

REFORMING UK REITS



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INTRODUCTION

Very occasionally, governments provide pleasant surprises. The Budget announcements in March 2011 included proposed reforms to the regulations governing UK Real Estate Investment Trusts (REITs), which reflected a welcome responsiveness to industry concerns and even went beyond expectations in some respects. The proposals were subject to an informal consultation which closed in June, with legislation on the measures expected in the 2012 Finance Bill.

The new measures are intended to support the development and growth of the UK REIT market which came into being in January 2007. The development of the UK REITs sector since 2007, in admittedly testing market conditions, has fallen some way short of earlier aspirations. The great majority of UK REITs were created through the conversion of existing quoted property companies and few new REITs have been established. The government's desire to see more investment in private rented housing through REITs has not been fulfilled; no residential REITs have been established. The government hopes the proposed measures will address barriers to entry and investment for new and existing REITs.

In principle, we welcome any changes to the rules governing REITs that will encourage the formation of new REITs and increase the attractiveness of the sector for investors. In this paper, we review the principal measures to reform the REITs regime and consider their potential impact and benefits.

DIVERSE OWNERSHIP RULE FOR INSTITUTIONAL INVESTORS

This measure would allow institutions to establish REITs with a diverse ownership rule enabling them to meet the non-close company rule. (A close company is one controlled by five or fewer participants). For the purposes of this measure, "diverse ownership" should be defined in relation to the existence of pooled investment interests. Entities qualifying as diverse owners under the rule should include those covered by Solvency II regulations, pension funds and other collective investment schemes such as unit trusts and OEICs.

We see the main impact and benefit of this measure to be the facilitation of an orderly movement of property assets from the unlisted funds sector to the listed sector

within the REIT regime. The ability for institutions to establish REITs will be helpful to the stability of the market in providing an alternative to asset disposals as an exit route from the unlisted funds sector.

Experience in the unlisted funds sector in the course of the recent severe market downturn has highlighted a number of problems in the architecture and operation of geared closed-ended funds in particular. These relate to issues of valuation, pricing, liquidity and access to capital and suggest that at least some of these funds may belong more properly in the listed sector. The development of a larger, more income-focused REIT sector may also be beneficial in attracting retail savings, potentially away from current open-ended structures which have an inherent mismatch

between the liquidity they offer investors and the illiquidity of the underlying assets.

In this context, the fundamental shift in the pattern of pension saving from defined benefit schemes to defined contribution schemes is relevant since this will create greater requirements for more liquid and flexible forms of investment in property. In the USA and Australia, for example, the listed REIT sector plays an important role in providing property investment options for retirement savings.

An orderly transfer of property assets from the unlisted funds sector into REITs would bring a number of benefits for investors, including:

- Tax transparency
- A move to “perpetual” investment vehicles rather than the limited life nature of some unlisted funds
- Greater liquidity
- A common IFRS accounting framework
- Greater transparency and analyst coverage
- Increased access to capital

One of the most important benefits of transfers into the REIT sector would be that this would facilitate the recapitalisation of property funds much more effectively than is typically possible within the unlisted sector.

The ability for fund managers to invest various of their funds in REITs without inadvertently breaching the 10% ownership condition, due to the structure of their organisation, will widen the attractiveness of the sector. For major institutional investors, who may have their own funds as well (e.g. Life Offices) and a fund management division, the ability to invest is significantly restricted, potentially to the detriment of their funds and the share price of the REIT concerned.

RELAXATION OF LISTING REQUIREMENT

This measure is intended to encourage entry into the REITs regime particularly for start-up property investment companies.

Listing on the Alternative Investment Market (AIM) involves substantially lower start-up and compliance costs compared to listing on the

London Stock Exchange. The higher costs of a full listing on the LSE are a significant size barrier to the creation of new, smaller REITs.

In addition, the cost of listing on a Recognised Stock Exchange (RSE) in other jurisdictions is often lower than in London, although such exchanges may be less used by smaller UK investors. Removing the restriction on the ability for a REIT to list on AIM, where costs may be more comparable to a smaller RSE, should increase the pool of potential investors.

Allowing REITs to list on AIM would help to increase the population of smaller REITs and aid the evolution of the UK REIT sector. Reducing the barriers to entry to the REITs regime for smaller property investment companies will expand the pool of REITs with potential to grow and achieve full listing. The ability for UK REITs to list on other exchanges would bring the UK regime governing this sector closer to that which operates successfully in other jurisdictions, some of which do not require REITs to be listed.

REITs listed on AIM will be subject to the same rules as those listed on the main exchange. It is worth noting that the REIT regulations afford a degree of investor protection that is somewhat stronger than that available with the generality of companies listed on AIM.

The creation of a larger pool of REITs with a greater diversity of investment profiles would be beneficial in increasing in the options available for retail investors.

ABOLITION OF THE CONVERSION CHARGE FOR COMPANIES JOINING THE REIT REGIME

The 2% conversion charge on asset values was designed as a tax payment to offset potential unrealised tax liabilities on capital gains in companies converting to REIT status. If a company has no unrealised liabilities relating to capital gains, then the conversion charge is a net cost which dilutes value and thus acts as a barrier to entry. This is of particular relevance to entities that may use IFRS as their accounting convention as capital losses give rise to deferred

tax assets on the balance sheet and consequently inflate NAV over and above Fair Value.

Commercial property values are, on average, still well below their market peak reached in 2007. Currently tax liabilities relating to capital gains are likely to be low or non-existent in many property companies. The conversion charge would therefore represent a net additional tax burden with no offsetting gain from cancelled liabilities. The conversion charge could also be a hurdle for new start-up companies with recently acquired assets.

The conversion charge therefore is a potential financial impediment to the creation of new REITs, either new start-ups or conversions of offshore funds to UK REITs. Its removal would lower the hurdles to entry to the REIT regime.

ALLOW CASH TO BE A "GOOD ASSET" FOR THE BALANCE OF BUSINESS TEST FOR REITS

The current test requires 75% of a REIT's assets to be investment property. This requirement can significantly constrain the ability of REITs to make decisions on a commercial basis in a number of circumstances, including:

- Potentially on initial listing or on conversion if a company is not "fully invested"
- Following a rights issue
- Following significant disposals
- Where a REIT has "trapped cash" retained to meet loan covenants (e.g. to rectify a breach of a Loan to Value (LTV) covenant)
- Where a prudent manager would normally arrange for funds to be available before embarking on a major refurbishment/redevelopment

Greater flexibility in allowing cash to count as a "good asset" would therefore be helpful in a number of circumstances to enable REITs to make investment decisions on a commercial basis. At the same time, the essential nature of REITs as property investment vehicles should be maintained and there is a need to avoid the potential for REITs to become "cash shell" structures.

There is a good case for cash should be allowed to count as a "good asset" for the balance of business asset test subject to a requirement that a REIT holds a minimum proportion of its assets by value in investment property. We consider that a minimum of 50% of assets to be in qualifying investment property would be reasonable.

OTHER MEASURES AND OVERVIEW

The Budget proposals also include other measures relating to the timing of certain distributions in certain circumstances and the definition of 'financing costs'. Without discussing in detail, we note these are designed to facilitate the operation of REITs in a sensible, commercial manner and regard them positively.

Taken overall, we consider that the package of measures proposed will aid the commercial operation of REITs and, more significantly, reduce the hurdles for new entrants to the REIT regime through start-ups and conversions. We therefore anticipate the impact to be an increase in the size and diversity of the UK REIT sector.

THE RESIDENTIAL REIT ISSUE

There is a question as to whether the measures will, by themselves, encourage the creation of residential REITs. As a further measure aimed at stimulating institutional investment in private rented housing, the 2011 Budget included a change to the Stamp Duty regime affecting the bulk purchase of residential property. Duty is now payable at the rate applicable to the mean value of properties in a portfolio rather than the aggregate price. This can significantly reduce the transactions costs for bulk residential purchases (e.g. 1% Stamp Duty on the purchase price rather than 4% or 5%).

The potential for development of a significant residential REIT sector in the UK is subject to important structural constraints arising from distinctive traits of the UK housing market. In particular, with residential values determined by pricing in the owner-occupied market, the typical income yields on residential property are low, both absolutely in net terms and in comparison with commercial property. The typical yield profile on residential property, when combined

with even moderate levels of gearing, limits the distributable income available to pay dividends, potentially making it difficult for a UK residential REIT to offer investors an attractive income return.

The new REIT measures will not in themselves alleviate this hurdle for residential REITs. There is a further specific issue that arises with residential investment companies as potential REITs that could be addressed by a change in the REIT rules. This concerns the proportion of a residential investment portfolio that typically comprises "trading stock" and the associated churn in property holdings. This creates potential problems in meeting the balance of business test for the proportion of REIT assets to be "investment property". Compliance with the balance of business test could be further complicated by inclusion in a residential portfolio of properties held on a shared ownership basis or other forms of intermediate tenure, given the increasing share of these tenure types in the residential market.

These issues could prove significant impediments to residential REITs under the current rules. To address these, we suggest that the balance of business test is modified in the case of residential REITs. This could take the form of a requirement that, to qualify as a residential investment company, at least 75% of the residential units held in the portfolio during any year must be let or available to let or subject to shared ownership arrangements.

To sum up, we envisage that the package of measures announced with the Budget will aid the creation of new UK REITs, but we are less certain that the reforms as proposed will particularly encourage the formation of residential REITs. Some further refinements of the rules look to be needed to enhance the prospects of residential REITs in the UK.

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