CITY OF LONDON
Investment Management Company Limited

The Case for EM REITs: CLIM's New Product Launch

October 2018

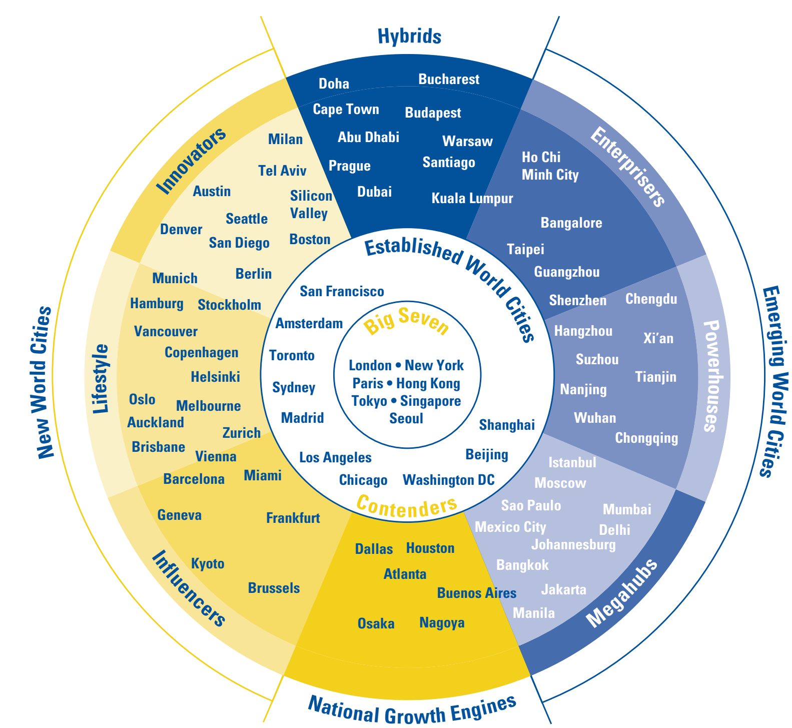
The development of Real Estate Investment Trusts (REITs) around the globe has been a relatively recent phenomenon. REITs were initially set up in the US in the 1960s to enable all investors, not just the wealthy, to buy commercial real estate in a cost and tax efficient structure. They also brought liquidity to what is otherwise an illiquid asset class. There are now just over 40 countries with REIT legislation in place with at least eight more considering it. In fact, if we focus on emerging markets we have seen our universe of stocks grow from around 70 with a market capitalisation of $25bn in 2008 to around 235 with a market capitalisation of approximately $625bn today. Our view is that this growth will continue as emerging markets mature and continue to grow more rapidly than their developed counterparts.

We believe REITs/listed real estate should play an important role in a balanced portfolio's allocation to property. Their liquidity allows investors to easily move their allocation over- or underweight, and between regions and sectors cheaply and efficiently. The issue with liquidity is that it makes REITs/listed real estate more volatile than direct real estate in the short term. However, this is only because they are priced daily on a stock exchange. In the long run they will trade in line with their underlying assets. This provides an opportunity for investors as they can potentially benefit from short term dislocations between share prices and net asset values to buy companies at historically wide discounts and sell them when their discounts have narrowed, or ideally when they are trading at premiums. Benjamin Graham put it best, "In the short run, the market is a voting machine but in the long run, it is a weighing machine."[1]

Looking around the globe, we feel emerging market REITs/listed real estate companies present an interesting and often mispriced opportunity. The main driver behind this is urbanisation. Studies by the UN show that approximately 55% of the global population lives in cities today. By 2050, the UN predicts 68% of the global population will be in cities. A 13 percentage point increase doesn't seem significant until you look at the numbers behind it. The UN studies estimate that from 2017 to 2050 the world's population will grow by nearly 30% with 2.5bn more people living in urban areas – an increase of 60% from today.[2] The majority of this growth will happen in emerging markets. It is therefore essential for cities in these regions to have the right infrastructure from a transportation, education, healthcare and housing standpoint to help them attract a diverse group of businesses and global talent to enable them to become key cities of the future.

Chart 1 from Jones Lang Lasalle helps highlight the opportunities. In the middle, there are the big seven and established world cities, which will continue to be attractive due to having the right infrastructure, despite having the most expensive rents and real estate prices in the world. However, our focus will be the emerging market cities in the outer rings that have the right attributes, and are investing in their infrastructure to help them become established world cities.

Chart 1: The Evolving World of Cities



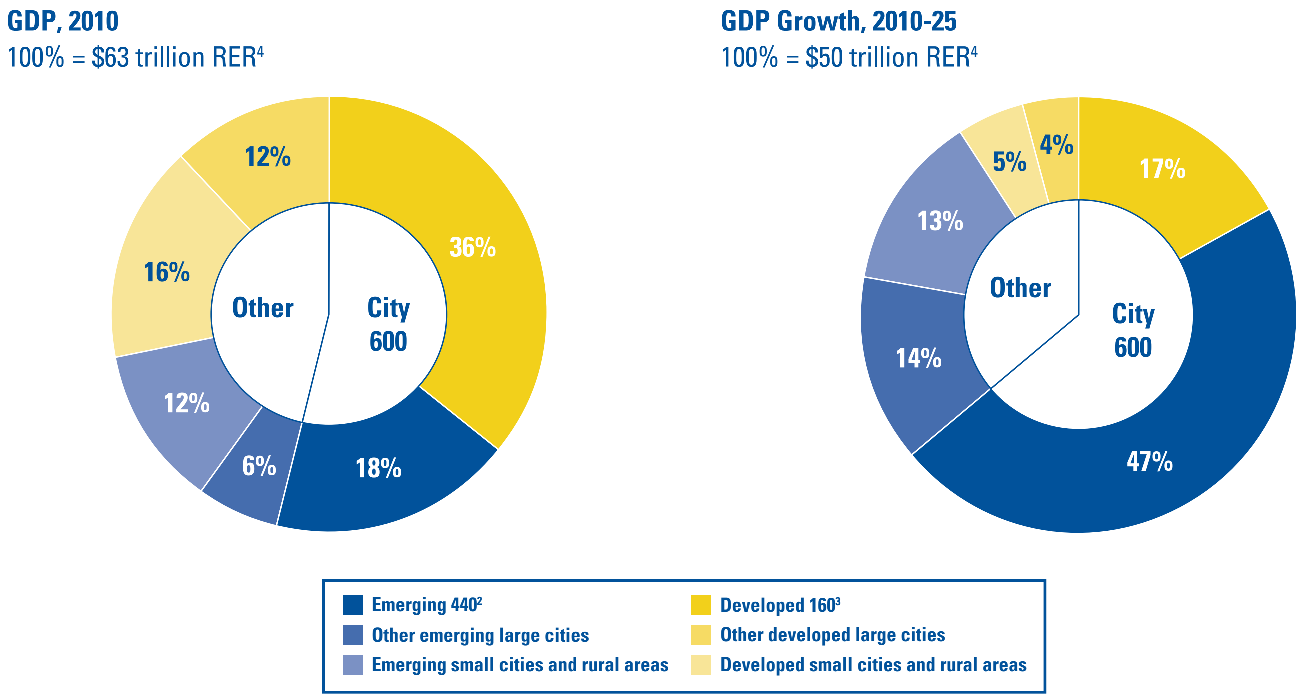
Source: JLL and the Business of Cities, January 2018

[1] *Source: Graham, Benjamin. The Intelligent Investor. Harper & Row Publishers Inc, New York, 1949.*
[2] *Source: United Nations. World Urbanization Prospects: The 2018 Revision. Web. 18 October 2018. https://population.un.org/wup/Publications/Files/WUP2018-KeyFacts.pdf*

A past study by the McKinsey Global Institute also highlights the importance of emerging markets in the future (see Chart 2).

Chart 2: Emerging 440 Cities are Poised to Deliver Close to Half of Global GDP Growth

Contribution to Global GDP and GDP Growth[1]



1 Global GDP and GDP growth figures include 2,600+ large cities in Cityscope, as well as smaller cities and rural areas.
2 The Emerging 440 is 443 emerging market cities in City 600.
3 The 157 developed market cities in City 600.
4 Real exchange rate (RER) for 2010 is the market exchange rate. RER for 2025 was predicted from differences in the per capita GDP growth rates of countries relative to the United States.

Source: McKinsey Global Institute Cityscope 2.0

The point the heading makes in the above charts is a good one; the charts also show that although 64% of GDP in 2010 was generated by developed cities, between 2010 and 2025 they estimate 74% of the GDP growth will come from emerging cities. This further backs our view that we will continue to see emerging market cities grow more quickly than their developed equivalents. This in turn will drive international recognition of their property markets, leading to above average rental and capital growth from relatively low levels.

This is where the expertise of CLIM comes in. In mid-2018, the Firm hired in an experienced REIT team, whose team members have worked together for ten years and over that time built up a strong track record. CLIM has invested in emerging markets since 1991, and has a macro economic team that specialises in developing markets. This is a crucial part of investing in real estate, as the majority of REITs/listed real estate companies focus on one region due to local knowledge being key. For example, if we take the UK main market (FTSE 100) around 70% of their earnings come from outside the UK. Therefore, the UK economy does not have much of a bearing on the performance of the companies in the FTSE 100. Conversely, most of the UK listed real estate companies are purely focused on the UK, making the local economic backdrop, alongside the direct market real estate fundamentals, crucial to their performance. We will therefore be able to replicate the existing in-house three stage macro process, and the emerging market expertise of the macro team to assist with the geographic and sector allocations. In addition, the Firm has contracted with Jones Lang Lasalle, a leading global professional services and investment management firm specialising in real estate, as a research provider. They have one of the largest, if not the largest, databases of direct real estate market data covering over 160 markets. We will meet with them on a regular basis to discuss real estate markets around the globe with a focus on emerging markets. They will also supply us with some hard data points to assist with our final check to rank the attractiveness of markets for the asset allocation process.

To populate the asset allocation calls, we will use a bottom up stock selection process that will encompass identifying long term real estate or economic trends that we think will drive above average revenue growth, such as urbanisation or demographics at the broader end of the spectrum or the growth of data usage at the narrower end. We will then look for companies exposed to these trends that have certain corporate characteristics that we believe will increase the likelihood that they will benefit from those trends. Finally, we will analyse their internal and external growth prospects, where they trade relative to net asset value and their pricing relative to peers.

In summary, investing in EM REITs is a natural extension to CLIMs diversification over the years. CLIM is well positioned to take advantage of above trend growth in rents and asset values from emerging market real estate in the medium to long term as their middle classes expand rapidly, and urbanisation trends catch up with the developed world.

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