

# IMPACT OF AGENCY ISSUES ON AUSTRALIAN REIT PERFORMANCE

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## ABSTRACT

*The study seeks to investigate agency issues in the context of AREITs through consideration of price increases and price decreases relative to CEO motivation by self interest and Board independence, controlled for sector and geographic portfolio weighting. Data for price increases in the period July 2006 to December 2006 and price decreases in the period October 2007 to March 2008 for the forty largest AREITs by market capitalization on 30<sup>th</sup> May 2008 was correlated against data for sectoral and geographic portfolio composition, CEO shareholding and four proxy variables for Board independence. Only 40% of the hypothesized correlations were found to be supported, with none of the hypothesized correlations between price increase or price decrease and related party shareholdings or extent to which an AREIT may be considered a family business found to be supported.*

**Keywords:** REIT, board, performance, governance, management, control

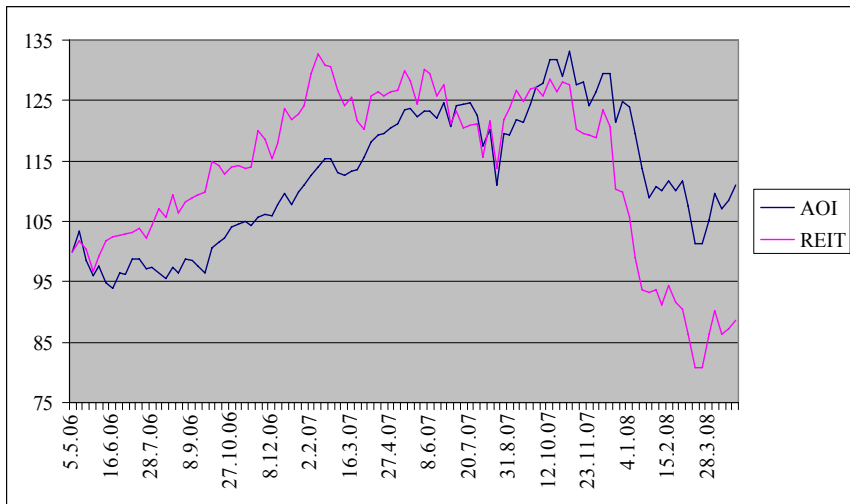
## INTRODUCTION

AREITs have grown significantly in Australia from a handful with a market capitalisation of around A\$7 billion in 1992 to 32 AREITs in the ASX 300 with a market capitalisation of over A\$124 billion in 2007 (UBS, 2007), before falling to a market capitalisation of \$78 billion by June 2008 (UBS, 2008).

AREITs now comprise the third largest sector on the Australian stock market and represent around 10% of the total Australian market capitalisation compared to 5% in 2000. The largest AREITs include Westfield (\$30.49 billion), Stockland (\$9.01 billion) and GPT (\$6.19 billion), with five having in excess of 100 properties in their portfolio (UBS, 2008).

However, the impact of the global financial crisis has been particularly significant for AREITs, as shown in Figure 1, reflecting the high levels of debt carried by AREITs and their extensive use of commercial mortgage backed securities for debt funding.

**Figure 1: AOI-AREIT relative performance**



Source: Author

In Australia, the AREIT internalized management model results in directors and managers being actively engaged in the management and operation of the AREIT and not statutorily precluded from so being. The typical AREIT model has a Board with a combination of independent and non-independent directors including a Chairman, together with a CEO who may or may not be a member of the Board. In rare cases, the COO and/or CFO may also be members of the Board. For the purposes of this research, members of management were excluded from analysis unless they were also members of the Board.

This separation of ownership and management in the AREIT business model may give rise to a range of agency issues. Fama (1980) considered fundamental aspects of agency issues arising from the separation of ownership and management that is typical of large corporations and the incentive problems that arise when decision making in a firm is the province of managers who are not security holders. Treating management and risk bearing as naturally separate factors within a set of contracts called a firm, the author noted the trend towards theories that reject the classical model of the firm but assume classical forms of economic behaviour on the part of agents within the firm. The firm is viewed as a set of contracts among factors of production, with each factor motivated by self interest. In effect, the firm is viewed as a team whose members act from self interest, but realize that their destinies depend to some extent on the survival of the team in its competition with other teams.

Fama and Jensen (1983) went on to argue that agency costs may be reduced by institutional arrangements that separate decision management from decision control, with an independent Board being the primary governance structure for oversight of management discretion and firm performance. Interestingly, in the context of Australian listed companies, Farrar (2001) suggests that the separation of ownership and control may not be as significant an issue for Australian companies as it is for large US and UK companies.

This study aims to investigate agency issues in the context of AREITs through consideration of CEO motivation by self interest and Board independence. CEO motivation by self interest may be proxied by considering the level of the CEO's shareholding in the given AREIT. Board independence may be proxied by the proportion of independent directors on an AREIT Board, the existence of an independent Chairman, the level of related party shareholdings and the extent to which an AREIT may be considered a family business.

Section 2 comprises a review of the literature concerning such agency issues leading to hypothesized relationships. Section 3 then summarises the data set and approach to analysis, with Section 4 outlining the results of analysis. Section 5 comprises the conclusions drawn from the analysis with the identification of areas for further research.

## **LITERATURE REVIEW**

McIntosh et al (1994) examined aspects of agency issues arising from the level of separation of ownership and management in US REITs. The authors investigated the relationship between REIT stock returns and top management changes, finding an inverse relationship between the probability of a management change and a REIT's recent stock price performance. The authors note that this is consistent with the internal monitoring of management activities by the Board, though raising questions about the strength of the underlying monitoring mechanism, as the relationships are strongest in the cases of extreme share performance and show long lags.

In a successor study, Sirmans et al (2006) analysed the relationship between management change and performance for a sample of US REITs in the period 1984 to 2002 and found a significant relationship between negative performance and a management change from a period of three months prior to the change in management. Interestingly, however, the authors found new management did not result in positive performance until two years after the management change.

Sirmans et al (2006) and Shakir (2008) also each considered Fama's (1980) discussion of the internal monitoring of management activities by the Board of directors, other top managers or large block shareholders. Shakir (2008) found a positive relationship between the number of non-independent or executive directors and performance for Malaysian

property companies, when measured by Tobin's Q, noting stronger performance from Boards with higher proportions of non-independent or executive directors. In the context of motivation by self interest, CEOs with shareholdings may be considered more likely to favour their own interests through driving unit price appreciation.

ASX (2003), in their best practice recommendations, favour the use of a majority of independent directors in Board composition. Bonn (2004) notes that independent directors are better placed to exert control over management self-interest and opportunism, being financially independent of management, not subject to the same potential conflicts of interest as non-independent directors and so more likely to support the interests of shareholders and to more effectively perform the monitor and control functions. Fama (1980) proposes that the inclusion of outside directors may lower the probability of top management colluding to expropriate shareholder wealth and may enhance the viability of the Board as a market induced mechanism for the low cost internal transfer of control.

Shakir (2008) found 35% of directors in a sample of Malaysian property companies analysed to be non-independent or executive directors, also citing a study of the top 100 Australian companies which found 23% of directors to be non-independent or executive directors. Consistently, Bonn (2004) found 76% of directors of a sample of 104 Australian listed companies analysed to be independent. For a sample of US REITs, Ghosh and Sirmans (2002) found performance was improved by a greater representation of external directors on a US REIT Board, a finding echoed for Australian listed companies by Bonn (2004). This is consistent with Feng et al (2005), who found a majority of outside directors to be an aspect of good governance that was associated with superior average REIT performance, though the effect was significant only for the 20% best and worst Boards. For US REITs, Friday and Sirmans (1998) found a positive impact of independent directors on shareholder wealth up to 50% of the Board, after which the market discounted the shares. In the context of monitoring management to ensure that they discharge their duties in the best interests of unitholders, a high proportion of independent directors may be considered preferable.

However, the authors did not continue to investigate the impact on performance of other agency issues such as the existence of an independent Chairman. ASX (2003), in their best practice recommendations, favour the adoption of an independent Chairman and the separation of the roles of Chairman and CEO for good corporate governance. Weeks et al (2007), in their preliminary findings, note a positive relationship between changes in REIT CEO salary and various factors including length of term in office, the simultaneous holding of CEO and Chairman titles and the percentage of stock ownership. Feng et al (2005) found a separation of the roles of CEO and Chairman to be an aspect of good governance that was associated with superior average REIT performance, though the effect was significant only for the 20% best and worst Boards. In the context of monitoring management to ensure that they discharge their duties in the best interests of unitholders, an independent Chairman may be considered preferable.

Interestingly, Shakir (2008) considered the issue of “grey” directors whose status as independent or non-independent is questionable, including family members, lawyers, investment bankers and former company officers. However, the author did not continue to investigate the impact of such “grey” issues as the extent to which a REIT may be considered a family business nor the level of independent or “grey” director shareholdings on REIT performance. Friday and Sirmans (1998) examined the relationship between shareholder wealth and director share ownership for US REITs, finding a positive relationship supporting an argument for the alignment of benefits. In the context of motivation by self interest, a high level of related party shareholding may be considered more likely to favour their own interests through driving asset price appreciation.

Weisbach (1988) found that firms with outsider dominated Boards are more likely to have a strong association between firm performance and management turnover. Warner, Watts and Wruck (1988) found an inverse relationship between firm performance and the rate of management turnover, though this relationship appeared to be weakened when the manager acquired power through family connections or stock ownership. Whilst an Australian study, but not for AREITs, Craswell et al (1997) found increasing levels of “insider” ownership by family founders, directors and executives to be positively related to performance. In the context of motivation by self interest, the incidence of family ownership may be considered more likely to favour their own interests through driving asset price appreciation.

Interestingly, concerning the impact of good governance on performance generally, Gold (2006) found a sample of ASX listed firms that did not meet good governance requirements but did exhibit superior investment returns and financial performance (measured by growth in underlying cash flow, normalized EPS and dividends) to the market overall. Notably, however, the study did not focus on AREITs.

With both price increases and price decreases to be considered in data analysis, the hypothesized correlations are challenging to specify:

- price increases: a positive hypothesized correlation indicates performance increasing as the quantum of the variable under analysis increases, with a negative hypothesized correlation indicating performance decreases as the quantum of the variable under analysis increases;
- price decreases: a positive hypothesized correlation indicates performance decreasing (ie: becoming more negative) as the quantum of the variable under analysis increases, with a negative hypothesized correlation indicating performance increases (ie: performance less negative) as the quantum of the variable under analysis increases.

Having regard to the findings of previous studies detailed above, the hypothesized relationships between AREIT performance and the proxies for CEO motivation by self interest and Board independence, respectively, are summarised in Table 1.

**Table 1: Hypothesis expectations**

<b>Agency Issues</b>	<b>Price Inc Hypo Corr</b>	<b>Price Dec Hypo Corr</b>
Level of CEO shareholding	Positive	Negative
Proportion of independent directors	Positive	Negative
Existence of an independent Chairman	Positive	Negative
Level of “grey” director shareholdings	Positive	Negative
Extent to which the AREIT may be considered a family business	Positive	Negative

Source: Author

## **DATA SET AND APPROACH TO ANALYSIS**

The data set comprised forty of the largest AREITs by market capitalisation listed on the ASX as at 30<sup>th</sup> May 2008 and represented approximately 96% of the total market capitalisation of all AREITs listed on the ASX. Those AREITs for which a continuous data series was not available or which did not disclose required information were deleted from the sample and replaced with the next largest AREIT.

Data for each variable was extracted from the most recent annual report for each AREIT. For the majority, the report was for the year ending June 2007 and for the minority, the year ending December 2007. Most variables, such as the proportion of independent directors and the existence of an independent Chairman, were absolute data.

Consistent with the approach of Shakir (2008), those directors with any form of connection to the AREIT, such as through a current or former executive role, family link or as a current or former service provider, were considered related or “grey”. Related parties were considered to include directors whose status as independent or non-independent is questionable, including family members, lawyers, investment bankers and former company officers. Related parties also included corporate representatives of a parent entity or of a major unitholder, with related party unitholdings including those with both human and corporate family links.

From the viewpoint of measuring the impact of agency issues, McIntosh et al (1994) and Sirmans et al (2006) note that, whilst the contribution of the Board and management of a REIT to its performance can be difficult to observe, stock return performance can be a source of information about management performance. Poor management performance may be implied by negative or declining stock returns on an absolute level or in relation to

the market. Further, effects on performance may arise from a range of Board or management variables including quantitative and qualitative variables.

As Figure 1 shows, movement for the AREIT index for the period from May 2006 to May 2008 is unusual in that it includes a period of significant price increase and a period of significant price decrease. Further, over that period, there were only minimal changes to the composition of the Boards and senior management of those AREITs comprising the sample. Accordingly, it is possible to observe if any of the variables under consideration have a greater impact in periods of price appreciation or depreciation.

Following the approach of Sirmans et al (2006), two periods of equal length were selected from the periods of price increase and price decrease and the closing price collated for each AREIT unit, on the trading day closest to the period start and end, from the Morningstar database. The appreciation period comprised 1<sup>st</sup> July 2006 to 31<sup>st</sup> December 2006 and the depreciation period comprised 1<sup>st</sup> October 2007 to 31<sup>st</sup> March 2008.

Performance was considered in terms of the absolute percentage increase/decrease in share price (price increased from \$10 to \$12, or 20%) between the beginning and end of each period, being a measure of capital return only. It is acknowledged that the use of price data disregards the impact of distributions on total returns and tax benefits on after tax returns. Price performance data was then correlated with each of the variables and the resulting correlations compared to those expected based on the hypotheses, above.

For control, the price increases and decreases were also analysed against sectoral and geographic portfolio composition. AREITs were characterized by sector as either exclusively owning office, retail or industrial property, owning a diversified portfolio or owning other property (such as leisure or retirement properties). AREITs were characterized geographically as either exclusively owning Australian property, exclusively owning overseas property or owning a global portfolio comprising Australian and overseas property.

## **RESULTS AND DISCUSSION**

Prior to reviewing the impact of agency issues, the impact of the control variables for sectoral and geographic portfolio diversification on price increase and price decrease may be considered.

**Table 2: Correlation matrix: price change and sector**

<b>Sector</b>	<b>Price Inc</b>	<b>Price Dec</b>
Office	-0.26	0.11
Retail	0.07	-0.34
Industrial	-0.11	0.15
Diversified	0.25	0.14
Other	-0.10	-0.04

Table 2 shows that during the price increase period, diversified AREIT prices trended upwards strongly whereas office AREIT prices trended downwards strongly. During the price decrease period, office, industrial and diversified AREIT prices trended downwards, whereas retail AREIT prices trended upwards strongly. Overall, the correlations between price increase, price decrease and sectors are generally low.

This finding is consistent with anecdotal evidence that, during the price increase period, the diversified AREITs achieved stronger price growth than the sector specific AREITs driven by the adoption of business models including funds management and development activities. Interestingly, during the price decrease period, sector specific retail AREITs achieved stronger price resilience which may be a reflection of increased negative sentiment towards office and industrial sector specific AREITs and diversified AREITs rather than positive sentiment towards sector specific retail AREITs.

**Table 3: Correlation matrix: price change and geography**

<b>Sector</b>	<b>Price Inc</b>	<b>Price Dec</b>
Australian	0.04	0.25
Overseas	-0.17	-0.30
Global	0.08	-0.03

Similarly, as Table 3 shows, the overall correlations between price increase, price decrease and geography are generally low, indicating that geography contributed relatively little to price increase or decrease. During the price increase period, exclusively Australian portfolio and mixed Australian/overseas portfolio AREIT prices trended upwards strongly whereas exclusively overseas portfolio AREIT prices trended less strongly. During the price decrease period, exclusively Australian portfolio AREIT prices trended downwards less strongly whereas exclusively overseas portfolio AREIT prices trended downward strongly.

Having established that, in most cases, sector and geography contribute relatively little to explaining price increase and price decrease, the variables for the impact of agency issues may be considered, with the summary statistics detailed in Table 4.



**Table 4: Descriptive statistics**

	<b>CEO</b>	<b>Ind Dirs</b>	<b>Ind Chmn</b>	<b>Rel Sh</b>	<b>Family</b>
Mean	1.75%*	59.18%*	60.00%*	10.79%*	0.80
Minimum	0.00%	22.22%	0.00%	0.00%	0.00
Maximum	16.64%	87.50%	100.0%	55.03%	1.00
Std Devn	4.02%	15.66%	49.61%	13.43%	0.41
R <sup>2</sup> Price Increase	0.37	0.23	0.25	-0.07	-0.26
R <sup>2</sup> Price Decrease	0.07	-0.02	0.00	0.27	0.19

\* significant at the 5% level

It is notable that the correlations in Table 4 are generally low, indicating that agency issues contributed relatively little to price increases and price decreases. In broad terms and subject to further research, the contributions of agency issues to price movements appear to be not dissimilar to that of sector and geography over the periods considered.

The results of the data analysis indicate that:

- the level of CEO shareholding was generally low;
- the proportion of independent directors was generally high, but below that found by Shakir (2008) for Malaysian property companies and that found by Bonn (2004) for Australian listed companies;
- the proportion of Boards with an independent Chairman was high;
- the level of “grey” director shareholdings was generally low; and
- a very high 80% of AREITs are family businesses of some kind (either human or corporate) which effectively dominates the sector.

**Table 5: Hypothesis findings vs expectations**

<b>Agency Issues</b>	<b>Price Inc Hypo Corr</b>	<b>Price Dec Hypo Corr</b>
Level of CEO shareholding	√	X
Proportion of independent directors	√	√
Existence of an independent Chairman	√	X
Level of “grey” director shareholdings	X	X
Extent to which the AREIT may be considered a family business	X	X

As shown in Table 5, only 40% of the hypothesized correlations between agency issues and price increase or decrease were found to be supported, including both hypotheses for the proportion of independent directors.

While the price decrease hypothesis for the level of CEO shareholding and existence of an independent Chairman were not supported, the correlations were very low at 0.07 and 0.00, respectively. Interestingly, none of the hypothesized correlations for level of “grey” director shareholdings and extent to which an AREIT may be considered a family business were found to be supported. It would appear that a high level of “grey” director shareholdings decelerates price increases but has the opposite effect on price decreases, acting as an accelerator of price decreases. Though apparently contrary to the findings of Friday and Sirmans (1998), it should be noted that the correlation between the level of “grey” director shareholdings and price increase was very low at -0.07. It would also appear that being a family business decelerates price increases but has the opposite effect on price decreases, acting as an accelerator of price decreases. Significantly, this is contrary to the findings of Craswell et al (1997) which also considered Australian corporates.

## **CONCLUSIONS AND AREAS FOR FURTHER RESEARCH**

The study sought to investigate agency issues in the context of AREITs through consideration of price increases and decreases relative to CEO motivation by self interest, proxied by the level of CEO shareholding in an AREIT, and Board independence, proxied by the proportion of independent directors on an AREIT Board, the existence of an independent Chairman, the level of related party shareholdings and the extent to which an AREIT may be considered a family business, controlled for sector and geographic portfolio weighting.

Data for price increases in the period July 2006 to December 2006 and price decreases in the period October 2007 to March 2008 for the forty largest AREITs by ASX market capitalization on 30<sup>th</sup> May 2008 was collected and analysed against data collected for sectoral and geographic portfolio composition, CEO shareholding and each of the proxies for Board independence.

Overall, the level of correlation between sectoral portfolio composition, geographic portfolio composition, agency issues and price increases or price decreases was low. This would suggest that other influences may be more significant on price increases and price decreases than those analysed.

Further research to identify such influences would be worthwhile. Anecdotal evidence suggests that the distinction between characterization as a fund manager AREIT or as a property owning AREIT was an influence on price increases and that the level of gearing and foreign exchange management were influences on price decreases. However, further research is required to support or refute same and to identify other significant influences.

Expected correlations between price increase, price decrease and each variable were

hypothesized but only 40% of the hypotheses were found to be supported. Significantly, neither hypothesized correlations for the relationship between price increase, price decrease and the extent to which an AREIT may be considered a family business (correlations of -0.26 and 0.19, respectively) nor between price increase, price decrease and the level of related party shareholding (correlations of -0.07 and 0.27, respectively) were supported.

It would appear, for the AREIT sample analysed, that being a family business or having a high level of related party shareholdings decelerates price increases but accelerates price decreases. As these findings are counter intuitive, further research is recommended to confirm the findings, perhaps through the use of a larger sample with fewer family businesses and related party shareholdings, prior to further investigation in an endeavour to explain the findings.

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