Explaining the Discount to NAV in REIT Pricing: Noise or Information?

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Abstract

This paper explores the determinants of both the level of and changes in premiums to NAV in REIT pricing over the 1996-1999 period. The first part of the paper specifies and estimates a model of cross-sectional and time variation in premiums to NAV using a sample of individual REITs. We find that the level of premium to NAV is positively related to REIT size (market capitalization), debt to equity ratio and the level of REIT liquidity as measured by the relative effective spread. Changes in premiums to NAV over time have a strong common element across REITs, which is related to but not entirely explained by a common element in REIT liquidity. The common, sector effect is stronger in the 1998-99 down-market. The second part of the paper aims to determine if the common effect in REIT pricing relative to NAV reflects informed trading or noise. We examine changes in REIT spreads in relation to fluctuations in the average REIT sector premium to NAV and show that the transaction costs of trading in REITs increase when REIT prices are getting closer to NAVs. This holds when controlling for changes in volume and changes in volatility. This result is consistent with a higher proportion of uninformed traders being in the market when REIT prices are diverging from NAV, which in turn is consistent with the noise theory of departures from NAV.

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