Insights on...

UK REAL ESTATE INVESTMENT TRUSTS

UK LAUNCHES REAL ESTATE INVESTMENT TRUST STRUCTURE

New vehicle offers potential benefits to investors and property companies

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The property industry breathed a collective sigh of relief when the government unveiled its proposed structure for its new property vehicles in the Chancellor's Budget in April 2006. Real estate investment trusts, or REITs for short, are one of the most talked about and long-awaited investment vehicles on the United Kingdom investment scene. Preliminary industry consultation and draft proposals had prompted much criticism from the industry with concerns that the proposed UK REIT structure would be unattractive to many investors and hamper their much-anticipated success. However, the government responded to these widespread views with a more accommodating regime in April, and with their official launch on January 1, 2007, REITs have finally become a reality in the United Kingdom. Yet, what are these new investment vehicles and what does their arrival really mean for property companies and investors?

WHAT IS A REIT?

REITs are not a new concept globally; they have existed in a number of the major financial centres for many years. They are a form of collective investment that is tax-transparent and available to both corporate and private investors. A REIT owns and manages income-producing property, commercial or residential, and its shares are traded on the stock exchange.

REITs collect income from rented property assets and distribute most of it to shareholders. In return the REIT is exempt from corporation tax. The removal of this "double taxation" at both the corporate and investor level better aligns the return from investing in a REIT with direct property investment.

THE RATIONALE FOR CREATING UK REITS

You are not alone if you wondered why the UK needed another property vehicle when many opportunities already exist to enter the property investment arena, including limited partnerships, listed property companies or direct ownership. Whilst these investment options have contributed to the significant growth of this thriving market, certain factors have deterred some potential investors from entering this market. High taxation, a requirement for significant capital outlay and inflexibility are just a few of the characteristics that may have caused investors to look elsewhere and contributed to the growing activity of offshore property owning structures.

By introducing REITs, the government hopes to overcome some of these barriers and develop a more efficient property market in the UK whilst ensuring that investors continue to contribute an appropriate share of tax. Their introduction should certainly facilitate access to property as an asset class to a wider range of investors, primarily retail, encouraging growth in both the commercial and private rented property sector.

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If anything, the UK is actually late to introduce REITs, compared with many of the major financial centres already operating these investment vehicles. In the United States they comprise an industry worth more than US$360 billion, representing 2.5% of the equities market, while in Australia, Japan and France in particular they are a fast growing phenomenon.

The UK government may have taken its time, but REITs have arrived at an opportune moment, with increased investment in real estate, high confidence levels in this market and continued low interest rates. Investors are increasingly seeking alternatives to traditional investments that will offer them lower risk whilst still providing the potential to produce high gains. This, coupled with significant changes to the UK pension system, such as liberalising personal pensions and many employers closing defined-benefit schemes, is leading many UK pensions to increasingly recognise property as a mainstream asset class. When integrated into portfolios of equities and bonds, property can provide considerable benefits.

OPPORTUNITIES FOR INVESTORS

REITs may have arrived at a good time, but what is their appeal?

Investing directly in real estate has several disadvantages for many investors: it's illiquid, expensive, and managing the purchased properties requires a significant amount of time and capital. In contrast, REITs are freely tradable on the stock market and, unlike many offshore property vehicles, have no minimum investment level. This gives REITs a unique level of flexibility and allows investors to gain indirect exposure to the property market and access to the expertise of established managements without the associated hassles.

REITs are an investment product designed for long-term savings. As such, they can provide regular income generation and prospects for good capital growth. Furthermore, investors only pay tax on the dividends received and profits from share and/or unit sales, thereby eliminating the double taxation incurred by quoted property investors, which is certainly an attractive feature.

REITs' key benefits for prospective investors include:

- Tax-transparency
- The ability to invest in commercial property, which can yield much greater profits than residential property investing alone
- Liquidity
- Regular income flow
- Access to the property market for minimal outlay
- Low/controlled gearing
- Portfolio diversification and
- Strong corporate governance due to listing

OPPORTUNITIES AND CHALLENGES FOR PROPERTY COMPANIES

REITs are indeed a flexible and liquid property vehicle, but has the government provided a regime that is attractive to property companies to convert to REIT status?

Converting to REIT status can provide benefits to property companies, but until April 2006, it appeared that the Treasury's proposals would deter many property companies from converting. However, the government's more relaxed framework has meant that many have already converted or are seriously considering doing so.

Prior to the introduction of REITs, listed property companies paid corporation tax on their income and investors paid tax again on any dividends paid out. REITs are exempt from tax on income, provided they distribute 90% of their profits to shareholders (a reduction from the originally proposed 95%). This has effectively removed the double taxation faced by property companies, which often caused them to trade below the value of their assets historically.

REITs are exempt from tax on income, provided they distribute 90% of their profits to shareholders.

Under the new regulations, UK REITs must meet certain conditions. To qualify, a company must:

- Be in the form of a closed-ended company
- Be publicly listed on a recognised stock exchange — this does not include the Alternative Investment Market (AIM)
- Be a tax resident in the UK and not dual resident in any other jurisdiction
- Pay a conversion charge of 2% of the assets if converting from an existing property company structure. However, companies set up initially as REITs will not incur such a charge
- Issue only one class of ordinary shares or non-voting fixed-rate preference shares
- Not have closely held shares, which means that no one shareholder (individual or corporate) should hold more than 10% of the shares
- Be formed of three or more properties, with no one property forming more than 40% of the total. However, the company can invest in any type of property in any location
- Be focused on traditional property investment activities; profits from the property letting business will be ring-fenced from business activities carried on within a property company and will be taxed according to normal taxation rules
- Have a minimum of 75% gross income from property rents and invest at least 75% of gross assets in properties generating rental income
- Distribute a minimum of 90% of income; income will be calculated after interest and certain other expenses

If a company meets these requirements, it will be tax-exempt. Investors will, however, be taxed on distributions as income at their marginal income tax rate (i.e., 22% basic rate, 40% higher rate tax payers). In addition REITs will pay Stamp Duty Land Tax in the normal way on their property transactions whilst investors will pay 0.5% Stamp Duty Reserve Tax on the purchase of shares.

The Treasury's final plan included several changes from its draft proposals designed to make REITs more attractive to property companies. The 2% charge on asset values faced by property companies converting to a REIT structure is lower than previously anticipated, and is a lighter conversion charge than the system France used when it set up SICCs (French REITs) in 2003. Another potential sticking point was the interest cover ratio, the factor by which a REIT's income has to cover its interest payments. The Treasury's final plan cut the proposed ratio in half to 1.25, a level at which more highly geared companies will be able to convert.

While REITs should certainly provide a more liquid and attractive option to investors than the universe of vehicles previously available, a number of factors may still hamper their anticipated success. The requirement that a REIT be a resident UK company listed on a "recognised stock exchange" means that many existing unit trusts or limited partnerships for example will be unable to easily convert themselves directly into REITs. The rules further limit the pool of potential REIT creators by excluding companies listed on the Alternative Investment Market and providing no clear incentive for offshore-based collective investment vehicles to convert to REIT status. Property companies with large individual shareholders may also view the 10% limit on shareholdings as a potential problem. These are just some of the factors property companies are considering as they evaluate whether to convert.

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THE REIT'S FUTURE

REITs have arrived at a very exciting time in the UK property market, and are expected by many to emerge as a significant industry as they have done in the United States and elsewhere. Indeed, the anticipation of their introduction may have contributed to the strong performance of the real estate sector in 2006. However, the results since their launch have left some advocates a little disappointed.

It is still very early days for REITs, and only time will tell whether they will live up to the hype and lead to the United Kingdom becoming a major participant in the European REIT market. Regardless of how significant they eventually become, REITs certainly present considerable opportunities for both investors and listed property companies as a tax efficient, transparent and liquid investment.

Northern Trust has been administering property funds since the 1980s and offers comprehensive solutions supporting a broad spectrum of fund structures across multiple jurisdictions.

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