UBS Asset Management

Intriguing premium

Rationale behind agios of listed Swiss real estate funds | White paper

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The rationale behind the agios of listed Swiss real estate funds is often subject to debate in the investor community. In this paper, we examine several internal and external factors contributing to premiums to net asset value (NAV) for this asset class.

A (largely) rational premium

Certain fund attributes and more versatile external factors drive the existence and variation of a premium to NAV in the market for listed Swiss real estate funds. Although agio movements may raise tactical considerations, investors should rather focus on long-term income strength and diversification potential of their listed Swiss real estate allocation.

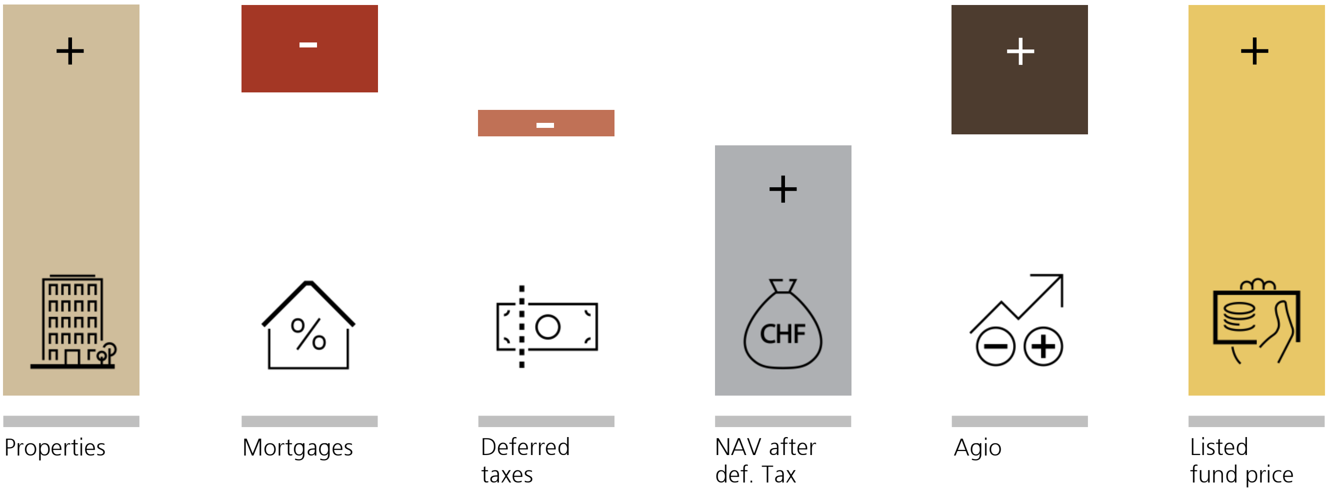
What is the agio?
In listed real estate funds, the difference between the market price and the net asset value (NAV) is termed a premium (agio). Swiss listed property funds are rarely exchanged at a price equivalent to the underlying NAV. Indeed, this asset class does tend to trade at an agio or, in rare cases, a discount (disagio) to the NAV per share (see Figure 1). Over the last 10 years, the average premium in the entire market amounted to around 25% of the NAV. The fundamentals behind the agio often raises questions within the investor community. In this paper, we examine how certain characteristics of a fund, as well as more volatile external factors, are likely to be driving a premium to NAV in the Swiss listed property fund market.

It can be difficult to isolate the contribution of one single driving force to the agio, since many factors show a strong cross-correlation – eg. fund vintage year, size, trading liquidity, portfolio diversification and amount of deferred taxes. Furthermore, the sample size of listed Swiss real estate funds with a long history of data is rather limited. With this in mind, we do not attempt to draw statistical conclusions on the following lines, but rather try to explain the existence and variation of this premium based on empirical observations and sound economic reasoning.

Deferred taxes as a tangible contributor
Deferred capital gain taxes are probably one of the most tangible contributors to the existence of agios in the listed Swiss real estate fund market. In the lifespan of a property fund, capital value growth accumulates over time, triggering substantial capital gain taxes in the event that the fund goes into liquidation. This aspect is recognized as a cost position when calculating the NAV (see Figure 1).

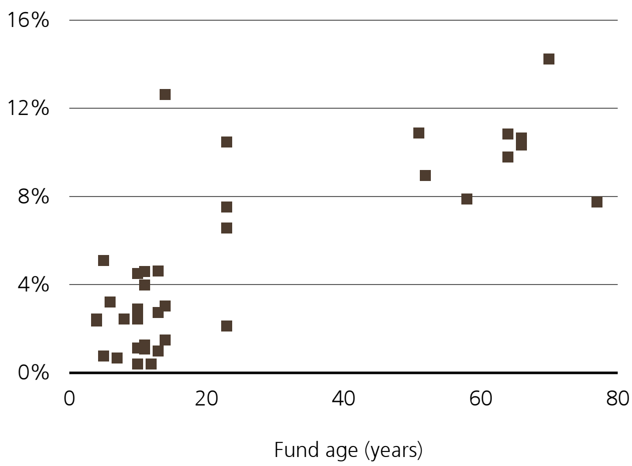
Since buy-to-hold property funds are usually established with a *going concern strategy* (the underlying assumption that a business will stay in operation for the foreseeable future), the subtraction of deferred capital gain taxes from the NAV may be legitimately questioned. Therefore, if a fund is not expected to be liquidated in the foreseeable future, deferred capital gain taxes may be considered a fictive cost position which should be added back to the NAV. Deferred capital gain taxes correspond to about 7% on average of the NAV in the Swiss market. The burden can reach over 10% of the NAV, particularly for funds that were either established decades ago or are invested in properties that have experienced a strong and rapid capital increase (see Figure 2).

Figure 1: From property valuation to fund share price



Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

Figure 2: Deferred taxes increasing with product age
Deferred taxes (% NAV)



Source: Various fund annual reports; UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

Portfolio and fund structure adding value
Once combined into a sizeable portfolio, invested properties can offer diversification benefits when compared to fragmented single real estate investments. Such portfolio structures minimize the exposure to rent default and property-specific risks by spreading the allocation over numerous investments, tenants and often sectors. This benefit is likely to justify a premium to NAV, as the exposure to an entire real estate portfolio is worth more to an investor than the sum of individual invested properties.

In addition, listed fund shares offer uncomplicated and efficient trading options to investors, which contrasts with the illiquidity of direct property investments. In fact, trading a direct property requires time, a willing buyer/seller, as well as comprehensive skills to conduct necessary due diligence and to deal with legal and financing aspects. By contrast, the acquisition of listed real estate fund shares might be executed in a few clicks on an exchange, with a different grade of liquidity depending on the product size and average daily trading volume. Although partly captured by the product fees, this convenience is likely to justify a premium to NAV when compared to direct property investments.

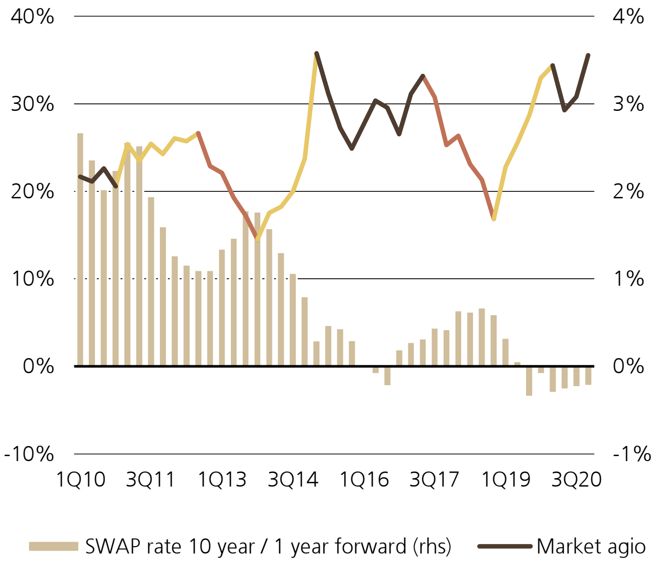
Unique portfolio characteristics such as the property, location and tenant quality are likely to lead to agio differences within the listed real estate fund universe. Such factors directly impact the earning power and level of risk of a product. Though considered in the valuation of a fund's properties, a sentiment premium or discount may result from the assessment of these characteristics by listed market players. Similarly, the perception of the investment manager skills may also influence the price of a listed fund share, and consequently, the agio level for a specific product.

Influence of macroeconomic and occupier market fundamentals
In addition to the long-term internal characteristics of a portfolio / fund, more volatile external factors are also key to help us to understand the dynamic of listed Swiss property fund agios. The consequences of the interest rate environment in terms of property investment fundamentals (financing costs, level of discount factor in valuations) and investment alternatives (bond market yields, risk-free rate) are particularly influential. As described in Figure 3, periods of decreasing interest rate logically tends to drive an increasing agio level, and vice-versa when yields are trending upward.

Occupier market fundamentals (i.e. vacancy level, rental growth prospects) are also susceptible to influence the agio level. In the long-run, both worsening or brightening prospects in the rental market can impact real estate value and the NAV of property funds. However, the listed market tends to price changing fundamentals much more quickly than property surveyors, and investor sentiment may lead to momentary exaggerations in the upward or downward price trend.

This effect may lead to significant agio differences depending on a real estate fund's focus, as investors may be willing to pay a premium for sectors and regions showing the best occupier market prospects, and to penalize products active in struggling markets. With this in mind, funds investing solely in the residential sector and products with a focus on the growing Geneva Lake region, have demonstrated above-average agio levels in the recent past.

Figure 3: Agio dynamic and interest rate environment



Source: Refinitiv, various fund annual reports; UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

Long-term focus on robust payout and diversification potential
As discussed previously, potential drivers of a premium to NAV in the Swiss listed property fund market are numerous. Some of these factors are inherent to a fund's characteristics and show a long-lasting nature, while other more volatile drivers arise from the external environment and investor sentiment (see Figure 4).

These more volatile factors are more likely to drive cyclical movements of the agio level in the market, which may raise tactical investment considerations. In practice, timing the agio level always involves a significant level of uncertainty regarding future market movement. In addition, transaction costs may also drag on performance.

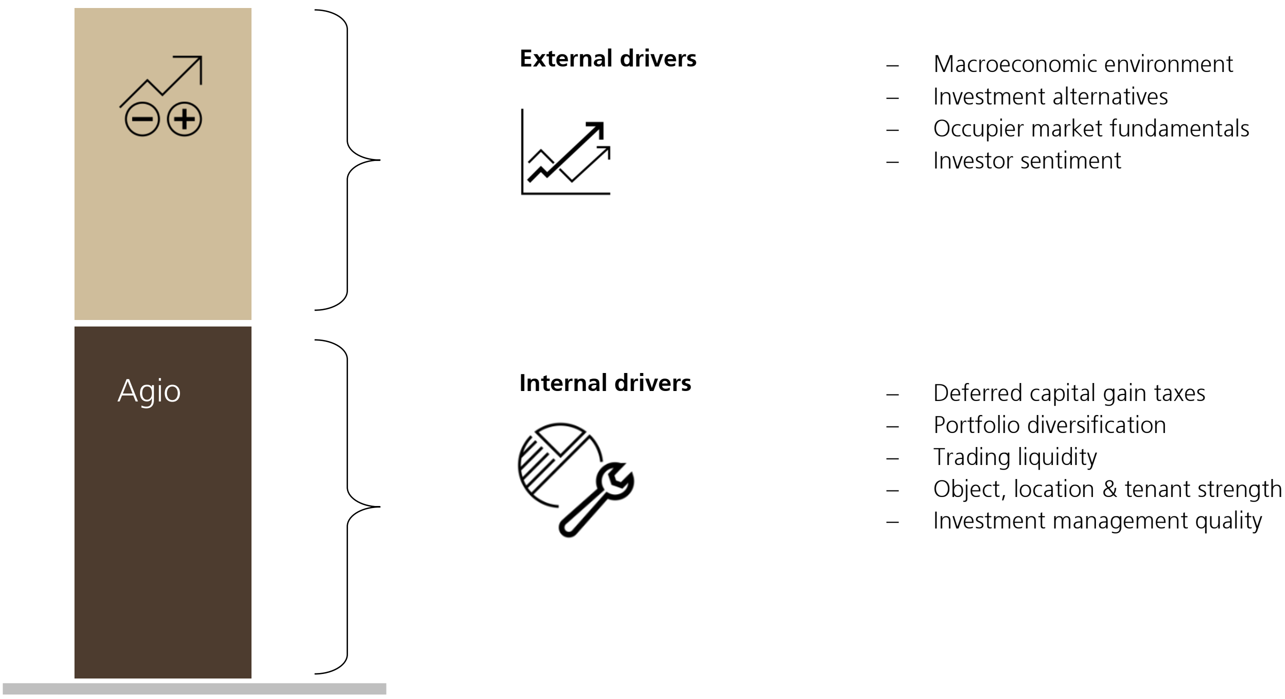
Moreover, some core benefits of an allocation to listed Swiss real estate funds include a low return correlation with traditional asset classes, as well as the stable rental income generated from the underlying property investments. These elements contribute to the diversification and the stability of a multi-asset portfolio.

In our view, long-term investors should focus on the strength of these aspects rather than on tactical adjustments based on short-term agio movements. In fact, the level of diversification as well as the quality of the payout yield are the main drivers of strong risk-adjusted returns for a long-term allocation in the listed Swiss real estate market.

In addition to the structure of the invested product, important soft factors such as the quality of the investment manager and its capacity to embrace growing industry trends (digitalization, ESG aspects) must also be assessed. In our view, these elements act as key catalysts for delivering both resilient returns and product value in the long run.

Low return correlation with traditional asset classes and a stable distribution yield are core benefits of Swiss listed real estate.

Figure 4: Internal and external agio drivers



Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

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