## Box 2
### Listed commercial real estate companies and real estate investment trusts: trends and implications for financial stability

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**Assessing the dynamics of the euro area commercial real estate (CRE) sector[12] during the current cyclical upturn remains important for identifying potential financial stability risks.** The downturn in CRE markets played a significant role in the last financial crisis in many countries and contributed to the increase in the non-performing exposures of the banking sector. As part of this assessment, this box analyses the growing importance of listed CRE companies, and a sub-set thereof known as real estate investment trusts (REITs), in the euro area.

**Over the last decade, the assets of listed CRE companies have grown rapidly in many euro area countries (see Chart A** – left panel**).** Since 2009 the size of these companies has doubled

12 Commercial real estate refers to already developed income-producing real estate and includes office, retail, logistics and multi-dwelling residential property.

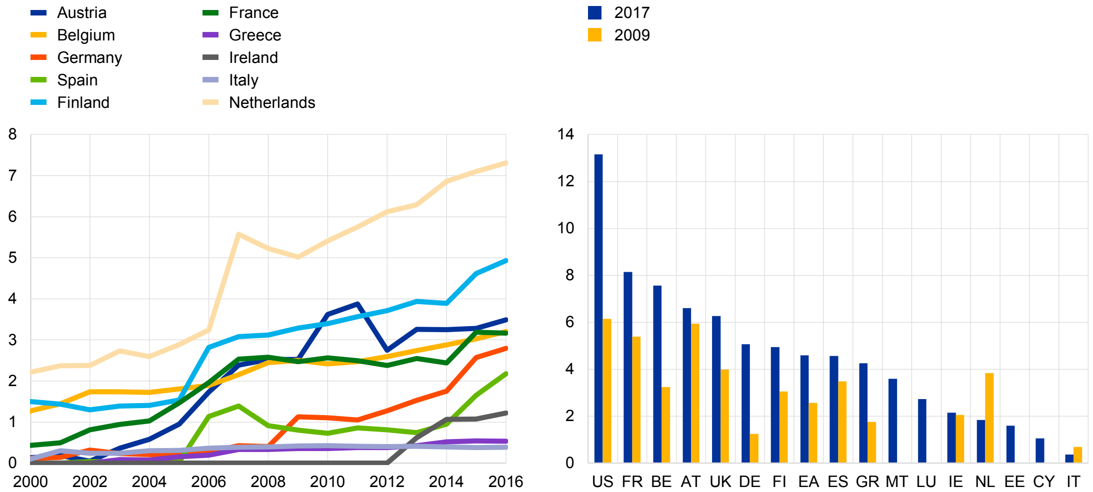
relative to the underlying commercial property sector in the euro area, although they remain small relative to their counterparts in the United States and the United Kingdom (see **Chart A** – right panel). In most euro area countries where listed CRE companies are relatively large vis-à-vis the size of the underlying CRE market REITs are the dominant form (e.g. in the Netherlands, France, Belgium, Spain and Ireland).[13] The main exceptions are Germany and Austria, in which the largest listed CRE companies are not REITs.

### Chart A

Both the assets of listed CRE companies and their weight relative to domestic CRE markets have grown markedly in many euro area countries since 2009

**Relative size of listed CRE companies**

(left panel: 2000-16; euro area FTSE EPRA/NAREIT index company assets as percent of GDP; right panel: 2009 and 2017; market capitalization of listed CRE companies as percent of total CRE assets)




Sources: Bloomberg company data for FTSE EPRA/NAREIT index companies, EPRA Total Markets Table and ECB calculations
Note: The drop for NL in the right-panel chart is due to the reclassification in the EPRA Total Markets Table of a large REIT as French after a merger. The same large company has, however, continued to be classified as Dutch in the FTSE EPRA/NAREIT index.

**Listed CRE companies usually derive most of their corporate revenue from the rental income that they earn on a portfolio of real estate property that they own.** They have two distinctive features that render them attractive to investors. First, in the case of REITs, companies can either minimise or completely avoid paying corporate income tax by distributing most of their income as dividends, so that only the shareholders are taxed on their dividend income or capital gains. This allows REITs to offer higher dividend yields than other company stocks, whose issuers must pay taxes at the corporate level before distributing any dividends. Second, listed CRE companies, including REITs, are listed on a stock exchange, thereby offering investors exposure in a liquid and transparent way to a relatively illiquid underlying asset like commercial real estate.

**Foreign investors are by far the most important source of both equity and debt funding for listed CRE companies in euro area countries** (**see Chart B** – left panel). US asset management companies are the largest single source of equity inflows into listed euro area CRE companies, although other euro area countries still account for around 40% of foreign holdings of equity (see

[13] "Dominant" means that in a specific country most of the companies included in the benchmark FTSE EPRA/NAREIT index are REITs. In the mid-1990s REIT regimes only existed in two euro area countries (Belgium and the Netherlands) and they began to expand across more countries only after 2007. Currently, specific national REIT legislation exists in ten euro area countries.

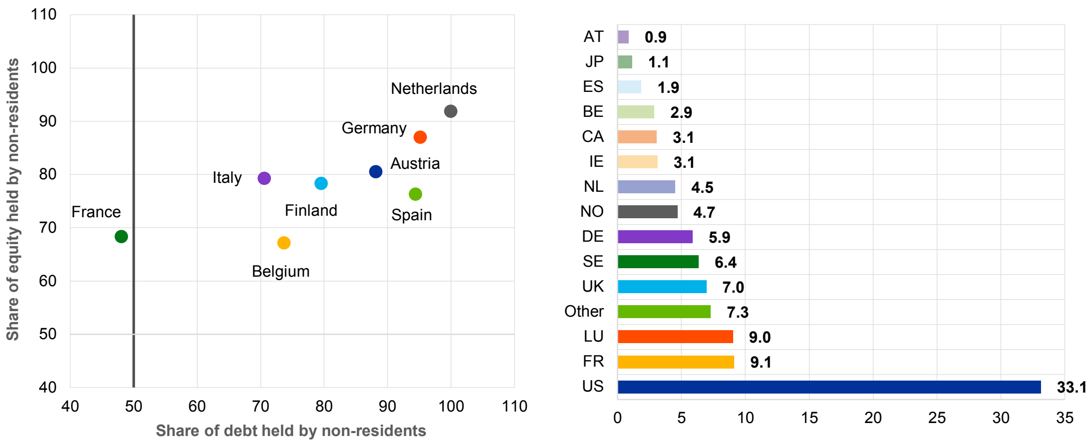
**Chart B** – right panel). In the current low global interest rate environment, foreign investors are attracted by the relatively high risk-adjusted returns offered by CRE company shares, through which they can also achieve a liquid exposure to a growing CRE sector.

**Chart B**

Foreign investors hold most of the equity and debt issued by listed euro area CRE companies, with US and French investors holding the largest equity stakes

**Share of debt and equity in listed euro area CRE companies held by non-domestic investors (left panel) and foreign holdings of equity in listed euro area CRE companies by country of holder (right panel)**

(2016; percentages)




Sources: Bloomberg, SHS, FTSE Russell and ECB calculations

Notes: Left panel: "Non-domestic" refers to investors from both inside and outside the euro area. Foreign holdings as a percentage of debt and equity issued by companies listed in the FTSE – EPRA NAREIT Europe Index and included in Securities Holdings Statistics (SHS). Right panel: Calculations are based on the weighted average of aggregate total assets in the euro area. Domestic holdings represent total holdings held by investors from the same country and foreign holdings represent total holdings held by investors from foreign countries (including in the euro area).

**In general, the funding structure of listed CRE companies and the dominant role of foreign funding sources could be seen as tempering any concerns about euro area financial stability.** First, there is no significant direct exposure of the banking system to this sector, as it is mostly funded by institutional investors and funds managed by global asset managers. Second, the main source of funding for the sector is equity, which reduces the risks typically associated with leveraged investment structures, such as debt rollover risk. In fact, listed CRE companies operate with relatively low leverage, and the average debt-to-assets ratio of these companies in the euro area is fairly stable at around 37%. Third, the geographical diversification of the holdings of equity and debt securities issued by CRE companies allows risk sharing in the event of the materialisation of losses, as they are spread across numerous euro area jurisdictions and among investors outside the euro area, rather than being concentrated in the home jurisdiction of the company.

**Foreign capital flows into listed CRE companies may, however, be susceptible to a sudden stop or reversal of search-for-yield flows should global financial conditions change.** The growth of investment transactions and prices in the most dynamic CRE markets currently appears to be influenced by increased commercial property purchases by these listed CRE companies. In this context, a sudden stop in the funding inflows into these companies could lead to disorderly price adjustments in commercial property markets themselves. Accordingly, looking ahead, monitoring the influence of developments in listed CRE companies and their potential impact on the dynamics of euro area CRE markets will remain an important part of the overall assessment of financial stability risks in the euro area.