Executive Summary

Property Investments and Property Development

Spills or Synergies?

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This paper shows the impact property development participations have had on the performance and risk of 331 property funds from five international markets during the nineties. This way we hope to contribute to the ongoing debate among real estate professionals who disagree on this matter. Some claim that participations in development projects are vital to get access to the most attractive investments opportunities and locations. Others, however, claim that property investment and property development are two worlds apart that each requires certain expertise and that the combination of both in one company will lead to inefficiencies. In each market of our study, the United States, Hong Kong, Australia, the United Kingdom and France we document that property development activities were mainly undertaken by companies with a market capitalization that exceeds the average. This could be due to the fact that property development activities require a critical mass in order to generate sufficient spin-offs. A second cross-sectional pattern we found in our national samples was the relatively strong reliance on debt financing that was present among developing companies. Listed property companies that were involved in development projects were associated with debt-levels that were higher than the national average for each market. Moreover we noted that development participations are mainly undertaken by property companies that focus on retail property, and significantly less by companies that focus on residential or industrial properties.

Besides these cross-sectional similarities we also documented differences in the development activities between the different national markets. Development participations were the most intense in our Hong Kong sample and the lowest in our French sample. These differences are partly due to differences in legislation that prohibit property companies from investing too much in relatively risky property development projects. These regulations are more strict in the United States and European markets than in the Hong Kong market. Besides differences in regulation we also documented significant differences in the size of the property development markets in our sample. In Hong Kong property development really seems to form a necessity in order to get access to good investment opportunities, because of the limited supply of land and existing property. In other markets like Australia and the United States the property market is less tight, and therefore the need to develop is less apparent.

Concerning the performance we found in each market that property companies that were involved in development activities outperformed both the benchmark and their non-developing competitors. However, concerning the risks we found a similar relation. Especially the systematic risk of property companies increased proportionate with the size of the development activities. Combining these differences in return and risk by applying the Risk Adjustment Model (RAM) of Litt and Mei (1999) we derived ex-post required returns for each company in our sample. These efforts resulted in performances that were more alike across the different development activity cohorts. In each market the initial outperformance of the developing companies decreased towards more humble proportions. This result illustrates that most of the excess performance of the developing property companies was commensurate with the higher underlying risk. In order to filter the influence of the stock market sentiment that is present in total property stock returns, we also analyzed the underlying operational profits of the companies in our national samples. This analysis shows above average profits in strong markets and below average profits in soft markets for developing companies. This result strengthens our total return outcomes and illustrates the higher systematic risk that comes with development projects.

The combination of our results indicates that involvement in property development increases both the risk and return of a property company and thereby forms a mean to alter a company's risk-return characteristics rather than to improve them.