

Why Europe Must Open Access to Equity Markets

WINTER 2011

by **Joseph Harvey**, president and CIO

In the midst of the credit crisis, we made the case that pre-emptive rights disadvantaged shareholders of real estate companies (Financial Times, August 10, 2009). In fact, the pre-emptive rights market structure helped push an industrial property REIT, Brixton PLC, nearly into bankruptcy. Brixton was crowded out by other REITs and could not bring a rights offering to market before the collapse of their share price. In business since 1924, Brixton ultimately was forced into the arms of another REIT through a distressed sale, instead of recapitalizing through the equity market. Many other REITs executed rights offerings at substantial discounts to both their market prices and intrinsic values.

Now that the crisis has passed—and many real estate companies are seeking to take advantage of the deleveraging process by acquiring property from over-leveraged landlords—we continue to believe that real estate company shareholders are disadvantaged by pre-emptive rights. As one of the largest global investors in real estate securities, we believe it is time shareholders in the U.K. and Continental Europe allow greater flexibility to management in raising equity capital. We will lay out our case in this paper and propose an agenda for shareholders to effect change.

Our agenda is direct and simple:

- We believe our holdings in the U.K. and Continental Europe would trade at higher valuations if companies had greater flexibility to issue equity capital free from pre-emptive rights.
- We would like to see a larger listed real estate universe in Europe, with more real estate companies accessing the public market and growing through securitization of private real estate.
- We believe U.K. and Continental European real estate companies should increase their focus on the cost of their equity capital, as pre-emptive rights have obscured this fundamental discipline.
- We want to raise awareness that pre-emptive rights do not adequately meet the financing needs of capital-intensive real estate companies, especially REITs that are further constrained by their requirement to distribute nearly all of their earnings.
- We believe that the pre-emptive rights market structure, considering its application broadly across many industries, particularly banking, has been a contributing factor to too much leverage in Europe.

To avoid any doubt, we are not seeking any economic edge with this agenda. By liberating capital-raising practices we believe the value of our holdings will increase by far more than any “alpha” we can create by buying follow-on stock offerings (or back-stopping rights offerings for that matter).

The Problem

Corporate law in the U.K. and Continental Europe mandates pre-emptive rights. These rights afford shareholders the opportunity to subscribe to newly-issued shares to maintain their pro-rata ownership. In this rights offering process, which typically takes five weeks to execute, companies set subscription prices meaningfully below the market price in order to induce shareholders to subscribe (we argue, coercively) and to reduce the risk for investment banks and shareholders to “back-stop” these offerings. Back-stopping is a procedure through which unsubscribed rights are taken up.

In our view, the rights framework significantly raises the cost of equity and impedes a company’s flexibility to access equity capital. This capital-raising framework takes away a management team’s ability to act quickly on investment opportunities and to issue equity when their stock is attractively priced—two avenues for managements to add value.

In contrast, a U.S. company can issue equity from an authorized share base without pre-emptive rights, enabling managements to move quickly on deals, mitigate financing risk and issue equity when shares are attractively valued.

For example, in December 2010 HCP, Inc., the largest health care REIT listed on the NYSE, acquired HCR Manor Care’s US\$6.1 billion portfolio of nursing home properties. One day after announcing the acquisition, HCP executed *overnight* an equity offering of \$1.5 billion at a 2.9% discount to the market price—but at a 24% premium to the net asset value (NAV) of its real estate. In this example, all shareholders had the opportunity to buy stock, either through the placement or in the after-market. Plus, HCP was able to attract new shareholders on terms management believed would add value to the company. HCP’s access to equity in size, and with speed, enabled them to make a transformational acquisition. This was followed with a \$2.4 billion placement of corporate bonds with an average coupon of 4.8% and term exceeding 10 years—a remarkable financing made possible by HCP’s strong balance sheet and access to equity.

In fact, in 2010 U.S. REITs acquired \$39 billion of properties. Many of these acquisitions were financed with equity raised in overnight or one-to-two-day marketed offerings—all without pre-emptive rights. The ability to execute quickly enabled these companies to negotiate property acquisitions, without financing contingencies, on attractive terms. Plus they were able to “match fund” with a known cost of equity. In contrast, we believe rights offerings are clumsy due to the timeframe for execution and the large discounts needed to mitigate market risk and attract back-stoppers.

A Solution

Although corporate law mandates pre-emptive rights in the U.K. and Continental Europe, shareholders may vote to waive pre-emptive rights. One roadblock, however, is that shareholder advocacy groups, such as the Pre-Emption Group and the Association of British Insurers (ABI), have established guidelines, long-rooted in history, that recommend shareholders approve these waivers only if issuances are less than 5% of shares outstanding in the U.K. or, generally, less than 20% in the rest of Europe. At these levels, the recommended waiver amounts are far too small to make any difference to real estate companies.

In the eyes of the advocacy groups, the case for pre-emptive rights is 1) to prevent shareholders from being diluted, 2) to prevent management from issuing shares to select investors at an advantageous price, and 3) to give shareholders more control over management decision-making.

We are not against rights offerings per se; there are circumstances, notably for a specific company that has balance-sheet distress in a stable market environment, in which a rights offering may be the best choice for shareholders. However, as a mandated form of capital issuance, times have changed. Considering the sophistication and size of global capital markets, we believe pre-emptive rights are like the “horse and buggy” in a world moving quickly towards the electric automobile.

Interestingly, proxy research and voting firms such as Institutional Shareholder Services, Inc. (ISS) have integrated local market customs into their voting recommendations. As a result, we see a significant inequity for shareholders in Europe compared with those in the U.S. In Exhibit 1, we summarize ISS voting policy for equity issuance.

EXHIBIT 1. ISS POLICY FOR SHARE ISSUANCE

	Corporate Law	ISS Policy
United States	No requirement for pre-emptive rights in most states	<ul style="list-style-type: none"> • Votes in favor of share authorization typically up to 100% of existing authorized shares • No requirement to disclose use of proceeds, form or price of issuance
United Kingdom	Pre-emptive rights required, unless shareholders resolve otherwise	<ul style="list-style-type: none"> • Votes in favor of waiver of pre-emptive rights for issuance up to 5% of shares outstanding; votes against amounts above 5% • Company must disclose specific use of proceeds, form of share issuance and price (discount) of offering in order to receive waiver approval
Continental Europe	Pre-emptive rights required, unless shareholders resolve otherwise	<ul style="list-style-type: none"> • Votes in favor of waiver for issuance up to 20% of shares outstanding; votes against amounts above 20% • Company must disclose specific use of proceeds, form of share issuance and price (discount) of offering in order to receive waiver approval

Source: Cohen & Steers and ISS.

How can these differences in voting policy be explained? We do not see a governance issue, shareholder value philosophy or economic basis that justifies voting one way in the U.S. and another in Europe, in our view. Why should European managements first disclose what they will do with an equity raise before they can receive approval to raise the money, as custom suggests in Europe? Are U.S. managements smarter or more trustworthy compared with European managements? Of course not. This institutional legacy can only be explained by a failure to keep abreast with the global capital markets—a failure perhaps motivated by the desire to retain some perceived economic advantage by large institutional shareholders, company managements, and investment bankers; these factors, we believe, encourage managements to execute rights offerings instead of pursuing waivers.

The Data Support Open Access to Equity

In our view, rights offerings have impaired shareholder total returns. To test the thesis, we compared the long-term returns of real estate securities in the U.S. and U.K. to the returns from private (direct) property. In the U.S., listed REITs have generated an excess return as compared with the direct property index of +513 basis points per year over the past 20 years. In comparison, U.K. listed property companies have underperformed the direct property index by -297 basis points each year. See Exhibit 2. Looked at another way, over the same 20 years, REITs in the U.S. have outperformed the global real estate security index by +292 basis points per year, while U.K. property companies have underperformed by -540 basis points.

EXHIBIT 2. LISTED AND DIRECT PROPERTY RETURNS: UNITED STATES AND UNITED KINGDOM

	Annualized Total Return in US\$ (20 years ended 12/31/10)	Excess Return vs. Global EPRA Index
United States		
NAREIT Equity REIT Index (listed)	12.2%	+292 bps
NCREIF Index (direct)	7.0%	
<i>Excess vs. Direct</i>	<i>+513 bps</i>	
United Kingdom		
EPRA Real Estate Security Index (listed)	3.9%	-540 bps
IPD Index (direct)	6.8%	
<i>Excess vs. Direct</i>	<i>-297 bps</i>	

Past performance is no guarantee of future results. You cannot invest directly in an index.
Sources: Bloomberg, FTSE, National Council of Real Estate Investment Fiduciaries and Cohen & Steers.

Interestingly over these 20 years, the indexes for direct property have achieved about the same performance in the U.K. as in the U.S. Why have listed real estate companies in the U.S. outperformed while listed companies in the U.K. have underperformed? It cannot be explained by the underlying businesses, because property companies in the U.K. own quality properties; in fact, many of them are included in IPD's direct property indexes.

We would attribute some of this long-term underperformance to the business models in the U.K., which historically have been focused on development and more highly levered. Before 2007—when many of the large U.K. property companies began to adopt the U.S.-style REIT corporate structure—companies often ran with higher leverage as a tool to reduce corporate taxes. The availability of low-cost bank financing further supported the decision to run with higher leverage.

Going forward, with the REIT structure in place, there is no need to shelter income with leverage in the U.K. Moreover, banks will be more conservative in the face of financial regulations, which will require real estate companies to use more equity. The use of a REIT versus corporate organizational structure would be consistent with a business model of less development, lower leverage, less retained earnings and higher-dividend payouts—all characteristics that have helped build the strong long-term track record for U.S. REITs. While the comparison of listed- to direct-investment returns within the U.S. is pure—since neither the NCREIF Index nor the REIT structure is subject to corporate taxes—we would note that the listed index in the U.K. bore a corporate tax drag until 2007 (possibly approaching 170 basis points a year, based on our sampling).

Less obvious, we believe that a portion of the underperformance is rooted in the market structure of pre-emptive rights. The philosophy of pre-emptive rights—that shareholders cannot be diluted because they can maintain their pro-rata ownership regardless of the subscription price—has instilled two tangible economic effects into the results for U.K. property stocks.

- First, some managements have made poor capital allocation decisions because their “feet aren't held to the fire” by having a true, transparent cost of equity capital. If rights offerings are not “dilutive”, and if a discounted rights offering ensures execution, then managements can rationalize capital deployment that is not attractive relative to the true cost of equity, if it had to be raised from new and existing shareholders without coercion. Mathematically, what is the cost of capital in a rights offering, in which shares are placed at large discounts to intrinsic value (NAV), but shareholders receive more shares and no value is transferred to new shareholders? In the rights offering context, the cost of capital cannot be calculated. Said another way, in 2009, rights offerings were a completely “fair way” of destroying shareholder value while repaying debt holders; this happened in the previous cycle as well, with a round of rights offerings in 1993 to repay debt.
- Second, and very importantly, U.S. REITs have added value by issuing shares above intrinsic value to new shareholders, with the accretion enuring to the benefit of existing shareholders. In the rights offering framework, there can be no accretion via share issuance (unless there is a simultaneously “open-offer” component, which is rare). U.S. REITs have been able to acquire more property, on better terms, and have been able to finance with a lower cost of equity capital. All of this has translated to higher and more transparent cash flow growth.

Thinking about the stock cycle, rights offerings have detracted value in both down and up markets. In a down market, shareholders and traders anticipate the need for a rights offering and then punish the shares before the rights offering pricing mechanism can be established. In 2009, Land Securities, the largest U.K. REIT, set a rights offering price 51% below the last trading price and 73% below real estate NAV. Segro, the industrial property company that acquired Brixton, set a rights price 87% below the last trading price and 97% below NAV. While shareholders may have been comforted by “not being diluted,” can any of them believe there is no detrimental effect from the nominal dilution to the financial results of the company? After all, company valuations are, in part, built upon a company’s track record of financial results over time. Finally, for those shareholders who could not subscribe and instead had to sell their rights, they did experience a true economic value transfer to the extent that the rights value was exceeded by the intrinsic value dilution in the offering.

Bottom line, these dynamics have been borne out in share price performance for U.K real estate stocks compared with U.S. REITs over the last bear market and recovery. See Exhibit 3.

EXHIBIT 3. LISTED REAL ESTATE RETURNS: UNITED STATES AND UNITED KINGDOM

	United States Cumulative Return US\$	United Kingdom Cumulative Return US\$	United States vs. United Kingdom
Bear Market (2007–2008)	-47.5%	-74.8%	+2,730 bps
Recovery (2009–2010)	+63.8%	+31.3%	+3,250 bps

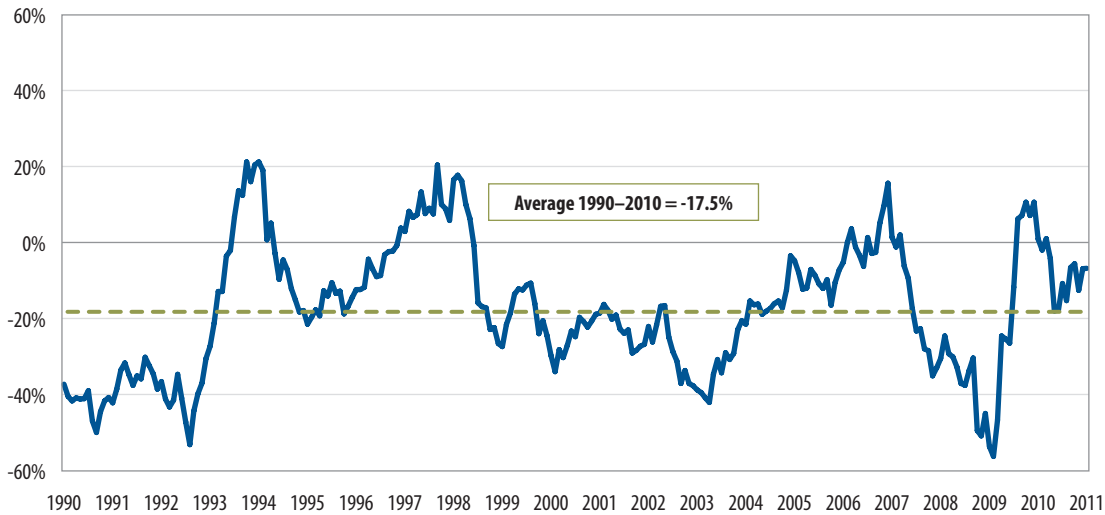
Past performance is no guarantee of future results. You cannot invest directly in an index.
Source: FTSE EPRA NAREIT Indexes.

Looking at valuations, U.K. real estate companies trade at lower price-to-NAV valuations than their U.S. counterparts; at January 31, 2011, the U.K. traded at a 7% discount, while the U.S. traded at a 13% premium. See Exhibit 4. This is consistent with the fact that value creation and market returns have been greater in the U.S. Proponents of pre-emptive rights would argue that their shares are worth more by virtue of the call option on share issuance; yet the data show otherwise. U.K. real estate companies with pre-emptive rights consistently trade at lower valuations (18% average discount since 1990) than do U.S. companies (0.6% average premium) that have open access to equity markets.

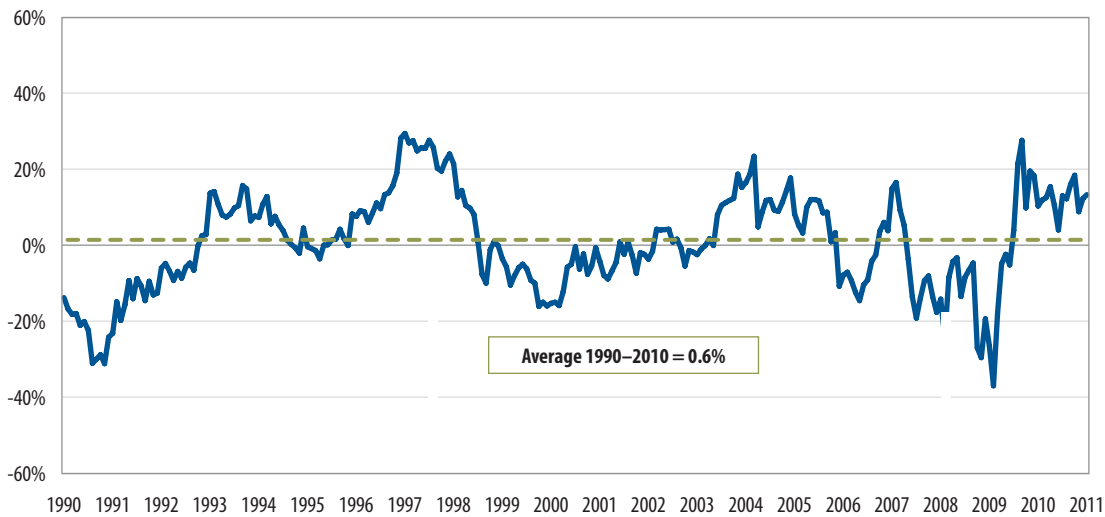
We believe the globalization of equity markets will shine a brighter light on this market inefficiency. Shareholder registers increasingly are populated by investors whose capital flows to the best opportunity anywhere in the world. Companies burdened by the legacy of backward-looking views on pre-emptive rights will be disadvantaged in terms of access to equity markets. Therefore we believe that shareholders must focus on this issue, recognize the burden of this market practice, and lobby for change.

EXHIBIT 4. PREMIUM/DISCOUNT TO NAV: LISTED REAL ESTATE

United Kingdom



United States



As of January 31, 2011.

Past performance is no guarantee future results. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that any market forecast set forth in this presentation will be realized. Source: UBS.

This information relates to the real estate securities market in each region as a whole and does not represent any Cohen & Steers portfolio.

Action Plan

We believe shareholders and industry analysts should lobby proxy voting firms and shareholder advocacy groups to change their voting policies on pre-emptive rights.

These groups must understand that the sophistication and efficiency of the public markets protect shareholders more effectively than do pre-emptive rights. The U.S. provides a daily case study for how this market governance practice works. Simply, if a company management executes poor capital allocation decisions, either by earning an inadequate return on capital or by abusing access to the public market, their cost of capital will increase and they will be shut out of the capital markets. Paradoxically, a rights offering removes the ability of the public market to “vote” on whether a company is earning returns in excess of its cost of capital. Here, because the rights discount forces an investor to put up more capital, management is no longer held accountable by virtue of the company’s access to capital.

Recognizing that pre-emptive rights can be waived through a shareholder vote, shareholders should 1) begin voting in favor of waiver proposals that allow meaningful share issuances free from pre-emptive rights, 2) begin asking managements to propose issuances without pre-emptive rights at their annual general meetings, and 3) propose for annual general meetings, as large individual shareholders or as groups, resolutions to permit issuances without pre-emptive rights. Although some shareholders might want to take these waivers on a case-by-case basis, we submit that if a shareholder does not have faith in a management team, then they should be lobbying for change in directors and/or management, or should reconsider owning the stock.

Our research revealed that market participants have major misconceptions about this topic. It is not well understood that shareholders can waive pre-emptive rights. Most believe it cannot be done and simply accept the impairment to shareholder value that pre-emptive rights impose. In Exhibit 5, we summarize the path to enhancing shareholder value for some major countries in Europe.

One other factor must be addressed, as it relates to speed to market. Generally issuances above 10% of shares outstanding require a prospectus in order for shares to be exchange traded. Therefore, companies must be prepared organizationally, which will include additional legal expenses, to have prospectuses at-the-ready. Prospectuses can be processed with regulators confidentially to avoid any overhang on the market. Regulators, too, should take a cue from the U.S. and liberalize the prospectus registration process to be more like that of the U.S. shelf-registration system, which allows real-time share issuance.

Companies should educate their shareholders, the advocacy groups and proxy voting firms that the real estate business is a special case and that issuing equity without pre-emptive rights can benefit shareholder value. Relevant constituents include: German Stock Corporation; Eumedion and VEB in Netherlands; ISS; and ABI, NAPF, Pre-Emption Group and Investment Management Association in the U.K.

EXHIBIT 5. SUMMARY OF WAIVER REQUIREMENTS FOR PRE-EMPTIVE RIGHTS

France	<ul style="list-style-type: none">• Shareholders representing 1% of companies with par capital over €15 million (2% above €7.5 million, 3% above €4.5 million) may propose a resolution at shareholder meeting.• With a two-thirds majority vote, pre-emptive rights may be waived without limit if the issuance price to the buyer is at a discount of less than 5% to the average three-day price (excludes underwriter discount).• With a two-thirds majority vote, pre-emptive rights may be waived for issuance of up to 10% at discount greater than 5%.
Germany	<ul style="list-style-type: none">• Shareholders, as a group, representing 5% may place resolution on an annual general meeting agenda.• Pre-emptive rights may be disapplied (waived) by a vote of 75% of votes present (not outstanding) for a regular capital increase of up to 10%—or in any amount—for a special reason. Up to a 50% increase from authorized capital for up to five years can be granted with a 75% vote.• Special reasons include: The company needs to issue capital quickly and can only be done on a pre-emptive basis; the company wishes to bring on new strategic shareholders to bring benefits to company or expand into a new business area.
Netherlands	<ul style="list-style-type: none">• Shareholders representing 1% of shares or €50 million may place resolution on an annual general meeting agenda.• Pre-emptive rights may be waived for five years with a simple majority vote.
United Kingdom	<ul style="list-style-type: none">• Shareholders representing 5% may place a resolution on an annual general meeting agenda.• With 75% vote of those voting, pre-emptive rights may be waived for up to five years.

Source: Cohen & Steers.

Conclusion

We believe pre-emptive rights have been a contributing factor in creating rather than relieving leverage in the corporate sector and financial system in Europe. Without the execution hurdles of rights offerings, companies across many industry groups likely would run more equity-rich balance sheets. With respect to property, we believe the public market is a solution to help de-lever the private property sector. This is happening in the U.S. in a significant way, but in order for it to take place in Europe, real estate companies must gain better access to the public market, at a cheaper cost, without pre-emptive rights. This is particularly important for REITs, which operate extremely capital-intensive businesses, yet must pay out their operating earnings in the form of dividends.

In our view, a notable development that illustrates the need for changing the way companies access equity occurred in late 2010, when Belgium reduced to three days the offering period for a rights offering. This allows more flexibility to simultaneously execute a broadly marketed equity offering to access greater amounts of capital with more efficient pricing. While not the ideal path, we believe Belgium took a small step in what will be a significant movement to open access to equity markets in Europe.

The views and opinions in the preceding article are as of the date of publication and are subject to change. This material represents an assessment of the market environment at a specific point in time, should not be relied upon as investment advice, is not intended to predict or depict performance of any investment and does not constitute a recommendation or an offer for a particular security. We consider the information in the article to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment.

There is no assurance that any historical trend illustrated in this article will be repeated in the future or any way to know in advance when such a trend might begin. There is no guarantee that any market forecast set forth in this article will be realized.

Risks of investing in real estate securities: Investing in real estate securities are similar to those associated with direct investments in real estate, including falling property values due to increasing vacancies, declining rents resulting from economic, legal, tax, political or technical developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. No representation or warranty is made as to the efficacy of any particular strategy or fund or the actual returns that may be achieved.

Cohen & Steers Capital Management, Inc. (Cohen & Steers) is a registered investment advisory firm that provides investment management services to corporate retirement, public and union retirement plans, endowments, foundations and mutual funds.

This article must be accompanied by the most recent applicable quarterly Cohen & Steers mutual fund fact sheet(s) if used in connection with the sale of mutual fund shares.

Cohen & Steers open-end funds are distributed by Cohen & Steers Securities, LLC.

About Cohen & Steers

Cohen & Steers is a manager of portfolios specializing in U.S. and international real estate securities, large cap value stocks, listed infrastructure and utilities, and preferred securities. The company also manages alternative investment strategies such as hedged real estate securities portfolios and private real estate multimanager strategies for qualified investors. Headquartered in New York City, with offices in London, Brussels, Hong Kong and Seattle, Cohen & Steers serves individual and institutional investors through a broad range of investment vehicles.

Copyright © 2011 Cohen & Steers, Inc. All rights reserved.

COHEN & STEERS

Corporate Headquarters

280 Park Avenue, 10th Floor
New York, New York 10017
212.832.3232 phone
212.832.3622 fax
cohenandsteers.com

Offices:

166 Chaussée de la Hulpe
1170 Brussels
Belgium
+32.2.679.0660 phone

21 Sackville Street, 4th Floor
London W1S 3DN
United Kingdom
+44.207.460.6350 phone

1202, Citibank Tower
Citibank Plaza
3 Garden Road, Central
Hong Kong
+852.3667.0080 phone

1201 Third Avenue, Suite 3810
Seattle, Washington 98101
206.788.4240 phone

For information, call us at:
800.330.7348

Come visit us online at:
cohenandsteers.com