The REIT choice

For owner occupiers considering how to realise their property assets, the choice has never been greater. The property sector already offers a variety of structures including sale/leasebacks, joint ventures and total property outsourcing. Investors in property include quoted companies, private companies and offshore vehicles as well as institutional direct and indirect investment. With effect from 1 January 2007, UK real estate investment trusts (REITs) will be added to the list.

PROPERTY OWNERSHIP REVISITED? Capital flows into the UK property market are estimated to be around £70bn in 2005 and the forecast for 2006 runs at a similar level. Increasing numbers of corporate occupiers have been taking advantage of the buoyant property market and have realised substantial capital via sale/leasebacks and disposals. Notable examples have been BT's £2.4bn property sale in 2001 and Tesco's ongoing sale/leaseback programme. However, estimates based on Blue Book data recently put forward by global information business IPD suggest that property with a capital value of around £145bn remains in the hands of owner occupiers.

Despite wider choice, greater investor appetite and more capital, some corporates are still reluctant to sell their property assets. The arguments for transferring property ownership have been well rehearsed: real estate is capital-intensive and the sale of property releases capital for deployment in core business areas. To unlock the full potential of property takes time and resource – for example, negotiating the various planning and environmental hurdles to undertake development is a highly specialised area.

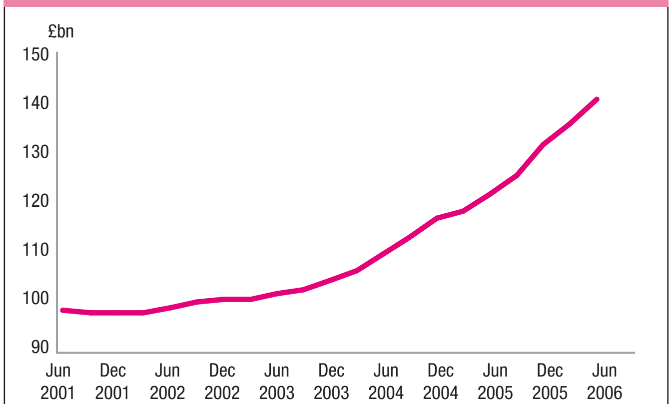
The choice of property ownership structures is considerable, and includes total outsourcing as pioneered by Land Securities Trillium and the government under property PFI, sale/leasebacks, 'op-co/prop-co' splits, partnering and outright sale.

There is also considerable choice in lease structure beyond the conventional 'upwards-only lease' – lease rentals can be linked to the retail prices index, turnover or have fixed increments. Operational flexibility need not be comprised either – break options and flexibility to vacate or substitute properties can all be incorporated in deals to ensure that any property commitments are consistent with business and financial goals. If loss of future upside is a concern, partnership arrangements are an option.

Executive summary

- The introduction of UK REITs in January 2007 is intended to facilitate access to property as an asset class to a wider range of investors by creating a liquid and tax-efficient vehicle. The move aims to encourage growth in the commercial and private rented property sectors.

Figure 1. All UK property capital growth 2001-05



Source: IPD

STEPHEN LEUNG EXPLORES THE POTENTIAL THAT REITS OFFER CORPORATE OCCUPIERS.

CORPORATES MAY BE IN FOR A SURPRISE Buildings owned by occupiers are usually held as a fixed asset and depreciated. Corporates that have not reviewed the current market value of their property in recent years may be in for a surprise. Capital values of average investment properties have increased over 40% over the last five years. Land values will also have increased where there is potential for future development. Total or selective realisations of property can generate significant one-off profits and may also help demonstrate the underlying value of a business.

EFFECTIVE FROM 2007 With effect from 1 January 2007, UK REITs will become effective. To qualify as a REIT, a business has to satisfy a number of conditions but fundamentally it needs to derive 75% of its income from property rental activities. An entry charge based on 2% of the value of the property is payable and in return REITs will not be required to pay income or capital gains tax on qualifying profits. Initial participants will come from the existing quoted sector but over time it is expected that new REITs will be established, reversing the trend of a shrinking UK quoted property sector.

WILL REITS BE ATTRACTIVE TO OWNER-OCCUPIERS?

Is regulation a good thing? One of the original policy aims behind the establishment of REITs was to create a stable and well-regulated investment product. REITs have to be listed and will be subject to minimum levels of interest cover. Gearing levels in the quoted sector have traditionally been lower than those adopted by private/opportunistic investors – the average loan to value in the quoted sector is a relatively conservative 40%.

REITs will be properly capitalised and will be subject to the governance and transparency that comes with a full listing. REITs' status should provide comfort to boards considering a sale of their crown jewel property assets.

Captive REITs. Restrictions on maximum shareholding and owner-occupied property will restrict the ability of occupiers to hive off real estate into wholly owned 'captive REITs'. Joint ventures with REITs will remain an option – a REIT's share of income and capital arising in corporate joint venture will be REITable provided that the REIT maintains at least a 40% stake. Limited partnerships will be tax-transparent for REIT purposes.

Capital gains tax efficiency. The UK REIT has not incorporated any umbrella partnership REIT provisions to allow for the tax-efficient transfer of real estate into REITs. Crystallisation of capital gains tax on sale of property can be a disincentive for corporates looking to transfer property. REITs should be at an advantage when acquiring property held in companies with high latent capital gains tax. Corporates that are considering property transfer should look at doing so via a corporate vehicle rather than direct sale.

Lower cost of capital. For existing quoted companies, REIT conversion will have the immediate effect of reducing their post-tax cost of capital as a result of tax no longer being payable.

While the cost of debt will become relatively more expensive due to the lack of tax shield, recent research by Lehman Brothers has suggested that one consequence of REIT conversion will be the reduction of average equity betas from 0.8 to 0.4, thereby lowering the cost of equity.

Benefits of scale. REITs are likely to benefit from economies of scale. These economies can benefit occupiers, for example, in the form of lower service charges, or ongoing maintenance and management costs.

More choice in the quoted sector. Over time it is expected that new REITs will be established, reversing the trend of a shrinking quoted property sector.

The breadth of property types is increasingly welcomed by investors. There is a growing number of specialist property funds investing in sectors such as education, healthcare and hotels. Tax structuring has been an important consideration in structuring a fund and while REIT legislation does not necessarily encourage migration of existing offshore funds onshore, the REIT structure does make onshore investment a viable alternative.

RECONSIDER THE STRATEGY There are clearly many factors that affect the corporate decision to own, lease or sell property. REITs should be viewed as attractive property partners, and the variety of property structures available should mean that occupiers can achieve an appropriate level of flexibility to match their business strategy. At the very least, the introduction of REITs should be a reason for owner-occupiers to examine whether an 'own' strategy continues to be the right one.

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A step in the REIT direction

The real estate market has been a booming industry for years in the UK. The industry has benefited from a lucrative environment that has delivered sound returns.

Despite the success of the property market, it has been missing out on one potentially transforming opportunity: the introduction of real estate investment trusts (REITs).

The US, Australia, France and Japan all have some form of REIT system in place whereby a property company can avoid paying corporation tax by embracing that country's REIT equivalent.

As a result of intense government lobbying by key industry groups, the British Property Federation, the Investment Property Forum and the Royal Institute of Chartered Surveyors, UK real estate companies will now also be able to convert to a REIT and benefit from being a tax-exempt company.

From 1 January 2007, UK companies will have the opportunity to take advantage of REIT status by paying a conversion fee, which equates to 2% of UK gross assets – a hurdle which is not widely regarded as prohibitive.

THE BURDEN OF DOUBLE TAXATION REITs work in a similar way to existing property investment trusts, in the sense that they also pool assets to buy a portfolio of properties. A number of UK-listed property companies are set to turn themselves into REITs because the new tax treatment will end double taxation and make them significantly more appealing to investors.

The exciting thing about REITs for property companies is that REIT conversion should enable them to become more tax-efficient and flexible than they currently are. There will be no double taxation of income and the gains that occur when a company's profits are taxed and then taxed again when distributed as dividends. By becoming a REIT, a property company gains tax-free rental income – providing a certain percentage of the UK earnings are distributed to the shareholders in the form of dividends. In the UK, this will be 90%.

MEASURING THE DIFFERENCE So how much will all this affect how these companies and their treasury departments operate?

Steven Owen, Deputy Chief Executive at quoted commercial property company Brixton, says: "Strategically, I don't think it is going to make a big difference. REIT is the classic property investment company model, where the distinction between revenue and capital is fundamental.

"The revenue profits from rental income activities are meant to be distributed to shareholders, which means that your capital profits are available for reinvestment in your business. This has always been the strategy that we have adopted and this is what the REIT model will look like."

Others agree with Owen that REITs are not something that will transform the whole business.

Despite speculation in the national press, large property companies such as Slough Estates, Hammerson and Brixton, which all plan to convert to REITs, argue that their business strategies will be undisturbed by the new tax regime.

Duncan Beardsley, Group Treasurer at Hammerson, a European retail estate company specialising in retail and offices, says: "The more relevant treasury question is, will it improve the credit rating of the company? The general consensus is that it should be marginally credit-positive. Any deferred tax will have jumped off the balance sheet due to the lack of a tax issue.

"The possible negative impact on credit is the conversion charge which you pay in four quarterly instalments. Apart from anything, it will change the gearing of the company."

Beardsley recognises that the modest 2% charge will not have a detrimental effect on a company like Hammerson, which is worth £4.2bn. This is likely to be the case for other large companies.

While becoming a REIT may be a positive for larger property companies, it is questionable whether all smaller companies will benefit. Beardsley says: "For some smaller companies with other issues, it is not going to be worth it because the amount of tax will be relatively small for them.

"I think there is a possibility that many of the larger companies will get bigger, particularly from acquisitions of property held in

JULIA BERRIS UNCOVERS THE MISSING INGREDIENT FOR THE REAL ESTATE MARKET.

corporate portfolios. REITs are able to buy companies with less regard to tax as this disappears when they enter into this regime."

GETTING READY FOR REITS Fitch Ratings Analyst Jean-Pierre Husband recognises the potential for a different impact on small and larger business. He says: "AIM companies are not recognised as being listed for the REIT regulations. Smaller companies which are listed on AIM will need to get stock market listing and there is an extra expense in that."

Although property companies argue that becoming a REIT will not fundamentally change the way in which they work, the switch has regulatory implications. Trevor Mant, Group Treasurer at Slough Estates, says: "Internally, we have to have the right systems that would enable us to comply with the terms and conditions.

"This is obviously more of a tax issue than a treasury issue, but we will have to be sure that the numbers are prepared properly and be able to demonstrate compliance."

Like Mant, other treasurers will be analysing the company internal capital structure and how becoming a UK REIT will affect any overseas operations.

Making sure that the company is fully prepared before 2007 is by no means a stroll in the park.

Owen says: "Although it has been painless in relative terms we have had to make changes. Brixton now has a full-time tax manager because of the two tax groups in the REIT model. There is a tax-exempt group and a tax-residual group.

"The compliance is quite burdensome and that is why we decided to get a full-time tax manager."

The government has presented UK REITs as a good saving option that could encourage people to provide and save for their pension.

Owen says: "With the pensions crisis in the UK, the quoted property companies and institutions said to HM Treasury that the way to improve the situation was to introduce a new savings product, a REIT. It will offer an alternative means of saving to private investors who are piling into the buy-to-let market because they have lost confidence in the equity market."

REITs seem to be a strong, safe and viable option for those needing a new savings method, which has been highlighted as something for everyone and not over-complicated to use.

Beardsley says: "It is about creating an asset-class or investment class that is relatively low risk in which individuals can invest. The government wanted to create an investment pool in which it would be easy to invest."

THE US EXPERIENCE With the benefits of REITs in the UK obvious to those running the property companies and the government, why is it only now that REITs are being introduced?

Owen says: "It was about three years ago when REITs started to appear on the Treasury's horizon. This was due to the double taxation on quoted property companies. As a result the ownership of property assets was being migrated offshore to Channel Island unit trusts.

"Approximately £13bn worth of property migrated offshore over about three years. HM Treasury wasn't getting any stamp duty or tax on these transactions.

"The UK was the only G8 country not to have a REIT structure, which is a large omission considering that property is the largest asset class in terms of investment."

REITs have been big business in other jurisdictions for years. They were established in the US in the 1960s by Congress as an accessible method of investment for the individual. Owen says: "US REITs only started kicking off properly from 1992 following the secondary banking crisis. Many banks became insolvent as a result of overlending to the property sector. Something had to happen to that property so they became REITs. The US REIT market grew from $10bn market capitalisation in 1992 to $300bn today."

The US market seems to offer enormous encouragement to UK property companies, but Husband argues it is unwise for investors to compare the two systems.

He says: "I would steer very clear of comparing UK REITs to US REITs. As an investor that would be dangerous because the fundamentals of the UK property market are different to the US."

The US market has changed dramatically over the years with many companies becoming asset-specific, in part due to REITs. Beardsley says: "The US has REITs which are specialised. I don't necessarily think that will be the case in the UK. I think if you can prove that you can make money out of more than one sector, which we have done, there is no reason why companies should separate into different areas."

While Beardsley sees sector-specific REITs as not necessarily the paradigm for the UK property market, he admits there will be a variety of vehicles under the REITs regime.

Owen says: "It will be interesting to see whether over time the market in the UK changes. The US single-sector specialists have outperformed the generalist. We'll have to wait and see if that happens in the UK."

The start of UK REITs is eagerly anticipated. Owen says: "The prospect for the UK market to grow quickly is definitely there. I think London will become the European REIT capital."

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