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**Impact of Board Composition on
Australian REIT Performance**

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Abstract:

Already well established in Australia and the USA, REIT's are now growing significantly in Asia and Europe.

Previous research focusing on US REITs has investigated the impact of board composition on REIT performance, with a particular focus on agency issues arising from the level of separation of ownership and management.

Following a brief literature review, a survey of Australian REITs is undertaken to determine the composition of REIT boards and the level of separation of ownership and management.

The findings on board composition are then compared to REIT performance and conclusions drawn, with areas for further research suggested.

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With a global market capitalisation now exceeding US\$872 billion (NAREIT (2007)), REITs are well established as an investment sector in the USA and Australia, with a growing role in Asia and an emerging presence in Europe as shown in Figure 1.

In Australia, AREITs grew phenomenally from a handful of AREITs 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 1997, as shown in Figure 2 (UBS (2007)), before falling to a market capitalisation of \$78 billion in 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)).

Further, the recent total return performance of AREITs in Australia was very impressive at 34.05% for the year to December, 2006, significantly outperforming Australian equities (24.97%) and Australian direct property investment (17.29%). However, for the year to March 2008, AREIT total returns were -24.2% compared to -6.0% for Australian equities and 18.1% for Australian direct property (IPD (2008)).

The Australian REIT sector has now evolved to comprise two principal groups, being:

- traditional, property owning AREITs, which invest in direct property and pay the net income to unitholders; and
- fund manager AREITs, which invest in direct property and pay the net income to unitholders and also undertake a range of further businesses to provide separate sources of revenue, such as funds management or business operations.

Traditional property owning AREITs may also be considered to comprise two principal groups, being:

- sector specific AREITs which invest in the traditional sectors of commercial, retail, industrial and hotel property as well as those which invest in emerging sectors such as CFS Retail or Commonwealth Office; and
- diversified AREITs which invest in a range of sectors, offering diversification within the AREIT such as DB RREEF or Mirvac.

However, unlike some other global jurisdictions, 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.

To date, there has been limited research into aspects of the relationship between AREIT performance and board composition, though some research has been undertaken concerning US and Malaysian REITs.

As both McIntosh et al (1994) and Sirmans et al (2006) note, 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.

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. 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.

Shakir (2008) investigated the impact of board size and the proportion of independent directors on the performance of Malaysian REITs. The mean board size was found to be 7 directors with a minimum of 4 and a maximum of 13, with the author citing various studies which found the mean board size of American, British, Canadian, Spanish, French and Belgian firms to be 12 or 13 directors, Japanese firms to be 28 directors and Singaporean and Australian firms to be 7 directors. The author found board size to have a consistent negative relationship with performance, when measured by Tobin's Q, noting stronger performance from smaller boards.

Comparatively, Dimovski and Brooks (2005) analysed Australian REIT IPOs in the period 1994 to 2004 and found the mean size of the board to be 5.52 and the median 6.0 directors.

Further, Shakir (2008) found 35% of directors in the sample of REITs 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. The author found a positive relationship between the number of non-independent or executive directors and performance, when measured by Tobin's Q, noting stronger performance from boards with higher proportions of non-independent or executive directors – a finding echoed in an Australian context by Boon (2004).

Regrettably, however, Shakir (2008) did not continue to investigate the impact on performance of other aspects of board composition, such as the existence of an independent Chairman or the proportion of directors with property experience or current directorships of REITs or other entities listed on the Stock Exchange.

Dimovski and Brooks (2005) investigated the level of female directors on the boards of Australian REIT IPOs in the period 1994 to 2004. The authors cite research by Sheridan (2002) that found women represented only around 3% of directors of boards of Australian listed companies, with other research finding 7.6% female directors for the top 100 publicly listed companies in UK and 13.6% for US Fortune 500 companies.

The authors found 3.8% of the directors in the AREIT sample studied to be female, which the authors noted to be broadly comparable to that for the boards of Australian industrial and mining IPOs in the period 1994-1997 at 4.0%. The authors further found that larger AREITs tended to

employ proportionally more female directors, with retail AREITs tending to employ fewer female directors and office AREITs tending to employ more.

Boon (2004) investigated the impact of the level of female directors on Australian firm performance and found a positive association.

Interestingly, Shakir (2008) considers the issue of “grey” directors whose status as independent or non-independent is questionable, including family members of employees, lawyers, investment bankers and former company officers. Regrettably, the author does not continue to investigate the impact of such “grey” issues as the extent to which the REIT may be considered a family business nor the level of independent or “grey” director shareholdings on REIT performance.

However, McIntosh et al (1994) note the findings of Warner, Watts and Wruck (1988) that the inverse relationship between firm performance and the rate of management turnover appears to be weakened when the manager acquires power through family connections or stock ownership. The authors also note the findings of Weisbach (1988) that firms with outsider dominated boards are more likely to have a strong association between firm performance and management turnover.

Fama (1980) considers agency issues arising from the level of 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. The author notes 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.

McIntosh et al (1994), Sirmans et al (2006) and Shakir (2008) each consider Fama’s (1980) discussion of the internal monitoring of management activities by the board of directors, other top managers or large block shareholders but do not go on to investigate the relationship between “grey” director and CEO shareholding and REIT performance.

Therefore, having regard to previous research, it is proposed to investigate the relationship between AREIT performance and the following:

- board size;
- board composition, including:
 - the proportion of independent directors;
 - the existence of an independent Chairman;
 - the proportion of directors with property experience;
 - the proportion of female directors;
 - the proportion of directors with current directorships of other ASX listed entities;
 - the proportion of directors with current directorships of other ASX listed AREIT entities; and
- “grey” issues, including:
 - the extent to which the AREIT may be considered a family business;
 - the level of “grey” director shareholdings; and
 - the level of CEO shareholding.

Data Set and Approach to Analysis

The data set comprised the twenty largest AREITs by market capitalisation listed on the ASX as at 30th May 2008 and represented approximately 95% of the total market capitalisation of all AREITs listed on the ASX. One AREIT did not disclose the level of director shareholdings and so was deleted from the sample and replaced with an alternative 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. A summary of descriptive statistics is included as Table 1.

As Figure 3 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 appreciation and a period of significant depreciation. 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 appreciation or depreciation.

Following the approach of Sirmans et al (2006), two periods were selected from the periods of appreciation and depreciation 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 1st July 2006 to 31st December 2006 and the depreciation period comprised 1st October 2007 to 31st 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. Price performance data was then correlated with each of the variables and the resulting correlations compared to those expected based on the hypotheses, below.

Hypotheses of Paper

The hypotheses for the respective variables may be summarised as follows:

Board Size

Shakir (2008) discusses board size in the context of monitoring management to ensure that they discharge their duties in the best interests of unitholders, noting that a large board may result in less meaningful discussions, a lack of cohesiveness and problems of co-ordination, so becoming symbolic rather than fulfilling its function. Conversely, a small board may lack sufficient outside directors and risk potentially easier expropriation of wealth by the CEO or non-independent directors, pre-occupation with decision making and less time for an overview function.

As shown in Table 1, mean board size was found to be 7.05 directors, which is broadly consistent with the findings of Shakir (2008), above.

It may be hypothesized, therefore, that the correlation between board size and performance may be negative, with performance decreasing as board size increases. However, given the potential range of influences on AREIT performance other than board size, such a correlation may be expected to be weak.

Board Composition

Board composition included variables for:

- the proportion of independent directors;
- the existence of an independent Chairman;
- the proportion of directors with property experience;
- the proportion of female directors;
- the proportion of directors with current directorships of other ASX listed entities; and
- the proportion of directors with current directorships of other ASX listed AREIT entities.

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 and an independent Chairman may be considered preferable.

As shown in Table 1, the mean proportion of independent directors was found to be 63.8%, significantly above the level found by Shakir (2008), with 60.0% of AREITs having an independent Chairman.

It may be hypothesized, therefore, that the correlations between a high proportion of independent directors, an independent Chairman and performance may be negative, with performance decreasing as independence increases. Reflecting the high proportions of independent directors and independent Chairmen shown in Table 1, such correlations may be expected to be strong.

Dimovski and Brooks (2005) contend that having female directors on boards is a desirable business practice as it is likely to improve the reputation of the firm and facilitate a better understanding of women's issues, consumer markets, customers and social and community issues in the determination of strategic direction, as well as contributing positively to the company's female employees. Catalyst (2004) found that those companies with the highest representation of women on top management teams had a 35% better return on equity and a 34% better return to shareholders than those companies with the lowest women's representation.

In the context of a small board, Shakir (2008) notes a potential lack of a spread of expert advice and opinion and a diversity of experience, skills, gender and nationality.

As shown in Table 1, the mean proportions were found to be 6.7% female directors (significantly above the level found by Dimovski and Brooks (2005)), 45.4% directors with cognate property experience, 19.9% directors with AREIT board experience and 34.0% directors with general ASX board experience.

It may be hypothesized, therefore, that the correlation between performance and the proportion of female directors, directors with cognate property experience, AREIT board experience and general ASX board experience may be positive, with performance increasing as the proportion of each variable increases. Reflecting the mean proportions shown in Table 1, such a correlation may be expected to be weak.

"Grey" Issues

"Grey" directors were considered by Shakir (2008) to be those whose status as independent or non-independent is questionable, including family members of employees, lawyers, investment bankers and former company officers. Consistent with this approach, those directors with any form of connection to the AREIT, such as through an executive role (CEO or CFO), family link or as a current or former service provider, were considered related or "grey". Family link included both human and corporate, where directors were representatives of a parent entity.

Consistent with Fama (1980) and Shakir (2008), in the context of monitoring management to ensure that they discharge their duties in the best interests of all unitholders, “grey” directors may be considered more likely to favour the interests of the family or parent. Similarly, 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.

As indicated by Table 1, 36.2% of directors were considered “grey” or related and 70.0% of AREITs were classified as family businesses. CEO unitholdings ranged from 0% to 16.6% but with a mean of only 1.94%.

It may be hypothesized, therefore, that the correlations between a family business and performance and between “grey” directors and performance may be both positive and strong, with performance stronger for family businesses and increasing as the proportion of “grey” directors increases.

Findings

The independent variable of price change was correlated with each of the dependent variables with the results summarized in Table 2 and compared to hypothesis expectation in Table 3.

Correlations were generally low, ranging from 0.001 to 0.617, suggesting that influences other than those analysed were of greater significance to price movements in the periods considered.

For the purposes of analysis, the strength of correlation was calibrated as follows:

Strong	>0.250
Medium	0.200 – 0.249
Weak	<0.199

For the price increase period, only 20% of the correlations were of the hypothesized nature and strength, being directors with property experience and CEO shareholding. 30% of correlations were of the hypothesized nature, but of a differing strength to that hypothesized being female directors, directors with other AREIT directorships and related or “grey” shareholdings.

Significantly, 30% of correlations were of the hypothesized strength, but of a differing nature to that hypothesised, being independent chairman, directors with other ASX directorships and family business. 20% of hypotheses were unsupported in either nature or strength, being board size and the proportion of independent directors.

For the price decrease period, only 20% of the correlations were of the hypothesized nature and strength, being board size and directors with property experience. Only 10% of the correlations were of the hypothesized nature, but of a differing strength to that hypothesized being directors with other AREIT directorships.

Again, a significant proportion (30%) of correlations were of the hypothesized strength, but of a differing nature to that hypothesised, being independent directors, female directors and family business. 40% of hypotheses were unsupported in either nature or strength, being independent Chairman, directors with other ASX directorships, “grey” shareholdings and CEO shareholding.

Conclusions

Based on the above findings, during a period of price appreciation, the stock price of an AREIT may rise more than that of other AREITs if the CEO has a shareholding in the AREIT, the AREIT has a larger board and the board includes an independent Chairman, a higher proportion of female directors and a higher proportion of directors with other AREITs directorships.

Conversely, during a period of price depreciation, the stock price may decline less if an AREIT board has a smaller proportion of independent directors and a smaller proportion of directors with other AREIT directorships but a higher proportion of directors with other ASX directorships.

It is strongly recommended that any AREIT investment decision not be based on the above findings.

Areas For Further Research

The inconsistency of the findings in both the price increase and price decrease periods was surprising. As it is unlikely that the majority of the hypothesized relationships were mis-stated, the unexpected results are more likely to be attributable to the relatively small data set analysed.

It would, therefore, be worthwhile to repeat the analysis with a larger data set comprising either all those AREITs in the ASX 500 or the entire ASX index. Whilst the market capitalisation of the sample would not be significantly greater, the number of AREITs considered would be far greater which may lead to greater validity in testing of the hypotheses.

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	Bd Size	% Ind	Chair	% Prop	%Female	Ltd Dir	REIT Dir	Fam Bus	Rel Sh	CEO Sh
Mean	7.05	63.80%	60.0%	45.42%	6.74%	2.4	1.4	70.0%	7.47%	1.94%
Std Error	0.45	0.03	0.11	0.04	0.02	0.57	0.37	0.11	0.02	0.01
Median	7	60.77%	1	40.00%	0.00%	2	1	1	2.92%	0.03%
Mode	5	60.00%	1	40.00%	0.00%	0	0	1	0.00%	0.00%
Std Deviation	2.01	0.13	0.50	0.19	0.08	2.54	1.64	0.47	0.09	0.04
Range	8	47.50%	1	77.78%	0.25	9	4	1	34.01%	16.64%
Minimum	5	40.00%	0	11.11%	0	0	0	0	0.01%	0.00%
Maximum	13	87.50%	1	88.89%	0.25	9	4	1	34.02%	16.64%

Descriptive Statistics

Source: Author

Table 1

	Price Inc 7/06-12/06	Price Dec 10/07-3/08
Board Size	0.446	-0.009
% Ind Directors	0.245	0.403
Ind Chairman	0.391	0.054
% Prop Directors	0.178	0.074
% Fem Directors	0.306	-0.173
ASX Directors	-0.158	-0.395
REIT Directors	0.332	0.617
Family Bus	-0.304	-0.390
Related Shldg	0.032	-0.242
CEO Shldg	0.399	-0.001

Summary of Correlations

Source: Author

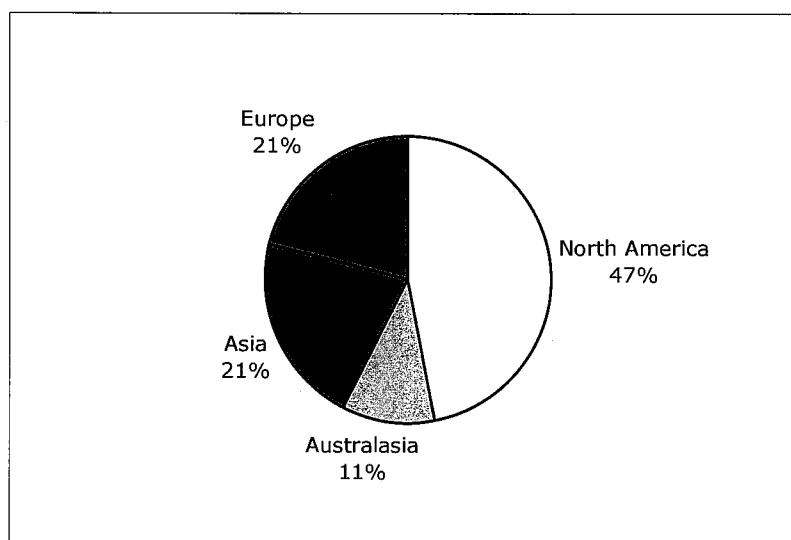
Table 2

Dependent Variable	Expected Correlation	Expected Strength	Independent Variable	Correlation	Strength
Board Size	Negative	Weak	Price Increase	Positive	Strong
			Price Decrease	Negative	Weak
Indep Directors	Negative	Strong	Price Increase	Positive	Medium
			Price Decrease	Positive	Strong
Indep Chairman	Negative	Strong	Price Increase	Positive	Strong
			Price Decrease	Positive	Weak
Dir Prop Exp	Positive	Weak	Price Increase	Positive	Weak
			Price Decrease	Positive	Weak
Female Dirs	Positive	Weak	Price Increase	Positive	Strong
			Price Decrease	Negative	Weak
Other ASX Dirs	Positive	Weak	Price Increase	Negative	Weak
			Price Decrease	Negative	Strong
Other REIT Dirs	Positive	Weak	Price Increase	Positive	Strong
			Price Decrease	Positive	Strong
Family Business	Positive	Strong	Price Increase	Negative	Strong
			Price Decrease	Negative	Strong
"Grey" Shareholding	Positive	Strong	Price Increase	Positive	Weak
			Price Decrease	Negative	Medium
CEO Shareholding	Positive	Strong	Price Increase	Positive	Strong
			Price Decrease	Negative	Weak

Hypothesis Expectations

Source: Author

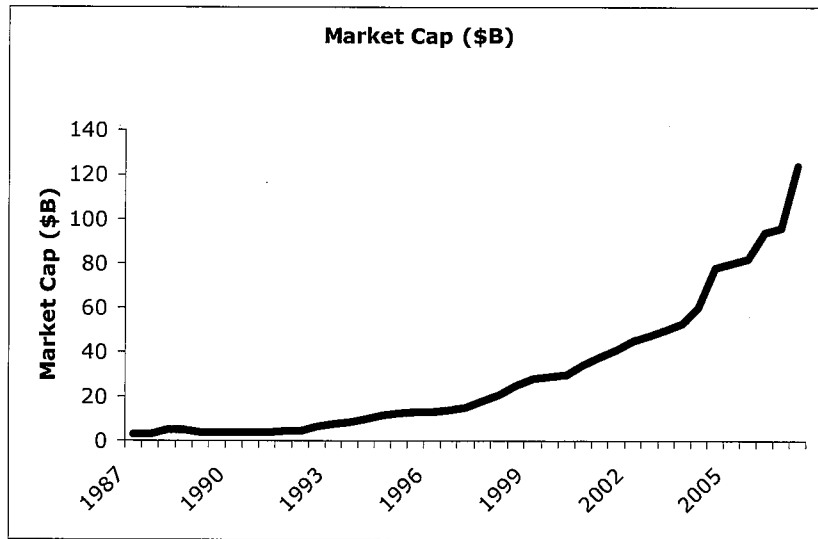
Table 3



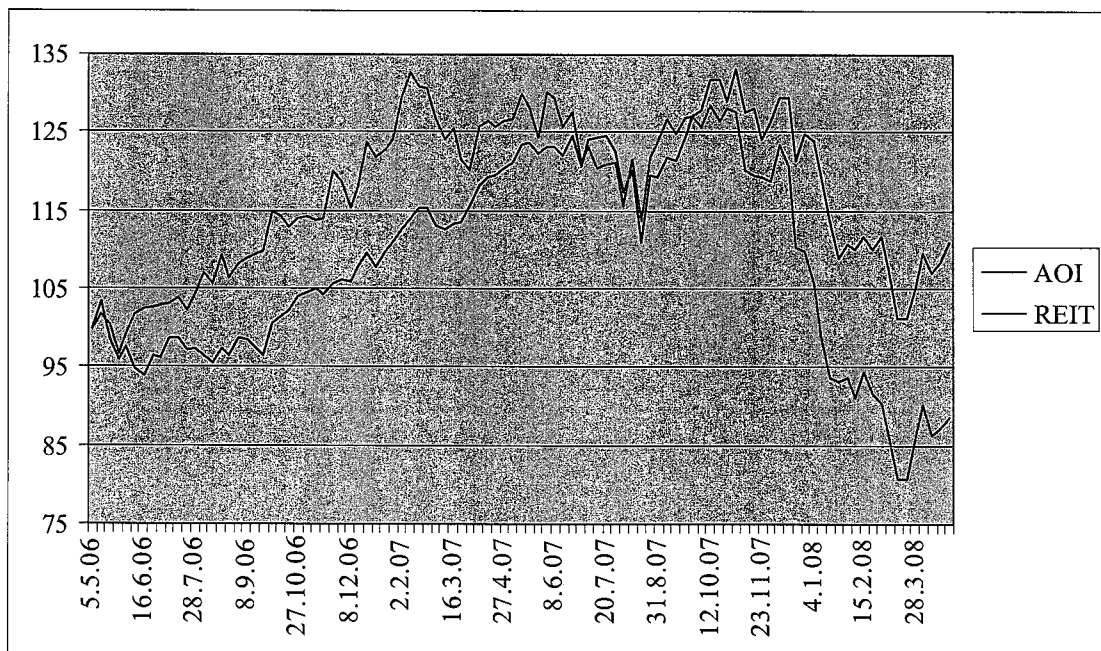
REIT Global Market Capitalisation

Source: NAREIT (2007)

Figure 1



Growth in REITs in Australia
 Source: UBS (2007)
 Figure 2



AOI-AREIT Relative Performance
 Source: Author
 Figure 3