

# Portfolio premium — Is the Sum Worth More than the Parts?

*Portfolio transactions constitute an increasingly large proportion of total transaction volume on the property market. Historically, portfolios have been valued at a discount, but a new phenomenon has now emerged: investors are paying a premium to buy large property portfolios. What is the rationale behind this premium? Will it last?*

*The transaction size is increasing.*

Over the past few years, the average size of property transactions in Sweden has risen successively from around SEK 170 million in 2000 to approximately SEK 330 million this year to date. This remarkable increase may to a large extent be explained by the rising demand for large property portfolios as well as the opportunity to obtain a high sales price.

*Average transaction size, 2000–2006*



\* January to May. The size of the average property transaction in Sweden has propelled over the past few years. The median size of transactions has, in fact, increased nearly fivefold since 2003.

# Rationale behind portfolio discount and premium

## Base case: portfolio discount is the normal situation

Historically, property portfolios have been valued at a discount on the property market. The basic rationale for valuing a portfolio at a discount is the fact that the investor does not select the composition of the portfolio. A given investor is unlikely to be prepared to pay the highest price for each individual property in a portfolio. Instead, the aggregate value would be maximised if each single property were purchased individually by the investor who is prepared to pay most for that particular property.

Historically, one viable business strategy — notably among opportunistic property funds — has been to acquire major property portfolios, or listed property companies, at a discount and thereafter divest the parts separately to the buyers who pay most for each part respectively.

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*The parts were worth more...*

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## Current situation: portfolio premium

In the current market, in contrast to the normal case, a premium is paid for property portfolios. Leimdörfer estimates the size of the premium to be between 5 and 15 per cent. A premium is also paid for blended portfolios comprising various types of property classes in more than one country.

Since our base case is that a portfolio discount is the normal situation, the remainder of this section will deal with possible reasons for today's situation, i.e. the rationale for a portfolio premium.

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*...but now the sum is worth most.*

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## High demand for property portfolios

The basic argument for the current portfolio premium is, of course, the fact that demand for portfolios is high while supply is limited. The rise in demand for portfolios, in turn, can be derived from a number of underlying factors.

Rationale for portfolio premium
High demand for portfolios
- Attractive total return on property
- Expectations of rising property prices
- Portfolio risk assessed differently from individual property risk
- More attractive financing terms

## Attractive total return on property

In relation to other asset classes, property valuation appears to have been low for a long time. From a historical perspective, interest rates have been very low and, since property yields have lagged behind the fall, property has become a relatively high-yielding asset (see Article 1:2005).

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*An attractive total return on property generates demand for large portfolios.*

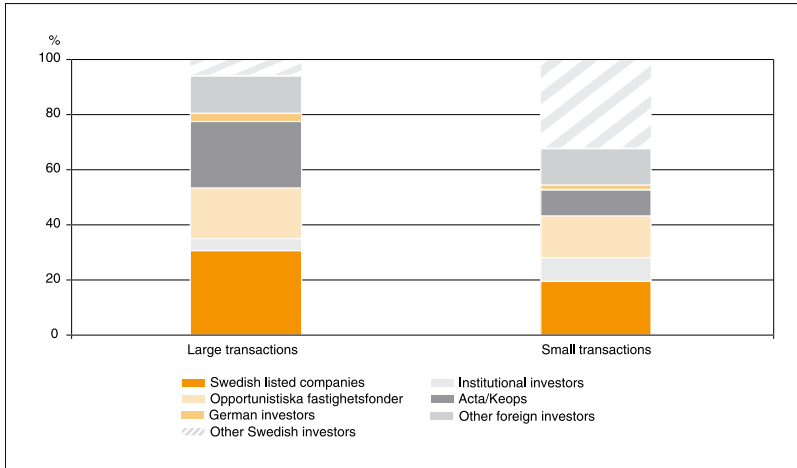
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The low valuation of property as an asset class has boosted interest among investors. This, as such, should not result in a portfolio premium as long as demand rises at the same pace for single properties and portfolios. For various reasons, however, the attractive total return on property gives most investor categories incentives to focus on acquiring property portfolios:

- *'Fee-driven' investors.* Investors who charge fees for offering institutions and/or private individuals the opportunity to indirectly invest in properties have incentives to acquire large volumes. At present, such investors are highly active on the property market. The fact that property offers an attractive total return is the basis for the fees that these parties can charge and still offer end investors an attractive product.
- *Property funds.* A large number of property funds have managed to attract substantial capital from investors. For these funds, with limited operational resources, it is rational to focus on large transactions.
- *Institutional investors.* Most institutional investors currently strive to increase their property exposure since, compared with other asset classes, property offers an attractive risk-adjusted total return. In order to rapidly attain the desired degree of property exposure, institutional investors must acquire large volumes.
- *Listed property companies.* The listed property companies have also increased their acquisition activity in the past few years due to a favourable valuation on the stock market. When properties are valued higher on the stock market than on the property market, listed companies have incentives to acquire large volumes.

International investors are well represented in all investor categories above. In the past few years, the proportion of international investors on the Swedish property market has increased considerably. This is largely due to the fact that prices on the Swedish property market, from an international perspective, are relatively low. International investors are primarily interested in larger transactions since, in general, they have substantial capital to invest.

*Investor categories for large and small property transactions respectively, 2005*



A portfolio premium can be partially explained by the fact that the investor categories are different for large transactions (SEK 1 billion or more) and small transactions (less than SEK 1 billion).

### Expectations of rising property prices

One reason explaining why many investors demand large portfolios is that they believe that property prices will rise. Expectations of rising property prices generate a demand for large portfolios, in particular, since it is rational for investors with such expectations to rapidly acquire large volumes. In the past few years, investors who have acquired ‘expensive’ portfolios have profited from rising property prices.

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*‘Expensive’ portfolio acquisitions have been profitable in a bullish market.*

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### Portfolio risk assessed differently from individual property risk

Another argument for valuing portfolios at a premium could be that a portfolio offers a higher degree of diversification, which means that the investor can require a lower return and pay a higher price. However, for an investor with an already diversified portfolio there is no reason to require a lower return on an add-on acquisition. This investor should not pay less for a single property merely because it does not offer any risk diversification. In other words, buyers who already are well diversified should be the most competitive and, consequently, individual properties should be valued as if they were part of a portfolio. One way of illustrating this argument is to compare properties with publicly traded shares. A stock portfolio carries a lower risk than individual shareholdings, but this does not result in any premium on stock portfolios.

Another closely related reason why a portfolio premium may be justified is that when acquiring single properties, investors have a tendency to pay more attention to specific risks in the properties concerned. Investors focus on the worst-case scenarios for these properties. When acquiring portfolios, on the other hand, investors tend to carry out a more statistical analysis of the risks and take into account the fact that the worst is highly unlikely to come to the worst across all properties. As long as the risks are specific (idiosyncratic risk) and do not co-vary with the market (market risk), the statistical approach is more correct for portfolios and individual properties alike. If investors, when acquiring single properties, demand higher compensation for the specific risks these properties carry, the result is a discount on single properties rather than a premium on portfolios.

### More attractive financing terms

Another argument for a portfolio premium is the opportunity to obtain attractive financing.

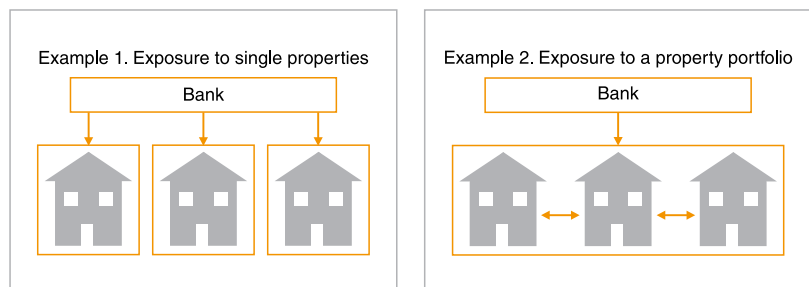
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*Banks offer more attractive terms for large transactions.*

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For a bank, it is rational, for reasons of profitability, to focus primarily on large transactions. In a major transaction, the bank devotes more time to analyse the properties and their risks, which enables a higher degree of financial leverage. Since more banks look at large transactions, competition among debt providers is also stiffer and more favourable terms are attainable.

Another reason why a higher degree of financial leverage and lower margin are attainable in the financing of portfolios is connected with the division of risk between investors and banks. Assume, for the sake of simplicity, that the party acquiring properties or property portfolios does not provide its balance sheet as collateral, and that the bank has security only in the property or portfolio that is being acquired (so called non-recourse financing). In *Example 1* in the figure below, an investor acquires three single properties on a stand-alone basis. The financing of each property is non-recourse. In *Example 2*, the investor acquires the same three properties but in the form of a portfolio.



In a portfolio, losses from one property can be covered by the cash flow or profits from another.

In financing the portfolio, the bank obtains collateral in all three properties. By doing so, the bank assumes a smaller risk in *Example 2* than in *Example 1*, since losses from one property can be covered by the cash flow from another. Correspondingly, the investor takes a higher risk in *Example 2*, since the risk in each individual property is not isolated from the others. In view of this higher risk, the investor should require a higher return from the investment. If investors do not increase their return requirements, the result will be that they pay a portfolio premium, since they benefit from the improved financing terms but do not require compensation for the increased risk.

## What is the right price?

Is there a premium on property portfolios or is it rather a discount on single properties? One way of answering this question is to analyse which of these markets is more efficient, and thereby obtain a more accurate valuation. One argument for the market for portfolios being more efficient is that turnover on this market is very large. Like publicly traded shares, the quality of price information is proportionate to turnover in the market.

Another argument that indicates greater efficiency in the market for large portfolios is that large portfolio transactions are carried out by professional players, usually with advisors on both the acquiring and the divesting side. Many individual properties, on the other hand, are acquired or divested by parties with limited transaction experience. Large investors have a better overview of the global property and capital markets and can thereby act faster if an asset, such as property in Sweden, is incorrectly priced in relation to other assets.

Even if the market for large transactions is more efficient and its pricing more accurate this does not imply neither a discount nor a premium. Whether or not prices should be higher or lower on an efficient market is impossible to say. However, in an efficient market the price carries more information and is, in this sense, more correct. For example, it may be that the more efficient market is a leading indicator for the less efficient market. This would mean that we have a portfolio premium in a bull market and a portfolio discount in a bear market, in the same way as listed property shares are a leading indicator for the property market (*see Article 1:2005*).

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*Portfolio prices – a leading indicator?*

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*The premium should disappear in the long term.*

## The future

Can we expect today's portfolio premium to last? In a well-functioning market, no arbitrage opportunities can persist in the long term since investors exploit them. Thus, if sufficiently many investors choose to acquire single properties and divest portfolios, the portfolio premium should disappear. The table below shows that several factors suggest that the present-day high valuation of property portfolios will not last. Hence, Leimdörfer's forecast is that the premium on portfolios should decrease in the long term and possibly translate into a discount.

*Arguments for premium and discount on property portfolios now and in the future*

	Current situation	In the long term
<b>Rationale for discount</b>		
Investors do not choose the composition of the portfolio themselves.	●	●
<b>Rationale for premium</b>		
High demand for portfolios		
- Attractive total return on property	●	
- Property prices are expected to rise	●	
- Portfolio risk assessed differently from individual property risk	●	(●)
- More attractive financing terms	●	●

*Buy individual properties...*

*...and sell portfolios.*

## How should investors act?

Regardless of whether there is currently a premium on portfolios or a discount on single properties, there appears to be an essential difference in pricing between these two markets. This price differential should have an impact on investment decisions. In prevailing market conditions, it appears advantageous for a buyer to acquire individual properties. For a seller, on the other hand, divesting property portfolios seems to be advantageous. By acquiring single properties and putting together an attractive portfolio, an investor can add value and also be paid for doing so, in the form of a portfolio premium.