>Historical performance: Volatility</u>

Differences in volatility can be evidenced by looking at the history of drawdowns across the sectors or in comparison to other investments, such as Australian equities. As noted above, the listed property space suffered a devastating drawdown during the GFC period, as valuations plunged by around an incredible 75% from their pre-GFC levels. Indeed, capital valuations have still not returned to their pre-GFC levels even to this day. The ASX also suffered a very large drawdown of around 50% and only completely recovered those losses by June 2019. The unlisted property sector suffered significantly smaller declines. During the GFC period, valuations dropped around 15% and recovered by January 2016. This compares with the 1990s recession, where valuations plunged by around 35% and only fully recovered by October 2006.

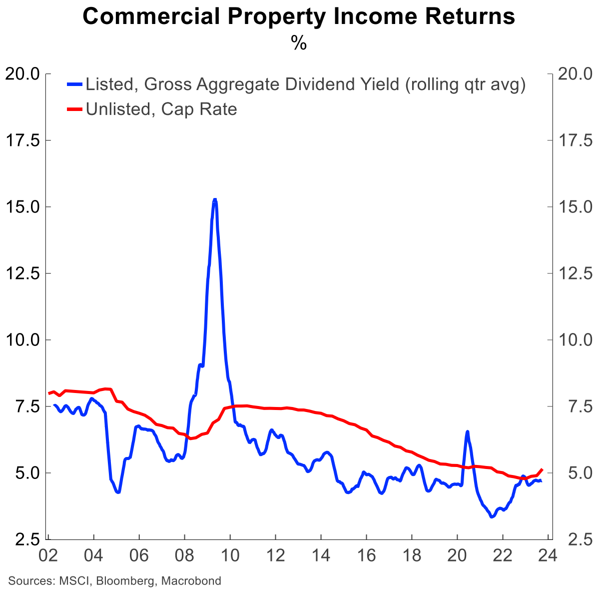
However, these drawdowns only capture capital. Income returns are also important, particularly for property. After accounting for income, drawdowns were less extreme, but still significant, and investments recovered earlier. Specifically, the listed sector lost around 65% during the GFC and didn't fully recover until the September quarter of 2016. The ASX lost around 40% and fully recovered by the December quarter of 2013. The unlisted sector lost a comparatively small 6% and recovered by the December quarter of 2010. This compares with a much larger drop of almost 16% during the 1990s recession and a recovery by the September quarter of 1995.

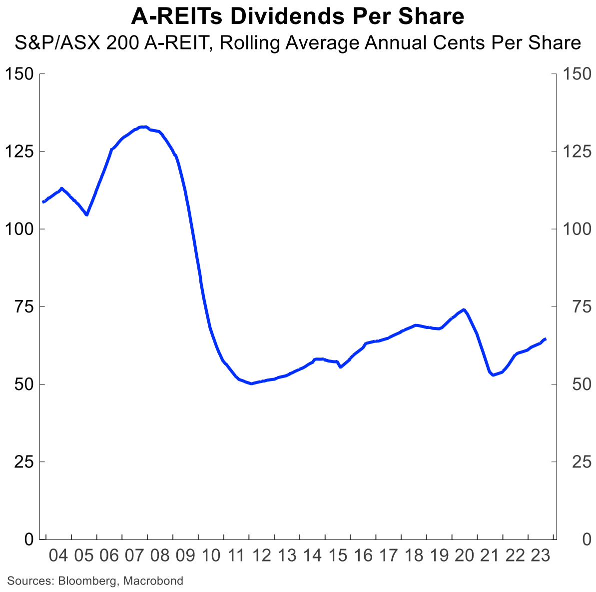




Historical performance: Income

Income is an important source of returns for commercial property investors and income tends to be more stable than capital. Commercial property leases are typically locked in for several years and have adjustment mechanisms built in for rents to rise in line with inflation or other measures. Vacancy is a consideration and would negatively impact income flows if vacancy rates rise. However, capital values, which reflect the discounted value of a stream of all future cash flows, tend to be more volatile than the cash flows themselves.





Income returns can be represented as dividend yields for the listed sector or cap rates for the unlisted sector. As a dividend yield calculation is impacted by both the numerator (income) and the denominator (values), yields are more volatile in the listed sector as values are more volatile.

Another way to examine income in the listed sector is to consider dividends per share. This approach shows that the rolling average annual dividends per share tend to be quite stable, reflecting the underlying income characteristic of commercial property noted above.

A cursory look at some of these metrics suggests unlisted investments are clearly the better choice. However, it is not that simple and direct comparisons are difficult to make for a range of reasons, key of which being that unlisted investment are only infrequently revalued.

Illiquidity premium

An important concept in financial markets is that systematic/undiversifiable risks cannot be eliminated, but they can be transferred. For example, derivatives such as options or futures enable producers to lock in the price they receive for goods, such as commodities, ahead of time. This removes the risk of prices changing for the producer. However, the party on the other side of that trade incurs that risk, so it has not been removed, but transferred. These risk transfers are not free and show up as risk premiums for those parties that are willing to bear them.

Unlisted assets add a particular ingredient to the mix which represents an undiversifiable risk. They have characteristics to them that have less impact for their listed alternatives. Specifically, it may be difficult or not possible to easily trade these assets on a regular basis, valuations are only updated infrequently, and the ability to sell the asset or redeem an investment from a fund quickly may be limited or completely removed. This creates clear drawbacks compared to listed alternatives, which are revalued and can be redeemed frequently.

Investors value liquidity. Greater liquidity enables investors to trade larger positions, with smaller differences between the price they can sell at versus the price they can buy at, with relatively low cost, and without causing large price deviations through their actions.

As a result, they arguably take more risk when they invest in illiquid assets. As this is an undiversifiable risk, theoretically, investors accepting this risk should be rewarded through higher expected returns over time. For investors willing to bear the risk, seeking to capture this premium is one reason why they may prefer to allocate to unlisted assets, such as unlisted real estate.

However, that begs the question, does the theory play out in practice and does the academic literature support the existence of an illiquidity premium? In other words, are unlisted investors receiving adequate compensation for this risk?

This is not a straightforward question to answer and there are conflicting pieces of evidence.

One of the challenges in answering this question is comparing the returns of illiquid assets to appropriate benchmarks of otherwise similar, liquid assets, to isolate the impact of illiquidity on returns. This is a challenging task for several reasons and the analysis above doesn’t fully capture the differences between the risk/return characteristics of these asset classes. Specifically:

- Comparing smoothed irregular returns to volatile daily returns.
    - Prices and returns for illiquid assets are not readily available. When comparing these returns to liquid benchmarks, the results can appear more uncorrelated and less volatile due to prices not being measured daily.
    - This is one key reason why the analysis above appears to show unlisted assets performing significantly better than listed alternatives.
- Selecting a risk-appropriate benchmark.
    - It can be challenging to find an appropriate benchmark to compare illiquid portfolios which is exposed to the same risks, other than illiquidity. As a result,

differences in returns could potentially reflect differences between the benchmarks used, in addition to differences in liquidity.

  - For example, differences in leverage ratios across listed and unlisted funds or differences in allocations across subsectors and geographies may impact risk/return characteristics.

- Accounting for higher fees.
  - Illiquid assets often have higher fees and various restrictions compared to liquid alternatives. As a result, results may be different when comparing before versus after fee returns.

Additionally, where exactly are we looking for an illiquidity premium? Is it within public markets (e.g. less liquid small cap versus more liquid large cap stocks), or by comparing private and public markets (e.g. unlisted real estate, private equity, or hedge funds against listed alternatives)?

Unfortunately, the evidence is mixed and differs somewhat across asset classes.

For example, Amihud et al. (2015) in their Journal of Financial Economics paper: "The illiquidity premium: International evidence" find support for an illiquidity premium within public stock markets across 45 countries, after controlling for exposures to common risk factors. That is, they find there is a premium for holding less liquid listed publicly traded stocks versus more liquid ones.

But what about commercial real estate? What does the evidence suggest there?

Firstly, it should be noted that real estate is already a relatively illiquid asset. So, the key difference between listed and unlisted real estate is not the liquidity of the underlying assets, but the liquidity of the investment funds used to gain exposure to this asset class and whether there are differences in the long-run risk/return characteristics between those choices.

In answering this question, academics looked at returns for listed and unlisted real estate funds in the US. But a simple comparison of the returns of these funds doesn't paint the full picture. That is because these indices are not directly comparably to each other. Adjustments need to be made for differences between leverage, industry composition (e.g. office, retail, and industrial), geographical differences, and the smoothing of returns.

Pagliari et al. (2005) and Ang et al. (2013) undertook such analysis. The results of their analysis showed that there was little difference between the average return and volatility of listed and unlisted real estate once accounting for these key differences. **<u>This suggests there is little, to no, illiquidity premium in the commercial real estate market.</u>**

Why could this be the case?

<u>Smoothing of returns: Paying for the 'smoothing service'</u>

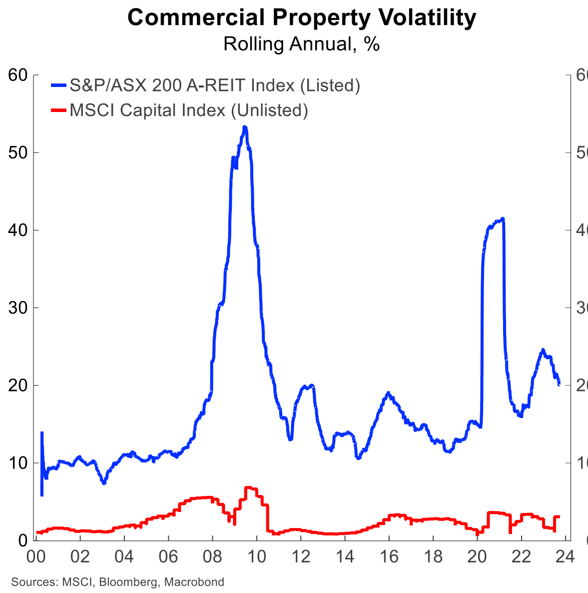
The lack of a measured illiquidity premium in academic studies may reflect two key factors:

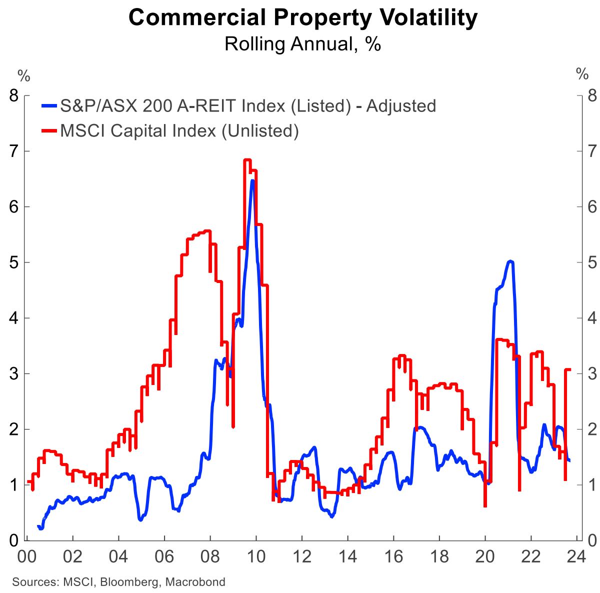
- An illiquidity premium doesn't exist, and/or
- Whatever illiquidity premium exists is more than offset by a separate discount.

Evidence suggests investors value smoothed investment returns. Pricing assets on an irregular basis leads to less volatility in reported prices compared to assets that are priced more frequently (e.g. daily). This can provide an illusion of greater returns for less risk if applying conventional risk measures such as standard deviation or Sharpe ratios. However, this may simply reflect the mathematical calculation of risk.

As noted by Antti Ilmanen (2020) in "The impact of smoothness on private equity expected returns", investors prefer smoothed returns in private assets. Investors appear willing to pay for what Ilmanen refers to as a 'smoothing service', pushing up the asset's price and lowering expected returns. This preference appears to be offsetting some, or perhaps all, of the illiquidity premium that may otherwise exist within asset classes such as unlisted real estate.

To examine this smoothing effect, we can look at the volatility of commercial property values across the listed and unlisted sectors. Here, volatility appears significantly lower for unlisted funds. However, much of this reflects the fact that unlisted properties are typically only valued once a quarter, while A-REITs are valued every day by the market. If we adjust listed valuations using a quarterly moving average (to simulate smoothed quarterly returns) and undertake the same volatility comparison, the volatility between the asset classes becomes very similar. This adds weight to the view that the smoothing effect is artificial, rather than an underlying characteristic.





So, what is the answer?

As is often the case, the truth likely lies somewhere in the middle and reflects a combination of these two factors. Additionally, the effects are unlikely to be the same across asset classes and some illiquidity premium may still be present across some unlisted assets.

Other risks of unlisted assets

<u>Redemption freezes and slower transmission of conditions to prices</u>

Unlisted assets expose investors to other risks that may be less evident with listed alternatives. This includes the risk that it may not be possible to sell the asset quickly or at all at certain times.

A rush for the exits as investors try to sell illiquid assets quickly typically leads to significant drops in price, forcing sellers to accept large haircuts to prices prior to liquidity issues arising. This effect partly explains why listed REITs can experience large falls in price during bouts of heightened market volatility, such as at the beginning of the pandemic. The underlying assets sitting behind REITs are still illiquid while the shares can be traded freely on an open market – meaning prices can be volatile during such stress periods. Importantly, the shares are being traded between investors on the secondary market rather than the underlying fund needing to pay out redemption requests. This reduces the risk that fire sales will need to be undertaken. However, it doesn't eliminate that risk as funds are also bound by other constraints, such as leverage ratio and debt coverage requirements imposed by lenders, including banks. This was evident during the GFC.

Importantly, while this risk may not show up as clearly in unlisted assets prices, that doesn't mean it isn't there. For example, funds may require that investors be locked in for several years and need advanced notice of any redemptions following lock-up periods. Redemption freezes for unlisted funds are not uncommon during periods of market stress, to reduce the risk that underlying assets to be sold at a discount. This means investors may be unable to divest even if they need to. For example, since late 2022, a number of unlisted funds both domestically and offshore have been forced to limit redemptions due to rising withdrawal requests.

Valuation changes can also impact unlisted assets inside super. For example, several superannuation funds have recently written down the valuation of some of their unlisted assets to better reflect current market conditions.

During periods where withdrawals are limited, investors are effectively forced to hold on to their investments and hope that valuations improve. If conditions remain challenging, valuations may decline in the future, but this process will take more time than in the listed market.

If an investor were able to sell quickly, they would most likely need to accept a significant haircut. This haircut would likely be similar to what listed alternatives are implying at the time given listed prices incorporate new market information quickly. Effectively, the price investors would need to accept if they were able to transact has still fallen, even if it appears like it hasn't.

A-REIT investors also have the option to hold on until values recover to avoid crystalising losses. So, this option is not unique. But falls in A-REITs are more immediate and reflect the weaker outlook. Another way to think about this is that A-REITs are effectively marked-to-market on a real time basis by the financial markets, while unlisted funds are marked-to-market infrequently.

As a result, a smaller fall in price for unlisted assets is not necessarily reflecting a lower risk, but rather the risk may appear in other ways.

<u>Opportunity cost of illiquidity</u>

Illiquid assets can also expose investors to opportunity costs. If capital is locked up for a period, other investment opportunities – which may provide a better risk/return trade off – cannot be taken up. This opportunity cost is less obvious than seeing the value of an asset fall in price. However, it is still a risk.

For example, AustralianSuper's Chief Investment Officer, Mark Delaney, noted in May this year that the fund would be looking to reduce its allocation to the property space over time, including divesting and reallocating capital from private investments towards other opportunities. However, Delaney noted that this process would take several years.

This is one of the costs of illiquidity. If an investor makes the decision to change their allocation towards other investments, this process is likely to take a long time, leading to potential missed opportunities while capital is locked up.

Additionally, during the divestment period, it is not guaranteed that the investment will perform well. The underlying fundamentals could deteriorate, leading to underwhelming returns.

<u>Behavioural biases</u>

Some investors may prefer to hold assets with smoothed returns. They may have a view that this encourages better behaviour and leads them to being more willing to hold assets with greater expected returns than they otherwise would. However, this is a behavioural bias and doesn't account for the risks of such a strategy.

Investors are typically better served through developing an understanding of their behavioural biases and seeking to limit them and improve their behaviour. This also helps investors form a clearer awareness and acceptance of the risks they are taking in their portfolio and the ups and downs they should expect. This approach places investors in a better position to capture higher expected returns, wherever they may be present.

Key takeaways

A key question is whether the illiquidity risks of unlisted assets are priced and rewarded. Academic evidence suggests that unlisted real estate investments are unlikely to be inherently less risky than listed alternatives. While short-term deviations exist, longer-term risk-adjusted returns have been historically similar in the US, after accounting for underlying differences such as exposures to different market segments and leverage. On balance, this suggests that an illiquidity premium in unlisted property assets may not exist or is lower than expected. While such analysis is not available for Australia, it is reasonable to expect that the relationships would be similar.

There are many factors impacting asset allocation decisions, including the listed versus unlisted choice. Investors should be clear on the risks they are taking, even if those risks are not overtly obvious. Chasing an illiquidity premium for its own sake should not be a deciding factor. Investors need to consider their own risk profile, including their willingness, ability, and need to take risk. This is ultimately an individual decision.

The commercial real estate sector is facing a range of challenges as significant changes to the way we live and work continue to impact the sector. A-REITs and unlisted real estate securities are both likely to be impacted by these challenges, but the speed in which valuations change will vary.

Jarek Kowcza, Senior Economist
Ph: +61 481 476 436

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
+61 404 844 817

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
+61 481 476 436

Senior Economist
Pat Bustamante
pat.bustamante@stgeorge.com.au
+61 468 571 786

Economist
Jameson Coombs
jameson.cooombs@stgeorge.com.au
+61 401 102 789