

LONG - TERM FINANCING FOR
REAL ESTATE DEVELOPMENT
IN THE UNITED KINGDOM

by

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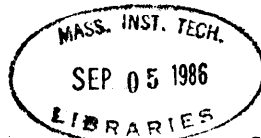
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ABSTRACT

This paper investigates the alternatives available for long term project financing in the United Kingdom. Historical investment trends of the major capital suppliers are examined and assimilated to the trends and economic conditions currently confronting the UK property market.

Equity financing techniques are reviewed, and the much discussed unitization of property is critically examined. Although at the time of this writing the unitization concepts as put forth by the Royal Institute of Chartered Surveyors and Richard Ellis were not yet tested in the marketplace, they did receive preliminary approval from Parliament and appeared well on their way to implementation.

Debt alternatives and methods for enhancing the attractiveness of a debt offering are discussed. It is concluded that given the current level of interest rates and property yields in the UK, debt is the favored funding vehicle for the major suppliers of capital, and should be addressed as such by the developer.

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I. Background on the Property Investment Market.

Before investigating the current UK property market, it is useful to understand how the market as it exists today evolved. A historical perspective will provide insights into the decision criteria that have guided the market players in the past. These guidelines can then be evaluated in terms of their applicability in today's environment, and all useful criteria can form the basis for assumptions about future behavior.

The UK property investment market traces its origins back to the end of World War II. Prior to this time, most commercial and industrial property was owner-occupied, and investors were generally uninterested in property as an investment vehicle. But during the war, 9.5 million sf of office space in central London was destroyed by bombing.¹ The significant decrease in space was coupled by a dramatic increase in occupational demand after the war. As productivity rose in the postwar period, office space requirements increased. This increase was highlighted by the economy's shift from a manufacturing base to the office-oriented service sector.

As a result of increasing demand for space with little

¹Fraser.

existing or new supply, rental and capital values escalated. Further development to loosen the supply squeeze was restricted, however, by both the construction industry's insufficient resources to handle the added space requirements, as well as by the Labour government's imposition of 100% tax on the development value of land.¹ The latter was not removed until 1953, which provided the impetus for massive redevelopment in the mid 50's.

At the beginning of this boom, property development was virtually a riskless venture. Demand was still high for office space, so there was little risk of vacancy upon completion. Construction costs were contained by fixed bids. Development financing was available through financial institutions, and long term mortgages were offered by the insurance companies at low fixed rates. Projects were self-financing, but all gains in rental and capital values were passed on to the developer.

In this profitable environment, it wasn't long before competition increased, financial resources became tight, and the stock of available space rose, thereby increasing the risk of vacancy. However, the Labour government once again moved to restrict development by passing the Control of Office and Industrial Development Act in 1965, or the "Brown Ban" named

¹ Fraser.

after the responsible parliamentary minister. The act virtually banned further office development in London, which turned out to be a blessing to those developers with partially or fully completed buildings because it restricted supply in a market with strong demand. The Brown Ban essentially laid the groundwork for rising rental values.

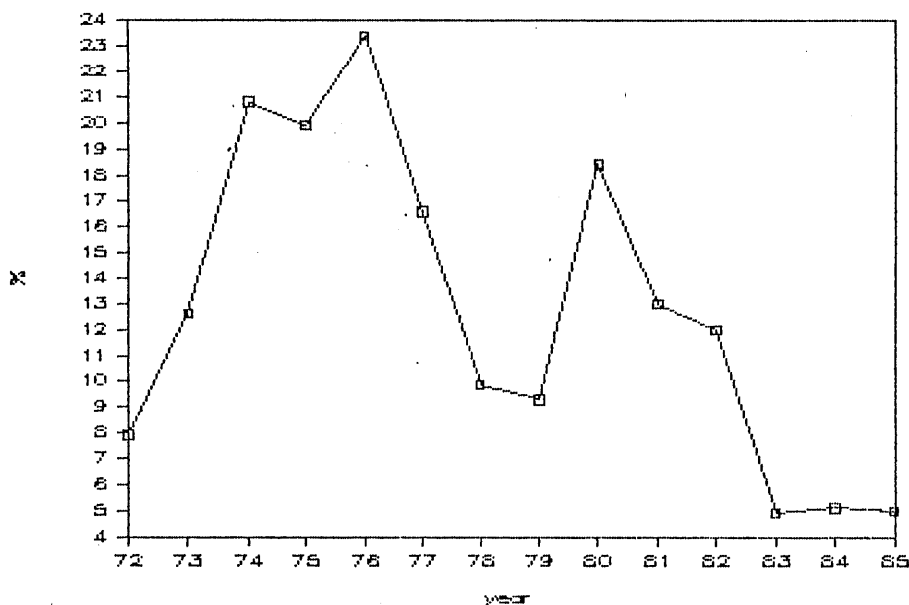
It was at this time that pension funds and life insurance companies turned from indirect funding of development through lending activity to direct investing by way of purchasing property. The Control Act of 1965 reduced the opportunities to finance development indirectly through mortgage loans. But the institutions were also becoming increasingly aware of the sensitivity of the stock markets, as the Financial Times All Share Index dropped 11% between 1968 and 1970 while the JLW Property Index increased 30% during the period.¹ (See Appendix C for information on property indices.) Direct property investment allowed the institutions to diversify their portfolios and was viewed as a strong hedge against inflation, which was steadily climbing in the early 1970's, as shown in Exhibit A. Furthermore, the long term nature of property investments was appealing because it matched the term of the institutions' liabilities. Despite the development controls, attractive investments were available as rising property values made

¹ Jones, Lang, Wooton.

tenancy more cost effective than ownership. Eager to fund the market, the pension fund and life insurance companies with large cash balances were willing to buy occupied properties and lease them back to the tenants. As a result of this buying activity, property investments by the funds and insurance companies increased over 90% in real terms during the late 60's.¹

EXHIBIT A

Inflation 1972 - 1985



New property development came on strong again in the early 70's, when the Conservative government made cheap credit available in an effort to stimulate the industrial base of the economy. The Competition and Credit Control (CCC) agreement introduced in 1971 reduced the bank rate to 5%, abolished bank lending ceilings, and defined new rules

¹ Richard Ellis.

for bank liquidity which allowed for greater lending.¹ The monetary expansion brought on strong demand for office accommodation particularly from the financial services sector. In addition, consumer borrowing and spending rose, bringing with it rising demand for retail space. The growing occupational demand coupled with the strong investment demand from funds and insurance companies caused rental and capital values to escalate. At the same time, the government eased the development controls imposed by the Brown Ban, which opened the door for new projects. With cheap money available, high space demand, and relaxed controls, prospects were good for most commercial and industrial projects. New construction orders rose 12% between 1972 and 1973.² And although cheap money reduced the supply of attractive leaseback arrangements, some pensions and insurance companies partook in the boom by acquiring property companies.

While occupational demand rose during this period, unemployment increased from 2.5% to 3.9% between 1970 and 1972.³ This mismatch between growth in demand for space and unemployment can partially be explained by the influx of foreign finance-related concerns. The emergence of the

¹ Fraser.

² Department of the Environment.

³ Central Statistical Office.

Eurodollar market in the mid 1960's and the growth of international money markets served to promote London as a major financial center. Foreign banks were attracted to the City and greatly impacted space demands, but their many expatriate employees did not boost the UK unemployment statistics.

The CCC also brought with it a massive influx of deposits, which allowed the banks to significantly expand their lending base. With rising capital values, property was attractive collateral to the bankers, who were often willing to lend on a variable rate basis 100% of development costs. Limits on borrowings were eased in favor of high expectations about future growth. Total bank advances to property companies soared from L450m in 1971 to over L2800m at the end of 1974.¹

Development companies were virtually unrestricted in the amount of debt they could accumulate because the banks did not encourage positive or even breakeven cash flows on the mortgaged properties. If the cash flow from the property did not satisfy monthly mortgage payments, some banks would simply roll over the interest and apply the deficit to the outstanding balance. This practice was essentially speculating on the rising value of the property. Without cash flow restrictions, the only limit on borrowing by developers

¹ Financial Statistics.

was their collateral. As the value of their collateral increased, they borrowed more and continued buying, which in turn further increased the value of their property. While property values increased an average of 10% annually between 1967 - 1970, during the next three years they increased 26% per year on average.¹ The property boom was snowballing, but was soon to come to the bottom of its mountain.

The government became increasingly sensitive toward the development industry. They viewed property as the main beneficiary of policies which were designed to stimulate the industrial sector. The industrial sector, however, was suffering from rising imports and labor unrest. Public anger escalated as developers' profits mounted while housing demands remained unattended. In 1973, the government responded by freezing rents, taxing development gains, and tightening credit.² Virtually overnight, the expected appreciation in property values against which millions had been borrowed disappeared. Both the developer and the lender were caught in rather serious dire straits. One major bank with a large portfolio of property loans, London & County Securities, announced liquidity problems because depositors were not renewing their money markets, a main source of funds for the bank. A run on secondary banks ensued, as it was the

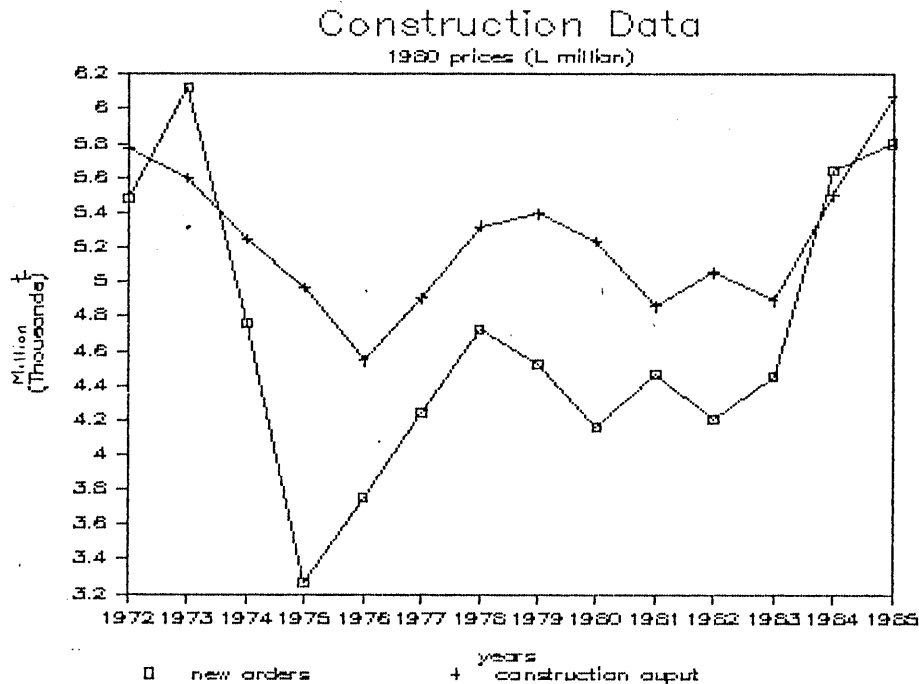
¹ Financial Statistics.

² Fraser.

smaller banks who held the majority of property loans.¹ Without the intervention of the Bank of England, many banks certainly would have failed.

Interest rates soared from 6.21% in 1972 to 12.17% in 1974, and property companies were forced to sell off property assets to meet rising debt payments. Property values fell dramatically as more and more property was put on the sale bench. But even as property became cheaper, without rental growth it was an unattractive investment. The pension

EXHIBIT B



funds and life insurance companies were the main potential purchasers, but with high interest rates, they could get a

¹ Fraser.

better yield in the short term money markets. And with the prospect of falling values, these institutions were not interested in the buying. Many of them already had large commitments outstanding. In this environment of falling values and high interest rates, developers simply could not afford to build, and virtually new orders for commercial and industrial space dropped 47% between 1973 and 1975, as shown in Exhibit B.

The market started to revive again in 1975, when the new Labour government removed the rent freeze and interest rates started to fall. Property companies were still trying to dispose of some of their assets, but the pension funds and insurance companies with new investment confidence were ready to buy. Prime investments were available at low prices, and rents were certain to rise, as there were no new developments coming to market and the economy seemed to be taking a turn for the better with falling inflation. But the pension fund's and insurance companies' appetite for property could not be satiated by the stock of completed buildings. High investment demand for property pushed prices up to the point where investment returns on completed buildings were unacceptable. In an effort to obtain higher returns, the institutions turned to development. However, with little internal expertise in development, these institutions relied on the property trading companies to supply them with projects for which the institutions could provide the capi-

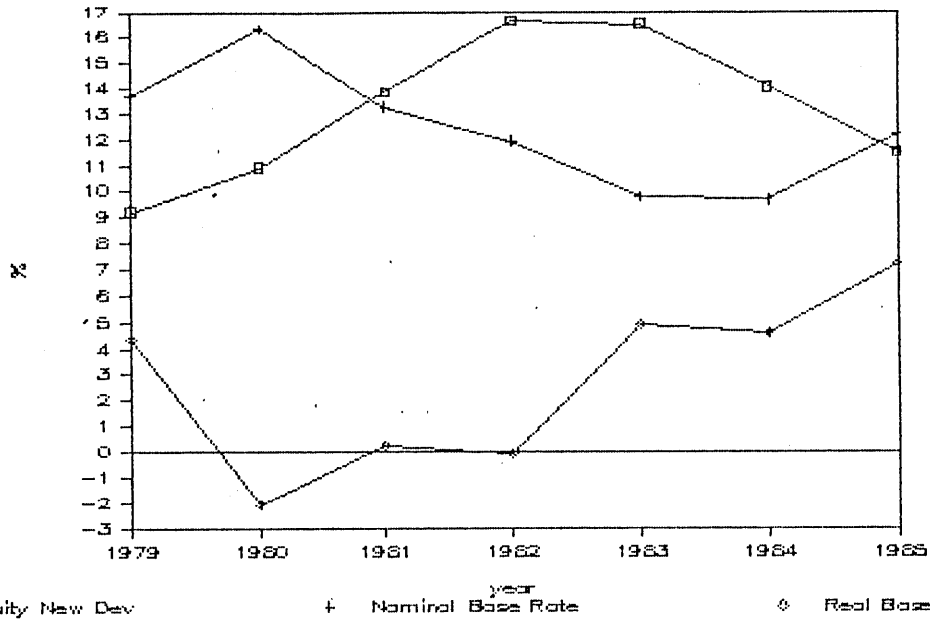
tal. To minimize the risk in the project for the institution, and to boost the developer's profit, the latter would typically guarantee rental upon completion. But in the strong rental market of the late 70's, this guarantee was rarely exercised.

At the same time, banks became reluctant lenders in the property market. The Bank of England expanded its supervisory role over the lending practices of the financial institutions, particularly the secondary banks. But after being stung badly, many were voluntarily avoiding property loans.

Investment by the pension funds and life assurance companies, therefore, was the backbone of development after the property crash of the 70's. It is useful to determine have large institutional investors funded the new developments in the past, ie through equity in a project or through lending activity to the developers. Exhibit C plots the percentage of commercial and industrial construction activity funded by way of pension fund and life insurance equity capital. Since there is typically a 2 year time lag between the time when the funding commitment is made and when it is actually fulfilled, the curve should be shifted to the left two periods to determine what influenced the decision to fund new projects with equity capital.

EXHIBIT C

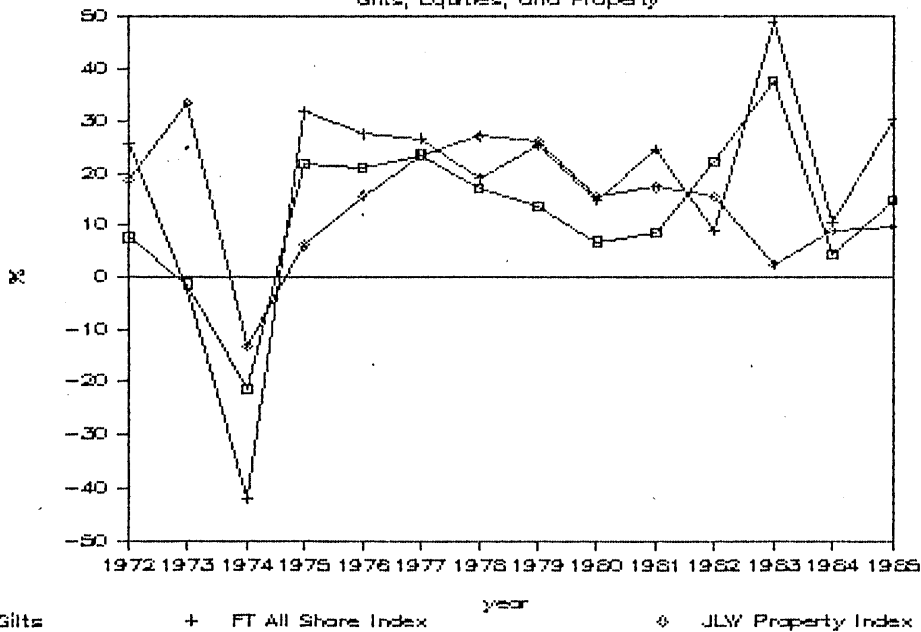
% Equity in New Developments



With a shifted curve, the percentage of equity committed to new projects increases steadily between 1977 and 1980, and drops from 1981 through 1983. Turning to Exhibit D,

EXHIBIT D

Comparative Returns
Gilts, Equities, and Property



which measures comparative performance between gilts, equities, and property, it can be seen that during the earlier period, property returns outperformed the other investment media. In the later period, property returns were significantly lower than gilts or equities. It can be concluded that when property has higher relative returns than alternative investments, equity funding will increase. While the data source does not provide for a more extensive period of review, this conclusion can logically be applied to any period because when returns are strong, investor confidence and expectations for property will be high. They are likely to downplay the risks associated with equity investments in property in favor of its attractive returns. The advantage of debt as a less risky investment may be outweighed by the higher returns on equity, and development funding through debt will decrease.

Note also that when the curve is shifted, it inversely correlates to the movements in real interest rates. When real interest rates were negative in 1980, equity funding reached a peak. However, the percentage of new development funded with debt increased as real rates started to rise. The curve, then, illustrates the investment preferences of the capital supplier in a market of insatiable demand. The borrowing developer prefers to borrow when real rates are low. But the capital - supplying investor is not satisfied with returns on debt during periods of low or negative real

interest rates. Therefore, the lender prefers equity instruments. The developer would have to resort to partnerships or shared equity schemes to obtain financing. Likewise, when real rates are high, the lender is attracted to debt instruments. But the developer may have difficulty servicing high - rate debt with a project's cash flow. Nevertheless, in a market where demand for project financing continuously exceeds the supply of funds available for property investments, the supplier has strong leverage with his demands. Real interest rates, therefore, are an important factor in the type of funding available.

Current Trends in the Property Investment Market

The property market entered another difficult period in 1982, a phase from which it is only starting to emerge. The privatisation and decentralisation policies introduced by the Tory government under Margaret Thatcher resulted in large scale unemployment throughout the UK, as shown in Exhibit E. Office rental growth rates reflected the drop in employment, which after adjusting for inflation, dropped 7% between 1981 and 1983.¹

EXHIBIT E

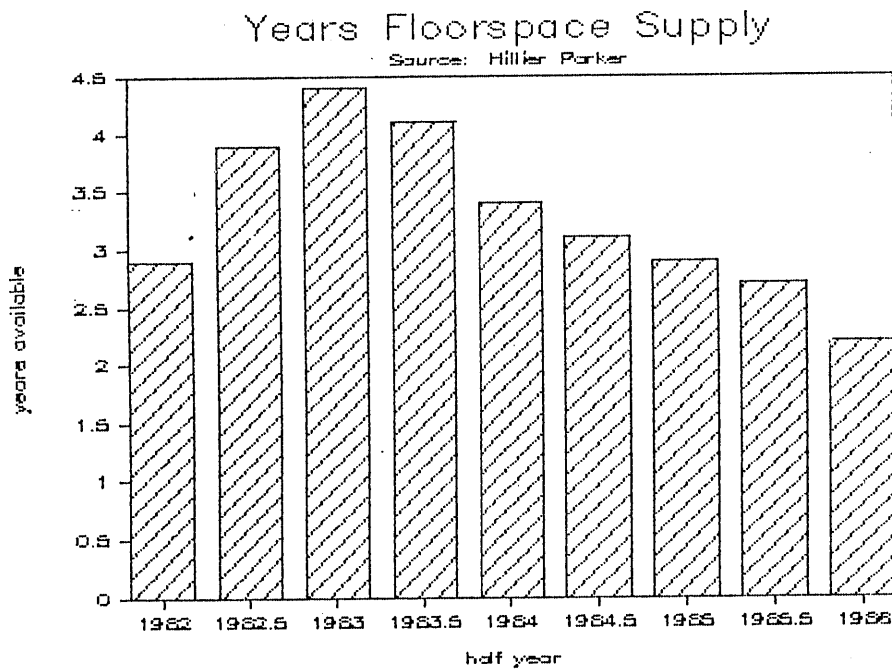


Unemployment has steadily increased since 1982, but the total workforce has slightly expanded thus increasing space

¹ Investors Chronicle/Hillier Parker.

demand in the last year.¹ The upcoming deregulation of the financial markets has also boosted space demanded by foreign companies much the way the introduction of the Eurodollar market effected demand in the late 1960's and early 1970's. Office space available for letting decreased by 3% in 1985, due primarily to a 28.6% uptake in let space and only a 2.5% increase in space placed on the market. The years floor-space supply has also fallen to 2.2 years as shown in Exhibit F, it's lowest level in four years.² This indicates a

EXHIBIT F



tightening in the supply of space. However, as shown in Exhibit B, new orders for construction have increased

¹ Debenham, Tewson & Chinnocks.

² Investors Chronicle/Hillier Parker.

steadily since 1982. Given that the time lag between ordered and completed space is typically 1 to 2 years, the supply of space placed on the market will also continue to grow. Therefore, supply may not remain restricted in the short term unless letting activity continues to outpace the growth in space placed. With unemployment at record high levels and the impact of foreign concerns on space demands past it's peak, the future growth rate of let space is dubious.

Nevertheless, the achievement of record rents in the London office market for modern facilities, as well as strong retail sales growth, has positively effected rental growth. However, tenants' requirements have become highly discerning and much of the existing stock does not meet their current needs. This outdating is reflected in the investment patterns of the pension funds and life insurance companies, whose sales of buildings rose 72% between 1982 and 1983.¹ The selling activity of these major institutions has resulted in a 2% inflation adjusted annualized fall in capital values between 1980 and 1984.² The obsolescence of buildings has, therefore, undermined any positive effects of rental growth, with the net result of only a slight rise in overall returns in the last year.³

¹ Debenham, Tewson & Chinnocks.

³ Ibid.

² Richard Ellis.

At the same time, gilts and particularly equities have outperformed the property market in terms of overall returns. (See Exhibit D). This has detracted institutional funds away from property and into the alternative investment vehicles. Furthermore, the introduction in 1982 of index-

Table 1. : Net Investment in UK Property by Pension Funds and Life Insurance Companies
(Acquisitions - Sales)

	Pension Funds & Insurance Companies (Lm)	Real Terms (1980 Prices) (Lm)
1980	1796	1796
1981	1917	1714
1982	1856	1528
1983	1412	1111
1984	1418	1064
1985	1423	1005

Source: Richard Ellis

linked gilts, which offer a 3 1/2% guaranteed return over inflation, has served to detract the inflation conscious investor away from property. In real terms, investment in property by the funds and insurance companies has fallen by over 40% since 1980, as shown in Table 1. The rise in

construction output apparently has been funded by the banks, whose loans to UK property companies increased from 2238 Lmillion in 1980 to 7076 Lmillion in 1985.¹

While funding by the nonfinancial institutions has declined in real terms, the capital requirements for certain schemes demanded by tenants have risen. In light of the upcoming deregulation of the financial markets in October 1986, financial occupiers, by far the largest tenant group in the City, are demanding larger, more sophisticated and flexible facilities to accomodate new conglomerates and their massive trading floors after the Big Bang.² Advances in communication technology have eased the priority of location, but tenants now require modern buildings with 20,000 to 40,000sf floors, fewer interior columns, raised floors, large floor to ceiling heights, and high power capacities for computer facilities.³ The costs of these projects are steadily climbing as evidenced by the 4m sf Broadgate project worth over L2 billion, and the 10m sf Canary Wharf development with a cost of L1.7 billion. These schemes are the more costly of today's projects, but they reflect the trend toward larger and more costly office developments.

The emergence of out of town shopping centers has also

¹ Richard Ellis.

³ Jones, Lang, Wooton.

² Ibid.

fostered larger capital requiring schemes. Increased mobility provided by the orbital motorway around the London has made rural centers more accessible to consumers. With wages rising faster than inflation since the early 1980's, consumers have enjoyed greater purchasing power and have spurred a buoyant retail sector.¹ Consumers are favoring shopping centers with a wide range of retailers, where one-stop shopping can be accomplished. These factors, in addition to the planning complexities of town center retail development, have spurred demand for retail outlets outside the traditional City shopping core. The amount of out-of-town retail space, either under construction by March of this year or with planning consent, was up by over 300% from the same period last year, with the average size of the schemes at 268,000sf.² The regional mall, long an established retail facility in the US, is coming of age in the UK.

The costs of the major new development schemes, therefore, are often beyond the financial capacity of a single lender. For even the largest funds, some of these projects could constitute more than 10% of their property portfolio, invoking a level of risk which would be unacceptable for a single investment. The decline in

¹ Jones, Lang, Wooton.

² Hillier Parker.

institutional allocations to property aggravates this funding gap. While in 1980 property accounted for an average of 22% of institutional holdings, in 1985 the figure was down to 12%.¹ Table 2 shows the top five pension funds in terms of assets. An investment in a single project of more than £84m by the largest fund, the National Coal Board, would exceed 10% of its property portfolio, assuming 12% of its holding is in property. Traditional financing resources, therefore, are no longer adequate to fully fund the rising development costs of buildings called for by tenants and consumers.

Table 2 : Five Largest Pension Funds in the UK 1986

<u>Fund</u>	<u>Assets (£000,000)</u>
1. National Coal Board	7000
2. British Telecom	6100
3. Electric Supply	4400
4. Post Office	4250
5. British Rail	4000

Source : A. P. Financial Registers

However, the composition of the investor market has dramatically changed since the 70's. Changes in the

¹ A. P. Financial Registers.

patterns of employment favoring smaller firms and the growing importance of individually held pension policies has resulted in a growing number of smaller schemes.¹ The rising number is evidenced by the 43% increase since 1982 in unit trust assets, which is the primary investment vehicle for smaller funds.² They typically maintain a lower percentage of their portfolios in direct property investment because any single investment can account for a greater proportion of invested funds, thus preventing the fund from adequately diversifying property interests. Most of the smaller funds' property investment, therefore, is indirect via property unit trusts. While the large institutional funds still dominate the market in terms of assets, the smaller funds have emerged as an alternative funding source.

The private investor has also emerged as a source of development capital. This is evidenced by the advent of successful new investment vehicles aimed at the private investor, such as residential property bonds and property enterprise trusts. (See Appendix A.) Furthermore, the primary investment sector for the individual, ie residential, has witnessed values climbing faster than inflation for the last five years.³ The private sector, therefore, holds a

¹ Jones, Lang, Wooton.

² Financial Statistics.

³ Hillier Parker.

vast source of wealth which if properly catered to, could prove a significant source of development funding for large capital requiring schemes.

III. The Investment Pool

Since no single source is typically capable of funding today's large projects, the market needs to pool together the financial resources available from the institutions, the smaller funds, as well as the individual to fund the large scale projects. The mechanism by which the funds are pooled should have more attractive characteristics than alternative investment vehicles, otherwise capital will not flow into the pool.

The illiquidity of property has long been viewed as it's primary investment disadvantage. Consequently, the pool should provide a means of quick and easy transfer of investors' interests. Liquidity would allow investors to respond to the changing nature of the markets and would reduce the long term nature of risk inherent in a property investment. For this reason, if a liquid property investment vehicle is introduced, institutions may allot a higher percentage of funds to property investment. In addition, individuals, whose presence in the debt and equity market is strongly felt in turnover, favor investment markets in which they can easily buy and sell their holdings.

The vehicle should also provide for the divisibility of property into smaller lot sizes. Because of the large

amounts of capital required for property investments, many investors, both individuals and funds, are precluded from direct investments simply because they cannot afford them. By reducing the lot size and hence the capital required for an investment in property, the market would be attractive to more investors. Smaller unit sizes would also enhance the liquidity of the investment. Funds would be able to effectively achieve their portfolio percentage targets, since large amounts of capital which could tip their portfolios wouldn't be required for investment. They could also diversify their portfolio to a greater extent, thereby spreading risk. Smaller unit sizes would also enhance their liquidity. These factors could work to bring additional capital into in the property market.

The tax implications are also of considerable importance in attracting funds into the pool. If the vehicle was more tax efficient than alternative investments, funds would also flow into the pool. Pension funds are tax exempt; therefore, while they would be indifferent to the tax consequences of a unitholder, they would be concerned about the tax implications of the vehicle itself. Other investors would investigate the tax liabilities to both the unitholder and the vehicle.

The vehicle for pooling capital can take the form of either a debt obligation or the issuance of equity in a com-

pany or development project. The following section reviews the possibilities for pooling via an ownership vehicle.

IV. Multiple Ownership

Equity ownership of property can take several forms, as follows;

1. Direct Property Ownership,
2. Partnership Ownership,
3. Corporate Ownership,
4. Property Unit Trusts,
5. Unitization Proposals.

Direct Property Ownership

Direct property ownership entitles the land owner, or the building owner in the case of a land lease, to all the rights associated with the asset. Taxes are paid by the property owner on any income generated by the asset, as well as on any capital gain arising from the sale of the property.

If the property is owned by more than one person, according to the Law of Property Act of 1925, it must be held in a trust for sale. Beneficiaries of the trust would be entitled to their share of profits and losses, which in turn would be subject to tax. Title to the property cannot be vested in more than 4 trustees. By the doctrine of the trust for sale, each trustee has a duty to sell the property but the power to postpone sale. Since the trust can be

enforced by any interested party, sale of the property could unexpectedly occur unless all the trustees agree to postpone the sale. Although in practice this uncertainty of sale is not considered a handicap, it is a legally binding aspect of direct co-ownership.

Partnership Ownership

According to the Partnership Act of 1890, a partnership is a relationship which exists between two or more persons with the view of making profit, but who are not incorporated. While the partnership holds legal title to the property, each partner is entitled to his pro rata share of profits and gains. However, the divisibility of these rights is again limited. According to the Companies Act 1985, it is "illegal to form a partnership of more than 20 persons which has for its object the acquisition of gain." Any such venture would have to be incorporated under the Companies Act.

Although partnerships are tax transparent, ie income and capital gains are taxable only to the partners themselves, they could pose a slight tax disadvantage to direct ownership. Tax assessments are based on the current tax year's pro rata distribution percentages, even if the current year's percentages were not actually used when the previous years profits were distributed. If a partner's percentage share of income increases during the year, he

would be liable for tax on income he did not actually receive the prior year.

Another offsetting feature of partnership vehicle is the full responsibility placed on each partner in the case of defaults by any other partner. Only limited partners are released of this duty; however, they are liable to the extent of their capital invested. Furthermore, by definition, a limited partner can assume no control over the day to day management of the property. For this reason, limited partnerships are often unacceptable to the sophisticated institutional investor, who views management as critical to the property's performance and may insist on management participation.

Corporate Ownership

Investment in the equity of a publicly traded property company shares is another means of property ownership. Title to the property is held by a company, which in turn is owned by its shareholders. As an indirect form of ownership, shareholders are entitled to the income generated by the property as defined by the board of directors through the declaration of dividends.

Typically, a shareholder of a property company invests in various buildings depending on the portfolio of the company. The company's portfolio is managed by the

executives, who may alter the composition of the portfolio at any time. Therefore, an investment in a property company is evaluated not only in terms of the property it owns, but also in terms of the company's management ability.

Single asset property companies, or SAPPCOs, are also available, as equity investment vehicles in property. Billingsgate City Securities plc, which recently offered debt and equity instruments to the public, is an example of a SAPPCO. Investors in SAPPCOs rely solely on the performance of a particular building, which in the case of Billingsgate City Securities is a 185,000 sf office building let to Samuel Montagu plc. SAPPCOs do not offer the diversity, or spread of risk, that property companies can provide; an investment in one building with possibly a single tenant involves more risk than an investment in various properties with multiple tenants. However, because SAPPCOs are evaluated only on the growth and income potential of one property, they allow for more thorough analysis than a diversified property company.

Companies are recognized in UK tax legislation as legal personae and as such are charged a corporate tax rate on income and capital gains. Shareholders are also taxed on income from dividends and any capital gain on the disposal of their shares. Therefore, the investor in a property company suffers double taxation. Assuming a 35% corporate

tax rate, the penalty of passing income through a corporate entity is effectively 8.45% of distributed income. (See Appendix B for tax treatment of dividends).

Property Unit Trusts (PUTs)

PUTs are open ended pooled funds which offer investors an interest in a diversified portfolio of property. The portfolio is managed by the trustees, and like that of the property company, its composition can change over time.

Because the Department of Trade and Industry has refused to authorise trusts investing in property, PUTs exist in "unauthorised" form only and therefore, carry with them certain marketing and fiscal disadvantages. It is illegal to distribute knowingly, without permission of the DTI, any documents which contain an offer to acquire any units in an unauthorised unit trust. The major exception to this rule is for schemes formed exclusively for investment by pension funds and charities, the "gross funds". Therefore, because they cannot be marketed directly to the general public, most PUTs are available only to the gross funds.

There are also tax disadvantages for unauthorised trusts. Management expenses cannot be deducted when computing trust income. Furthermore, for capital gain tax purposes, the trust is treated like a company and is liable for tax at the full company rate. Unitholders are also liable

for capital gains tax on disposal of their interest in the trust, although most investors in PUTs are tax exempt pension funds and charities.

Since most PUTs have only small borrowings, the value of the units closely reflect the value of the underlying assets. However, because the trustees are obligated to redeem the value of the units upon request from a unit-holder, the assets are not most efficiently invested. The trustees must keep a small percentage of the trust assets in the form of cash or liquid assets to meet redemption requirements. If many unitholders demand redemption, the trustees may be forced to sell some of the trust assets. Therefore, the optimal use of trust assets is prevented by the liquidity of the units.

Unitization

Currently, the industry is also debating the viability of two proposed methods of multiple ownership, or unitization. The first is backed by the Royal Institute of Chartered Surveyors and is characterized as a Single Property Trust (SPT). The second, developed by Richard Ellis and County Bank, is known as the Property Income Certificate (PINC).

The SPT is similar to the Real Estate Investment Trust concept in the US. The trust would acquire a single build-

ing, with legal title vested with the trustee but all benefits of title would accrue to the beneficiaries, ie the unitholders. The trust deed would provide for the appointment of property managers, and would specify the rights of the unitholders. The RICS hopes to obtain DTI approval so that the SPT would be an authorized trust exempt under the Finance Act of 1980 from capital gains tax on investments sold by it. An amendment to the Finance Act of 1980 would also be required so that ordinary income would be taxable only to the unitholder. If the DTI authorizes the trust, the units could be marketed to the general public. The number of investors would not be restricted by law, but the trust would be closed ended with the proceeds used to acquire one property.

The PINCs proposal, on the other hand, would be an investment security having two inseparable parts; an income certificate which would entitle the holder to a share of rental income by right of contract, and an ordinary share in the management company specifically created for the property. Unlike the SPT, the PINC would require no change in existing law. According to Richard Ellis, rental income less management charges and withholding tax would be passed directly to unitholder and subject to tax according to the applicable personal rate.¹ The owner of the building will

¹ Richard Ellis/County Bank.

have the right to decide what percentage of equity in the building will be floated. Although the freehold interest would remain with the owner, the sponsors expect that since the value of the property will be determined by the market over time, the freehold interest will assume only a nominal value.¹ The management company will have a Board of Directors appointed by the shareholders, ie the owner and the PINCs investors. If the owner retains more than a 50% interest in the property, he will control the management of the property. The vehicle is not designed for the small investor, since the unit cost on flotation is expected to be a minimum of L20,000.

Although it is not a revolutionary concept, the single property trust has not been implemented in the past because of legal restrictions. The RICS is now lobbying to change the law to provide for the trust vehicle, but at this point the passage of the necessary changes in the law is uncertain. The PINCs concept, however, does not require any changes to existing law, nor does it take advantage of recent amendments or "loopholes." It's complexity probably explains why it has not been devised before. PINCs relies on the law of contracts instead of the rights of property title. In essence, it is composed of two distinct instruments which, although inseparable, carry with them

¹ Richard Ellis/County Bank.

different rights and obligations. The investor must conceptually understand both instruments, as well as the implications of their combination.

Both proposed schemes have inherent problems which need to be addressed. Both schemes promote majority ownership of units, since control of the building's management will ultimately rest with the largest unitholder. However, frequent shifting of majority interests could result in frequent replacement of the property manager. Long term management of the property would be replaced by short term decisions, which could work against the efficient use of the property.

With the appointment of the management company either indirectly controlled by the SPT unitholders, or in the case of PINCs directly owned, a conflict of interest may arise for the managers. Market demand for the units, and hence the units' trading price, will largely result from annual or quarterly information about the underlying property, such as pro formas, rent reviews and lease renewals. This information would be furnished by the property managers. However, the unitholders will be inclined to replace property managers when their investment is not performing up to par, ie if the units are not returning an adequate yield. Therefore, it would be in the property managers best interest to provide only optimistic information on the property in

order to boost the units' performance and retain investor confidence.

Capital outlay decisions which could enhance the long term value of the property, such as refurbishments or the purchase of adjacent properties, would be decided by majority vote of the unitholders. However, the majority of the unitholders, perhaps naive as to the management of property, may not understand the long term consequences of these decisions. Therefore, necessary and advantageous expenditures may be avoided. This is particularly probable with the SPT in which the general public participates.

The funding of major capital expenditures could also present problems. The RICS and Richard Ellis both propose the issuance of stock with rights of first refusal to the existing shareholders to cover refurbishment or redevelopment costs. However, these decisions must be authorized by the shareholders themselves, who would be confronted with either dilution or additional personal capital commitments should they decide in favor of the expenditure. Furthermore, additional capital expenditures on a property with a stable income stream will lower the return on their investment. In the long run, rental income would rise to account for the expenditure. But in the short term share value may fall, again to the detriment of the shareholder. Therefore, while the capital expenditure may be beneficial for the long term

value of the property, it would not be advantageous to those who would decide whether to make it.

The possibility of fraudulent trading in the units would also exist. The price of the shares would largely be a function of the income capacity of the underlying building. Changes in rental income would be a function of periodic rent reviews. The price of the shares, therefore, would largely depend on the outcome of the review. Significant gains or losses could be made once the market receives the information. This opens the door for insider trading. With a wide range of parties having access to the information before it becomes public, ie the lessor, the valuer, the manager, a supervisory body would have a difficult task in controlling the fraud.

Even if the aforementioned problems with SPTs and PINCs are sorted out by their respective sponsors and the vehicles are introduced to the marketplace, there is no guarantee of their success. Both unitization concepts are new to the investor, so there are no predecessors with which to judge their viability. However, the unitized vehicle can be evaluated in terms of the benefits and disadvantages it will have to other investments available to the different groups of investors.

A unitized vehicle would allow the large insitutions to

partially dispose of buildings which are tying up large amounts of capital. The freed funds would most likely flow back into the property market as the institutions maintain their portfolio allotments. Since unitization promotes majority ownership, the secondary market in units will offer the institutions only minority stakes in various unitized properties. However, the large institutional funds are reluctant to invest in minority ownership of property. Management control over their property investments is a primary investment criteria for the large funds. Therefore, the institution's free funds will probably be directed toward majority ownership or development, not the unitized property market which will most likely offer only minority interests in the secondary market.

Institutions tend to hold their property investments for extended periods, as shown in Table 2. Although the turnover ratio in 1983 was the highest in the period shown reflecting more active portfolio management by the funds, only 3% of total property holdings were sold. The institutions, therefore, are unlikely to relinquish majority control of their investments over much of the useful life of the property. Without the majority of the shares being actively traded, the liquidity of the investment could be hindered.

With regard to the smaller funds, investments in

unitized properties would require them to diversify their portfolios internally. Traditionally, diversification of property holdings was left to the property unit trust in

Table 2: Turnover Ratios (Disposals As Percentage of Assets)

	Property	Gov't Securities	Company Securities
Insurance Companies			
1979	2.6	90.4	10.7
1980	1.5	79.2	14.3
1981	1.6	80.1	15.1
1982	2.2	86.3	17.5
1983	3.1	76.2	20.1
Pension Funds			
1979	1.7	81.2	13.2
1980	1.5	48.2	11.0
1981	1.8	45.5	14.2
1982	1.7	70.7	18.3
1983	3.2	56.4	22.5

Source: Debenham, Tewson & Chinnocks

which they participated. As a result, the small fund may not have the internal expertise to adequately diversify a unitized portfolio. They may prefer the PUT vehicle instead of multiple unitized property investments.

Although the liquidity offered by a PUT can work to the

funds' disadvantage, the unitized market would not be attractive to the small fund until its liquidity was proven. Without liquidity, there will be no incentive for the fund to change their investment patterns and invest in SPTs or PINCs. While the sponsors of the unitized market claim that the small funds would be able to invest in properties which they would not otherwise be able to own, there are no guarantees that unique, high yielding investments will be offered by unitization. The high-performing buildings that large institutions presently control are not likely to be unitized, since the funds will want to retain the benefits. The institutions will instead be inclined to divest the under-performing properties in their portfolio, in spite of the fact that some type of regulatory authority may control the type of properties unitized. The new development schemes of today will be prime candidates for unitization. While these large schemes presently sell at discounts due to their size and limited marketability, once unitization is introduced this discount will disappear, thus bringing the yield on the large developments down to the level of other property investments. The return will, of course, depend on the particular characteristics of the property. But the PUT investment will still be very competitive with an SPT or PINC.

Since the small fund cannot be relied upon to generate liquidity, and the large institutions are not likely to

actively buy and sell shares, the individual investors' participation will be critical in creating a liquid and viable unitized market.

In order to attract the individual investor, the unitized market will need to provide more benefits than the individual's primary investment alternative, ie shares in property companies. Ownership of shares is an established, familiar vehicle for the individual which offers indirect ownership of various properties, in addition to skilled management. While unitization would provide a direct ownership vehicle, individuals are unfamiliar with the ownership of commercial properties and all the rights and obligations thereof. The directors of the property companies are assumed to understand these concepts and are appointed by the shareholders to maximize the benefits of ownership and satisfy all obligations. Direct ownership may not be attractive because it would require the individual to understand the specifics of managing the underlying property. They may prefer to accept the 8% tax penalty for investing through a company structure, and leave these responsibilities in the hands of the directors.

Liquidity is also offered through property company shares. In comparison, the unitized market will rely on the private investors' participation before liquidity will be generated. But in light of the property disaster of the

70s, the individual will be cautious towards a new property investment vehicle. Given the choice between an established liquid market and a market in which liquidity is still in doubt, the investor is likely to chose the former. Therefore, the unitized property market will need to demonstrate clear advantages before the private investor will partake. Without the individual, however, it is unlikely that the market will be able to establish itself. This will lead to a Catch 22 situation.

The property investment companies themselves are another class of potential investors in unitized properties. Unitization would allow them to hold portions of the larger projects they develop, further diversifying their portfolio and spreading risk. Like the large institutional investor, however, they are likely to retain majority ownership of the property in order to control its management. Furthermore, as they diversify their holdings, property company shares could become even more attractive to the private investor, thus further detracting private investment in unitized property. Property company investment could hinder liquidity for units more than it would help.

Multiple ownership of single properties does not seem to be the answer to the funding gap. The traditional vehicles for multiple ownership are inadequate to broaden the base of investor participation in the property market. The methods

of unitization proposed are impounded by legal restrictions, but even if these restrictions were relaxed, investors' attitudes would not support such a property market. The investment substitutes available to the critical support group, ie the individual, are simply more attractive than an investment in a single property.

Furthermore, as previously determined, equity capital provided for new construction is lower in periods when returns on alternative investments outperform the returns on property and when real interest rates are high. Currently, gilts and equities offer higher investment returns than property, and real interest rates are extremely high levels. Therefore, suppliers of capital are likely to finance new development with debt. A new equity vehicle seems inappropriate at this time. Instead, debt instruments should be investigated and refined. The next section examines debt alternatives readily available in the marketplace.

V. The Securitized Debt Market.

As an alternative to equity ownership, investors can partake in property market debt issues. The debt market offers a wide range of instruments, allowing the investor to choose the form of debt which best suits his/her investment criteria. The issuer, in turn, can structure debt in various fashions to meet particular funding needs. The debt markets are appealing to the issuer because full equity interest in the property can be retained. In theory, leverage maximizes the potential for growth and returns to the owner. In the case of a public property company, these benefits would accrue to the shareholder.

Debt financing for property has many advantages over multiple ownership. While the proposals for unitization call for changes in the law, various debt alternatives are available within existing legal boundaries. Most debt issues can be offered to any number of investors in any lot size. The marketability of debt instruments is generally not restricted, so a broad range of investors can participate. Furthermore, although the liquidity of a particular debt instrument cannot be guaranteed, the secondary market for debt is well established and familiar to the investing public.

While equity instruments for the private investor are

doubly taxed, debt does not require a taxed intermediary. Interest on debt is taxed as income only to the unitholder. At the same time, interest on debt can be deducted by the issuer for tax and accounting purposes.

Since debt has priority recourse over shareholders in the event of liquidation of the company, it is considered a safer investment. The payment of interest and principal is usually secured by the assets of the the company. However, if the property company wanted to minimize their liability and protect their portfolio assets, they could establish a wholly owned SAPPCO, in which case secured financing would only provide for recourse to the building alone. In either case, equity interest in the property would remain with the issuer, ie property company.

Investors attraction to property debt instruments was demonstrated by the Safeway Loan Stock issue and the recent Billingsgate Securities offering. Launched in October 1985, the Safeway issue was the first deep discount sterling issue aimed at the UK market. The issue margin of 90 basis points over the $13\frac{1}{2}$ Treasury Stock 2004/08, the benchmark long term gilt, was the lowest achieved at that time by a private issuer. The Billingsgate deep discount issue successfully closed at 115 basis points over the long term gilt, a low margin considering the issue was backed by a SAPPCO. Since traditional long term financing is usually priced anywhere

between 200 and 300 basis points above the benchmark gilt, these low margins also imply that developers can substantially reduce their financing costs by directly accessing the debt market.

The most common types of debt are the traditional bonds, the convertible, the participating, and the deep discount. The traditional bond entitles the holder to periodic payments of interest and/or principal at some contractually guaranteed rate of interest. Interest can be fixed, or vary according to some predetermined indicator, eg Libor. The bond can be secured by the assets of the company, but unsecured debt is also common. Normally the latter will provide a higher return to compensate the investor for the added risk.

The participating mortgage provides for investor participation in future earnings and/or gains upon disposal of the property. Typically income has to exceed a certain level before participation commences. On the downside, the investor is guaranteed a periodic payment, regardless of the income generated by the property. Since the investor can share in future profits, the rate of interest is generally lower than the traditional bond. This provides the issuer with cheaper upfront capital at the cost of reducing his potential future yield.

Convertible bonds entitle holders to convert their debt

interest into equity ownership in the future at a fixed conversion rate. With the expectation of future gain upon conversion, investors are often willing to accept a lower rate of interest than the traditional bond. The main disadvantage of convertibles to the issuing company is that although the issuer will have lower initial capital requirements to support the debt, the conversion will dilute shareholders interest in the company. However, if the underlying equity is not attractive to the investor during the conversion period, the exchange will not occur, leaving the issuer with lower cost financing.

Although deep discount bonds have been legal forms of financing since 1982, it was not until the government clarified their tax treatment in the 1984 Finance Act that deep discount bonds became an attractive source of financing. A bond is deemed to be deep discount if the issue price is less than 85% of the amount payable upon redemption or if the discount exceeds .5% per annum over the number of years between the date of issue and the redemption date. It's obligations are much like those of the traditional bond. The critical distinction lies in the tax treatment of the bond. While the investor is liable for tax on the bond coupon, the issuer can deduct the interest paid as well as a portion of the issue discount. For example, the Safeway bond had a coupon of 3% in the first five years on L100m nominal. The yield to maturity was 11.25%, thus raising roughly L40M for

the company. For tax and accounting purposes, Safeway could deduct L4.5m ($L40m \times 11.25\%$), although they only paid interest of L3m. The L1.5m difference is the amortized portion of the L60m discount. The L4.5m expense leads to a tax deduction of L1.575m at a 35% tax rate, and an after tax cost of only L1.425m. At the same time, most investors are only liable for tax on the L3m interest paid, not the annual accrual of the discount. Investors are liable for tax on the discount only upon disposal or redemption of the bond. Although this accrual is taxed as income, the deferral results in significant tax advantages over the traditional bond.

While debt has its many attractions, the market is not free of disadvantages. Debt is a obligation which must be fulfilled regardless of the income performance of the underlying properties. If property income does not meet expectations, the company may encounter liquidity problems with its debt obligations. A cash drain could hinder future property developments or necessitate a reduction in dividend. It could also force the company to liquidate some of its assets.

The cost of debt is largely a function of economic conditions and is priced in relation to yields on Treasury stock. In periods of high interest rates, new debt may be very expensive compared to other capital financing

alternatives. At the same time, in periods of low interest rates, a company can lock into a low rate of financing. However, investors generally seek short term or variable rate debt instruments in periods of low rates with the expectation that rates will rise in the future. Short term debt to be refinanced in the future, as well as variable rate debt, exposes the issuer to unfavorable changes in interest rates and rising capital costs.

Although the debt may be secured by the assets of the issuing company, investors generally will not accept a loan to value ratio greater than 60 - 65%. This margin protects the investor from a drop in the market value of their collateral. However, the developer of a scheme who wishes to add the building to his portfolio needs only to recoup his costs. If the cost to market value ratio is less than 60 - 65%, the developer can finance the project entirely with a carefully structured debt issue against the building via a SAPPCO.

If the costs of the project exceeded that which could be raised via debt, or if the property company wishes to acquire a building developed externally, a debt issue against the building itself will not cover 100% of the costs. The remaining costs can be financed in various ways without diluting equity ownership. Firstly, the development company can realize it's own portfolio appreciation by issuing debt

against the increase in market value of its assets. A second mortgage would provide capital which otherwise would not become available until the asset was sold.

The developer could also issue warrants for debt which would enable the investor to buy at a predetermined cost a specific issue of debt to be placed on a future conversion date. The developer would collect the proceeds of the warrants, but cash outlay would not be required until the debt was actually issued. This form of financing gears the expected future appreciation of the property. If interest rates rise, the bonds will not be attractive to investors and they will let the warrants expire. The developer gets the warrant premium without any associated costs. Although the new debt issue could prove expensive if interest rates fall, the benefit of upfront interest free capital may outweigh the added cost in the future.

By decreasing the risk of a debt issue in the eyes of the investor, the developer could boost his loan to value ratio and raise more capital on the offering. A well recognized standard of risk measurement is a credit agency debt rating. Standard & Poor's now commonly rates properties for their ability to generate lease income to meet specific debt obligations. A strong S & P rating stands on its own as a sign of a safe investment, and is enough to attract investors who otherwise might not have invested in property.

Among other things, S & P analyzes the lease terms, tenant strength, and quality of the building's construction. Since investors in SAPPCO's only have recourse in a particular building, they are particularly interested in that property's ability to provide for the debt payments. An excellent rating by S & P is viewed as a sound investment, and therefore, could significantly reduce the cost of capital, and/or increase the amount which might be raised.

Since S & P rates the security of the bond obligations, the developer could maximize investor protection by obtaining insurance for the lease payments. The insurer would agree to assume the lease obligations if the tenant defaulted for any reason, thus significantly reducing the risk of investing in a debt instrument on the property. S & P recognizes that insurance minimizes the investor's exposure, and is often willing to award a higher rating on the debt. The cost of the insurance would have to be evaluated against the projected reduction in interest which could result from a higher rating to determine its potential benefit.

If any costs remained to be funded, the company could turn to its own capital resources, which for most development companies is in short supply. With perhaps 60 - 65% of costs covered through a debt instrument, the developer would need additional capital of 35 - 40% total project costs, assuming he seeks 100% financing. The

developer has two alternatives at this stage. He can structure a secondary mortgage with a higher yield. However, as a higher risk instrument, the range of investors would be limited. A secondary mortgage may also prove too expensive to the developer in light of the higher interest rate the secondary mortgage would bear.

Secondly, he can turn back to a shared ownership scheme with the institutional funds or venture capital interests. Without any capital at stake in the project, it may be difficult to maintain majority interest in the project. Those providing the needed funds may claim that they are assuming most of the financial risk in the project and want to be compensated accordingly. However, if the debt was recourse to the developer, then the developer would assume most of the project risk. In this case, the funder should be entitled to a only proportional share of growth and income equal to the percentage of the total project costs, giving the developer the majority of benefits from the project.

VI. Conclusion

Is the funding gap a temporary phenomena, one that will disappear once the yields on property investments outpace those on other investments? Historically, capital flowing into property investment was strongest when property prices were driven down by weak investment demand or when strong occupational demand pushed rental growth steeply upwards. Is the cry for alternative funding merely echoing the developers' need for cash at a time when property is simply not an attractive investment compared to gilts or equities?

While higher allotments from the institutions can be anticipated when, and if, the margin between property yields and yields on gilts or equities narrows, it cannot be expected that institutional funds alone will be able fund the large office and retail projects demanded by todays workforce and consumer. The financing required by these huge schemes will not allow a single lender to adequately diversify his portfolio. As a result, it may be imprudent for even the largest institution to fund this type of project.

The large non-financial institutions and banks, however, are no longer the only financiers for the developer. The private investor has started to play the development game,

and could prove a significant source of funds for the property market. As a distinct class of investors, the individuals' investment criteria differs from that of the institutions. The individual does not have vast resources of the funds, and is generally a shorter term investor than large fund. The property market, therefore, needs to alter the nature of property as an expensive and illiquid investment in order to tap this source of funds.

The proposals for unitization and multiple property ownership seek to address these needs by introducing smaller lot sizes and liquidity for large schemes. However, the ability of a unitized market to generate sufficient liquidity to attract the individual is questionable. The individual must be an active participant in the unitized market in order to generate liquidity in the shares. But as a new property investment vehicle, it is unlikely that he will partake until liquidity is proven because his alternative property investment, ie shares in property companies, adequately suits his needs as an established, liquid market.

Furthermore, historical investment patterns indicate that investors tend to increase their investment in debt instruments when faced with property yields and real interest rates such as those prevalent today. Developers should look to the traditional methods of corporate debt financing

and apply these concepts to property. Debt is an established investment market, and offers a wide range of funding options to the developer. Long term financing at significant interest rate savings can be structured to suit the developer, with the benefits of a high yielding, liquid asset accruing to the investor.

The attractiveness of debt over multiple ownership was highlighted by the owner/developers of the Canary Wharf scheme, who claimed at a recent property market conference that they would prefer securitization over unitization to finance their L1.5b scheme.¹ Their sentiment is probably echoed by many owners of schemes which otherwise would be prime candidates for unitization simply because the unitized market can only succeed with projects that are so promising that everyone wants to own them. The promising projects, however, attract investors and are the easier ones to float debt against. By issuing debt, the owner/developer can maintain a full equity position in the project, and receive all the benefits thereof. Not that developers are stingy, but after all, they are not known to be pass up a sure bet.

¹ J. Scott Lowry, Director Canary Wharf Development Company Ltd. speaking at Profex Conference on Development, Investment and Finance After the Big Bang.

APPENDIX A

Property Investment Vehicles Aimed at the Private Investor.

Residential Property Bonds.

This investment bond is essentially a single premium life insurance policy which can be increased or withdrawn at any time. The units range in size from L50 to L1,000, although minimum investment is usually L1,000. After initial subscription, the price of the units is determined by the value of the underlying fund. Units can be cashed by selling them back to the fund, although the funds usually reserve the right to defer payment. Tax is charged on any profit realized when the units are cashed.

Property Enterprise Trusts.

PETs are designed to take advantage of the industrial building allowances available in Enterprise zones. Established in the form of unauthorized unit trusts, PETs are permitted by the DTI to distribute promotional material to the general public provided they invest in three or more properties. The trust purchases qualified properties in Enterprise zones with the subscription funds received. The allowances which can be claimed for 100% of capital

expenditures on qualified buildings in the Enterprise zones are proportionally split between each beneficial investor in the trust. These allowances can then be used to offset other income in the year of assessment. However, the income on which tax relief was claimed will be subject to a charge if the shares are disposed of within 25 years. Minimum investment is L5,000, with L1,000 unit increments, and redemption is not guaranteed by the promoters.

APPENDIX B

Tax Treatment of Corporate Dividends.

While shareholders are subject to income tax on dividends, UK tax legislation provides partial relief from double taxation in the form of tax credits. The Finance Act of 1970 provides that shareholders may claim as credit a portion of the tax paid at the corporate level on dividends. In 1986, this rate is 29/71 of the distributed dividends. The investor would then pay personal rates on the net dividend after credit.

Assume taxable income of company =	100
Tax @ 35%	<u>35</u>
Distributable income	65
Associated tax credit	
(29/71 x distribution)	<u>26.55</u>
Net dividend	91.55

Therefore, the tax cost of passing income through a corporate entity is 8.45%.

APPENDIX C

A Note on Property Indexes in the UK:

It is important to note that property returns cannot be effectively measured because of the lack of real open market valuations for property in the UK. The indexes published by the various sponsors of market data, ie Jones, Lang, Wooton; Richard Ellis, etc., are calculated by dividing the increase in capital value during the period plus rental income by the value of the property. Since the increase in capital value in any period is based on valuations performed typically by the same sponsor, the actual returns are clouded by the assumptions used in the valuing. The value assigned to a property is not necessarily the value that would be realized if the property was sold. Unfortunately, there is no way of obtaining a true open market valuation because property does not actively change hands. Even the value of Property Unit Trust units is determined by third party valuation, not through an investor pricing mechanism. This contrasts to capital indexes in the United States, where capital values can easily be determined by the value of traded Real Estate

Investment Trust units. Therefore, while valuation-based indices in the UK may be indicative, they are not definitive.

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