FINANCIAL TIMES FRIDAY FEBRUARY 9 2001

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# A debatable question of value

Companies are rethinking their approach when it comes to finding a benchmark by which to measure share performance

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Do property companies need a valuation methodology all of their own, or are they best understood when analysed by the methods used for other corporates?

The answer to this question has been debated in just about every property market in the US and western Europe, and analysts and investors have yet to agree an answer.

Within Europe, and among some analysts in the US, net asset values (NAV) per share remain the standard benchmark against which share price performance is measured generally.

No other industry uses this standard, leaving real estate securities isolated from other equities analysis.

However, research on European property stocks, unveiled this week by analysts at Goldman Sachs, throws its weight behind an analytical method more closely akin to that used for, say, telecommunications providers, than the traditional European approach to property valuations.

In its pan-European property shares analysis, only two of 20 stocks are added to Goldman Sachs' Recommended List – Canary Wharf Group and Unibail – and neither for their forecasted NAV growth.

"In our view, cash-oriented companies focus on the right indicators in making their decisions and thus their chances of success are much higher than those who focus on NAV," the analysts note.

Focusing on NAV, they say, does not reveal the need to improve efficiency or business methods, nor does it reveal cost inefficiencies. Managements take credit when NAV rises and blame the market when it falls, Goldman Sachs says.

"The base principle of our valuation method is simple," the analysts say.

"Companies which generate positive EVA – (Economic Value Added as defined by the econometric research firm Stern Stewart) – deserve to be valued at a premium to their Net Asset Value, companies which generate negative EVA (value destruction) deserve to be valued at a discount to their NAV."

EVA is broadly defined as returns on capital employed (ROCE), which are greater than the cost of capital, a method as suitable to understanding retailers as it is to understanding utilities, petrochemical suppliers or nearly any other sector.

EVA-based models are gaining currency among UK property securities analysts. Last year, analysts at Credit Suisse First Boston constructed a not-too-dissimilar model based on "economic rents" – a concept that takes into account the rate at which returns to shareholders exceed capital costs.

Analysts at Charterhouse Securities have also constructed EVA models for the UK market, as have analysts at JP Morgan for the European market.

Traditionally, analysts of real estate securities have made buy and sell recommendations to clients based on the size of the discount to NAV at which a stock was trading relative to its peer group. A stock with strong prospects was one which showed scope for NAV growth and which could combine that with relatively cheap finance.

But with a growing number of analysts abandoning the NAV-focused approach, companies are being forced to rethink conventional strategies.

Perhaps the most dramatic example of this strategic shift is demonstrated by the UK's largest property company, Land Securities, whose focus is moving from assets to occupiers. Goldman Sachs rates the company a Market Performer, but gives credit to its management for creative thinking, which is still in its early stages.

Goldman Sachs also gives high marks to Castellum, the Swedish office and industrial investor whose shares are rated Market Outperformer because of its focus on cash returns with clear hurdle rates for investments and disposals.

Goldman Sachs defines ROCE as a company's forecast net operating profits divided by capital employed, or the market value of its real estate assets plus its debt marked to market.

Significantly, the Goldman Sachs model, unlike that of, say, CSFB or Charterhouse, abandons attempts to assign a price tag to companies' equity capital. "When you get into cost of equity, that's where everything breaks up," says Jeppe de Boer, the Goldman Sachs analyst responsible for the report.

Academic debate about how to calculate the cost of equity capital, along with the volatility and limited liquidity of the real estate sector, discourages analysts from taking it into consideration, he says.

Instead, Goldman Sachs has devised the concept of Market Implied Cost of Capital (MICC), which tracks the trend line of ROCE of companies in its real estate universe against the discount to NAV at which their shares are trading. Where the shares trade at a 0% discount – currently an ROCE of 7.48 per cent – is what the market says is the cost of capital.

The Goldman Sachs model, in calculating ROCE, takes account of tax rates often stripped out from other models.

Only tax efficient companies can justify traditional property investment strategies, Mr de Boer says.

Taxpayers, he adds, must be unconventional.

Mr de Boer says that when the forecasted ROCEs for the 20 companies in his universe are backtested from the end of 1996 and plotted on a graph against the current discount or premium to NAV at which the shares are trading, the forecasting model is surprisingly accurate.

The characteristics isolated by the Goldman Sachs model, he says, account for 81 per cent of the share price performance of the 20 European property companies in its universe.

Mr de Boer says the stock markets are efficient at pricing real estate shares.

Nine of the companies are trading at discounts within 10 percentage points of where they should be, while three are overvalued.

**Upside down: how the forecasts compare**

**Over 10% upside**

| Company | 1996 price (pence) Year end | Target | Total return (%) Upside/downside forecast | Actual* |
|---|---|---|---|---|
| Klepierre | 52.9 | 89.6 | 69 | 147.30 |
| Metrovacesa | 12.4 | 18.2 | 47 | 47.14 |
| Unibail | 78.7 | 175.7 | 123 | 192.31 |
| VIB | 21.1 | 27.3 | 30 | 76.26 |
| Slough | 278.5 | 334.8 | 20 | 76.56 |
| IVG | 8.6 | 9.5 | 11 | 70.10 |
| Average | – | – | – | 101.61 |

**Over 10% downside**

| Company | 1996 price (pence) Year end | Target | Total return (%) Upside/downside forecast | Actual* |
|---|---|---|---|---|
| Confinimmo | 89.2 | 78.4 | -12 | 24.95 |
| British Land | 524.0 | 380.5 | -27 | 0.78 |
| Hammerson | 402.5 | 251.4 | -38 | 40.40 |
| Land Securities | 773.0 | 651.9 | -16 | 38.64 |
| VastNed Retail | 48.6 | 35.0 | -28 | 16.27 |
| Average | – | – | – | 24.21 |
| **Overall average** | – | – | – | 61.45 |

*Source: Goldman Sachs Research estimates*

* Year end 1996 to date