

**REIT Here, REIT Now.
Should the UK consider the Introduction of a REIT-style vehicle?**

by

Nicholas A Spencer

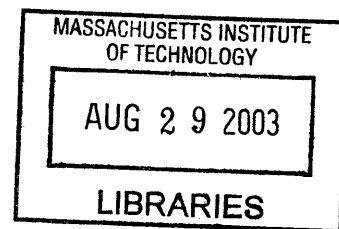
Bachelor of Science in Land Management, 1997
University of Reading, England

Submitted to the Department of Urban Studies & Planning
in partial fulfilment of the Degree of

Master of Science in Real Estate Development
Massachusetts Institute of Technology (MIT)

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ROTCH

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ABSTRACT

This thesis investigates a number of the issues currently pertaining to the introduction of a UK Real Estate Investment Trust (REIT) vehicle. It uses a combination of qualitative and quantitative studies to evaluate whether the UK government should investigate and pursue this form of property equity securitisation. The report is split into three parts.

The first describes the history of the UK securitisation lobby and investigates the theory and characteristics of the US REIT vehicle. It describes similar vehicles used throughout North America, Europe, Asia and Australia with specific regard to their varying restrictions and regulations.

The second section uses Modern Portfolio Theory to examine the benefits of a securitised property vehicle within a mixed asset portfolio. The exercise tests the theory that the UK Public Limited Company is at a disadvantage to the American REIT and the Australian Listed Property Trust. Finally, an American REIT and an American C-Corporation are compared in a valuation exercise to assess the magnitude of the US REIT's tax benefits.

The final section draws from the previous analyses to present a qualitative discussion of the key arguments with regard to different participants in the UK property market. In conclusion, it considers the pros and cons of a UK REIT vehicle in light of current UK macro-economic issues.

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Research for this thesis would have been inconceivable without the cooperation, guidance and generosity of the many industry professionals who took the time to speak to me. Many have been intrinsically involved in the UK-REIT lobby, and I am grateful to all those who shared their knowledge and insights. Since the lobby is ongoing, I feel it is only politic to respect their anonymity, but I look forward to returning their numerous favours in the future.

I would like to thank my thesis advisor, David Geltner, for his patience and guidance. His enthusiastic interest in this subject inspired me to take such a broad task to hand over such a short period of time.

My sincere thanks also go to the many clients and colleagues who encouraged and supported my decision to pursue a Master's degree. Special mention must go to David King and David Marks, without whom I never would have discovered MIT; to Steve Mallen and John Snow, whose unerring support helped make this year possible; and to Stephen Benson and Miff Chichester who have helped keep me up-to-speed with the London market.

Finally, I owe heartfelt thanks to my Dad. Not only for inspiring me to get into the property-game, but also for giving me the opportunities that he never had.

FOREWORD

Over the course of the past year, whilst studying at MIT, I first learnt about REITs. Having spent virtually my entire professional life in the UK, the REIT concept struck me as a wonderfully sensible property vehicle for the “man in the street”. It sparked my enthusiasm to write this paper. By undertaking this study I have learnt a great deal more about REITs, but acknowledge that this is only the tip of the iceberg.

In choosing to focus on the issue of whether or not the UK should consider introducing a REIT, I had stumbled across a very topical issue. The subject is now being discussed on a fairly regular basis in the UK property press, and new data and reports have been published during the course of my research (July-August 2003). I have tried to keep all data and reference as current as possible for the purposes of my analysis. Any errors or omissions are, of course, the author's.

The report is predominantly written in “English” English but I take this opportunity to apologise for any unconscious lapses into “American” English, in terms of both spelling and phraseology. To quote Leon Clore¹, “If Americans didn't speak English we'd have no problem!”

NS

¹ - a 1950s film producer, quoted in the New York Times, July 1980

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CHAPTER 1 INTRODUCTION

Background

Commercial property, by virtue of its heterogeneity, typical lot size and required capital outlays has often been considered a lumpy and illiquid asset, requiring costly and time-intensive management. These negative characteristics have historically influenced the pattern of real estate ownership and created barriers of entry for private investors – that is, until the establishment of the REIT in the United States in 1960.

The US Real Estate Investment Trust (REIT) is a securitised vehicle that facilitates indirect ownership of real property, mortgage assets, or a combination of both. It can be held privately or traded publicly. Rather than participating directly in the ownership of the underlying assets, investors buy and sell units in the REIT, which acts a conduit. US Congress waived corporate level income tax for REITs. This reflected real property's status as an independent asset class (versus an operational corporate entity) and stimulated investor interest in the new vehicle. However, in order to elect REIT status, a number of regulatory criteria had to be met. These criteria are discussed in detail in Chapter 2.

Besides the US, REITs² have become established in many countries. Notable examples include Australia³, Belgium⁴, the Netherlands⁵ and more recently, Japan⁶. Despite local variations, the common themes unifying the structures of all countries' REITs include tax transparency, corporate tax exemption and liquidity, as well as ownership and dividend regulations. In January 2003, France approved the introduction of its REIT-style instrument, the SIIC (Societe d'Investissement Immobiliers Cotees), leaving the UK as the only G7 country without a comparable investment vehicle. The French policy re-ignited a longstanding debate between the UK Government and the commercial property industry regarding the introduction and benefits of a UK REIT.

A brief history of UK real estate 'securitisation' will be examined later in this chapter. The UK has had a substantial quoted property sector since the late 1960s, however, Public Limited

² (Or their equivalents)

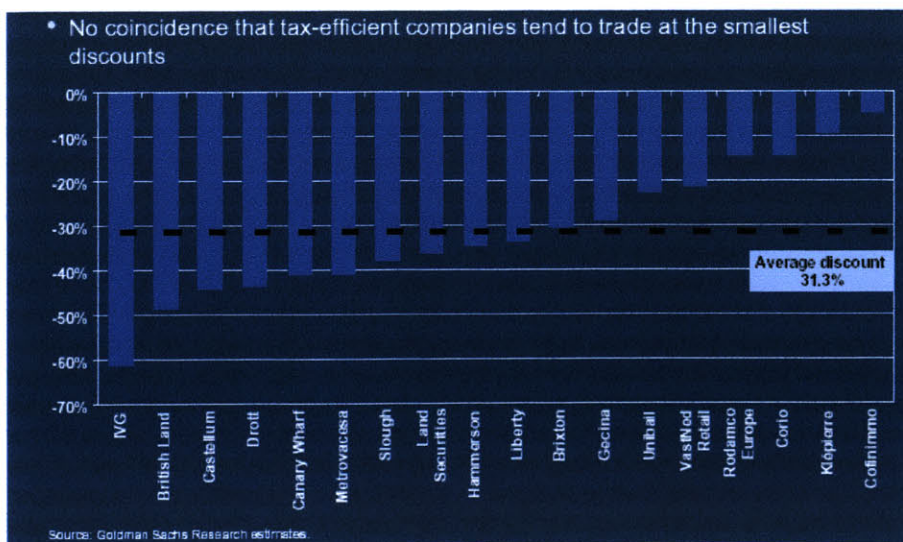
³ The Australian Listed Property Trusts (LPT)

⁴ The Belgian Societe d'Investissement a Capital Fixe Immobiliere (SICAFI)

⁵ The Netherlands' Fiscale Belegginginstelling (FBI)

Companies (Plcs) have often traded at a substantial discount to net asset value. Investors have been concerned that these discounts prevent the quoted companies from providing a true and efficient conduit to the underlying property assets. Unlike the typical REIT model, UK quoted property companies are not subject to special tax privileges or other specific operational regulations. Many investors hold the view that a REIT type vehicle would provide a fairer model for property investment, reflecting the characteristics of direct ownership within a stock market framework.

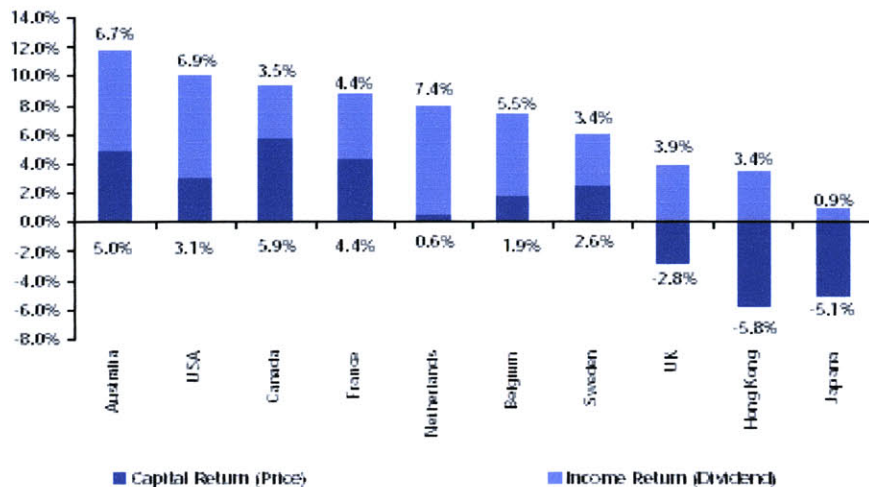
In March 2003, Goldman Sachs produced a report encouraging ‘tax harmonisation’ across European real estate markets⁷. The report illustrates how countries offering a REIT structure provide a competitive advantage for their quoted real estate sectors. The abolition of the Advance Corporation Tax (ACT) in 1997 had significant consequences for the UK quoted property sector. Previous to the abolition, (property) companies paid ACT on the dividends they intended to distribute. At the same time, the ACT offset ‘normal’ corporation tax liabilities. At the investor level, tax exempt shareholders were able to claim this tax back via ACT Credit to increase their total gross dividend. Following the ACT abolition, major pension funds and charities had little incentive to hold property interests indirectly. This reduced overall investment in the quoted sector, in terms of both money and research. Goldman Sachs noted that companies with tax efficient structures also tend to trade at the smallest discounts to Net Asset Value, compounding their advantage.



⁶ The Japanese J-REIT

⁷ Pan European Real Estate, Tax Harmonisation in the Evolving Market – Goldman Sachs, London, March 2003

Deutsche Bank took the argument a stage further⁸, recommending the introduction of a UK REIT as the potential ‘saviour’ for the quoted property sector. This was largely due to their strong income characteristics (below). Deutsche exemplify the “transfer tax” introduced by the French SIIC as a fundraising method to nurse an ailing UK budget deficit. Other 2003 reports by Merrill Lynch and the European Public Real Estate Association (EPRA) serve to strengthen the industry case for a tax efficient vehicle⁹.



Note: Australia, USA, Canada, Netherlands, Belgium had REIT structures for at least half of time period. UK, Sweden, Hong Kong and France did not have REIT structures over the time period. Japan only had a REIT structure for one year of the time period.

Source: EPRA

Pro-REIT lobbyists argue that the introduction of such a vehicle will enhance the UK property industry in terms of liquidity, tax transparency and both informational and overall market efficiencies. The secondary benefits include reduced risk for the private and institutional investor through portfolio diversification, as well as reduced property costs to occupiers through competition encouraged by a lower industry cost of capital. Other potential benefits include economies of scale and improved industry monitoring and benchmarking. The UK government has historically rejected plans to introduce a REIT amidst fears that it would reduce tax receipts¹⁰. At the 2003 UK Budget, Treasury Minister Ruth Kelly was quoted, (overleaf)

⁸ Pan European Property – Deutsche Bank, May 2003

⁹ Quoted explicitly in Chapters 2 & 6

¹⁰ Treasury Opens Door to UK REITs – Property Week, 25 April 2003

“Commercial property is an important factor of production...the Government’s long-term aim is to remove tax distortions and facilitate an efficient property sector that can better support its economic and social objectives.”¹¹

Following this headline-grabbing (although somewhat nondescript) indication of the Government’s objectives, Ms. Kelly was quoted once again, during an interview with the UK property press,

“A number of countries have introduced tax-efficient property investment vehicles and we need to look at the evidence of how these worked and what they have achieved. The (UK) property market is uniquely complex and not as efficient as it might be.”¹²

The potential effect of a UK REIT on tax-revenues was studied in 2000 by a team of industry researchers led by Arthur Anderson¹³. The potential tax implications were found to be largely neutral. The UK real estate industry allegedly shelters around 50% of taxable income by holding it offshore, preventing the government from reaping its ‘pound of flesh’. In the case that REITs are *not* introduced, it must be a genuine government concern that UK companies will seek further offshore or overseas structures in order to avoid the penalties of the UK tax regime.

In light of continued industry lobbying by the British Property Federation (BPF), the Investment Property Forum (IPF) and the Royal Institution of Chartered Surveyors (RICS), the UK Government now appears to be adopting a more pragmatic standpoint regarding the future research and possible implementation of a US-style REIT vehicle.

External factors may also have influenced the Government’s opinions towards REITs. All the other G7 countries now either have a REIT-type structure, or are in the process of implementing one. The European Union has expressed an interest in the UK REIT issue as a result of its openly stated objective to harmonise tax policy and facilitate cross-border investment¹⁴.

¹¹ UK Inland Revenue, Budget 2003 Press Notice PN 05: Modernising the Taxation of Property

¹² “What’s the Treasury’s Game?”, Property Week, 30 May 2003

¹³ Property Securitisation in the UK, Arthur Anderson, Donald Robertson and Andrew Scott, 2000

¹⁴ EPRA CEO Nick Van Ommen, quoted in Estates Gazette, 17 January 2003

The implementation of the Myners Report¹⁵ is likely to influence the behaviour of institutional investors towards their UK real estate holdings, and the implications of the Basel Accord could be far-reaching within the UK property industry.

Given its requirements for banks to reduce gearing and exposure to lending on commercial real estate, the Basel Accord will rely on securitisation as one method to divest risk¹⁶. Finally, the current UK pensions crisis is forcing the government to devise new methods of investing for private and institutional investors, particularly whilst the bond and equities markets continue to languish. Similar pension crises in America and Australia have bolstered their respective REIT and LPT markets due to the capital and income growth characteristics of real estate.

Despite the proliferation of press commentary, relatively little formal research has been published on the subject of introducing a REIT to the UK property market. The purpose of this thesis is to identify and examine the feasible arguments for the inclusion of a new vehicle in the UK property market and to suggest further areas of study.

The study is intended to educate and inform the layman about key REIT concepts and characteristics. The US REIT's perceived "Holy Grail" status within the UK market has often led to misunderstandings regarding the true benefits of the vehicle. This report presents an introduction to the theory and history of real estate investment trusts. It utilises a combination of quantitative and qualitative data to discuss the potential benefits, or drawbacks, of a REIT for UK property ownership. Specific areas of interest include the role of a REIT within a mixed asset portfolio; the true magnitude of the REIT single-layer tax benefit; and examples of REIT successes and failures in other countries.

¹⁵ http://www.hm-treasury.gov.uk/Documents/Financial_Services/Securities_and_Investments/fin_sec_mynfinal.cfm

¹⁶ The Case of the Missing Real Estate Cycle, Bank of International Settlements, Quarterly Review 2002

A Brief History of Real Estate Securitisation in the UK

Securitisation is technically defined as “the substitution of tradable paper securities for privately negotiated instruments”¹⁷. In the specific case of real estate, securitisation refers to the pooling of equity shares or debt loans and other receivables, and the subsequent division and issuance of paper securities that are backed by the pool. The term ‘securitisation’ is most often applied to a debt-related income flow, and almost any income-producing asset can be securitised. This thesis is primarily concerned with the securitisation of tax efficient equity interests, but it also describes the relevant relative growth in Commercial Mortgage Backed Securities (CMBS) and Asset Backed Securities (ABS) over the past two decades.

Technically speaking, the UK currently has a ‘securitised’ property equity vehicle, apparent in the form of the Public Limited Company (Plc). In this report however, the term ‘securitisation’ is used to describe a REIT-style vehicle, reflecting a tax-transparent equity instrument that is regulated in terms of leverage and dividend requirements¹⁸.

In the absence of an alternative vehicle, private investors wishing to hold low denominations in commercial real estate have typically resorted to share ownership of FTSE-quoted property Plcs. Although studies show a positive correlation between the performance of the UK direct property sector and UK quoted property companies¹⁹, investors have often lacked the benefits of the underlying property performance, due to double-layer taxation²⁰ and the retention of substantial profits to fund development activity and future growth.

UK quoted property companies have often traded at a significant discount to Net Asset Value (in many cases ranging from 20-35%), a factor considered when examining the magnitude of REIT tax benefits in Chapter 4. The quoted property sector accounts for approximately 1.5-2% of total UK stock market capitalisation. Trading discounts are reducing the sector further, by inspiring investor malaise, privatisation, management buy-outs and other de-listing events.

¹⁷ Principles of Corporate Finance, Brealey & Myers, 2003

¹⁸ The issue of terminology is discussed later in Chapter 1, and in Chapter 6

¹⁹ Price Discovery in American and British Property Markets, Barkham & Geltner, 1995

²⁰ Corporate Level Income Tax main rate 30% and Personal Level Income Tax top-band 40%, www.inlandrevenue.gov.uk

Developments in UK securitisation are examined below, initially in terms of equity vehicles and then in terms of debt instruments. A brief synopsis of each will serve as a context for the main body of research.

Equity Vehicles

The Unauthorised Property Unit Trust (PUT) was launched in the early 1970s as a collective investment vehicle for unitised real estate equity. However, participation was limited to institutional investors. Tax exempt pension funds and charities could invest in ‘Exempt’ Property Unit Trusts²¹. The PUTs were not listed and secondary trading was rare. PUTs were monitored and regulated by the Association of Property Unit Trusts²². The Association currently has 27 members with total assets in excess of £6billion²³.

The Barkshire Committee was established in the early 1980s to research property securitisation. In 1986 it presented “The Barkshire Proposal”²⁴, which supported the creation of a unitised vehicle aimed at private, retail investors. Real estate’s inherent lack of liquidity had been emphasised by Barkshire's research. Ironically, this hindered the asset’s perceived adequacy for unregulated Unit Trust vehicles, due to regulations governing the ‘timely realisation’ of investments.

Following the findings of the Barkshire Committee, alternative unitisation instruments were conceived, such as Single Property Ownership Companies (SPOTs), Single Asset Property Companies (SAPCOs) and Property Investment Certificates (PINC)s. The broad purpose of each was to enable private investors to participate in the capital and income benefits of commercial property ownership. Of the three, PINCs offered the most promise, with an approved London Stock Exchange listing and an uncomplicated trust structure to ensure single-layer taxation. However, by the time all the necessary approvals had been obtained, the property market had begun its now legendary decline. Unfortunately low investor demand, coupled with dubious projected performance levels, would not warrant the launch of a new property instrument.

²¹ Liquidity and Private Property Vehicles, Where Next? – University of Reading & Oxford Property Consultants, 2001

²² (APUT) established in 1971 and formalised in 1986.

²³ The Association of Property Unit Trusts website - <http://www.aput.co.uk>, June 2003

²⁴ Securitisation in the Commercial Real Estate Market –Australian Graduate School of Management, Harbour, 1999

In 1990, the London FOX Futures market launched various property-related futures contracts based on interest rates, a house price index and the Independent Property Databank (IPD) indices²⁵. Although this was a step in the right direction, in 1991 the industry again lobbied the Government for a liquid, transparent collective investment vehicle. Property was in the midst of one of a harsh recession and although this created some ‘vulture’ opportunities, the majority of banks were fiercely defending their loan books while they nursed their wounds.

In an effort to help the industry recover, new Financial Services (Regulated Schemes) Legislation introduced the Authorised Property Unit Trust (1991). The Trust was capable of listing on the London Stock Exchange (LSE) and was open to all investors. It was subject to stringent regulations and governed by the Financial Services Authority (FSA). The Authorised Property Unit Trust was limited in terms of leverage, portfolio distribution, annual valuation and open-ended status. Of the 27 current APUT members, only two are Authorised. No Authorised trust has ever been listed²⁶.

The Authorised Property Unit Trust soon became another vehicle that failed to deliver the promised panacea. As if to further antagonise the property industry, when investor interest in the London FOX Futures Market finally gathered pace, the trading of ‘Property Futures Contracts’ was suspended following an investigation into alleged trading irregularities.

In 1993 the economy began to strengthen and the property market started its cyclical upswing. Institutions led the resurgence due to their low cost of capital. Private equity investors followed suit, increasing their activity through the use of Limited Partnerships²⁷ and Single Purpose Vehicles. Both were tax transparent and offered the ability to exploit certain tax loopholes, perhaps most notably Stamp Duty. The quoted property sector slowly recuperated through increased stock market activity and the improving underlying asset values. Towards the middle of 1994 banks began increasing the flexibility of their loan-books and loan to value ratios.

In late 1995 the Investment Property Forum published a report entitled ‘Property Securitisation’. Once again it appeared that the Government might take REIT proposals seriously.

²⁵ Property Securitisation, Working Group of the Investment Property Forum, 1995

²⁶ “A Taxing Issue”, Estates Gazette, 7 December 2002

²⁷ Regulated by the Limited Partnership Act of 1907

From 1995-1996 the London Stock Exchange co-operated with the Government to support the introduction of Housing Investment Trusts (HITs). Residential investment vehicles were a long way from the 'Holy Grail' of commercial REITs, but were an undeniable step in the right direction. The HIT aimed to attract investment into the private rental sector, whilst offering the benefits of reduced Corporation Tax and Capital Gains Tax exemption²⁸. In June 1996, The Times wrote,

“The Stock Exchange is ready to allow Housing Investment Trusts a listing in London without the usual 3-year qualifying period, in an effort to encourage support from investors”.

The incentives did not ignite investor enthusiasm and take-up was poor. In the 1998 Budget, the Government failed to respond to industry calls for HITs to be totally exempt of Corporation Tax. In addition, the vehicles were burdened by prohibitive restrictions on valuations, gearing and overall size²⁹. Nick Raynsford, then Planning Minister, commented,

“(Housing Investment Trusts’) potential foundered, essentially because the rules were too complicated and subsequent changes to the tax system damaged their transparency. I hope lessons have been learned from this.”³⁰

He followed this comment by telling the Press that the Government was once again seriously considering the introduction of REIT style real estate securitisation to the UK. This time it would be in the form of two vehicles; one for residential properties and one aimed at the commercial market. The Government continued to research the proposals in discussion with the BPF, IPF and RICS. Meanwhile, the Limited Partnership cemented its status as the vehicle of choice for much of the industry.

In November 1999, the “Limited Liability Partnerships (LLP) Bill” was introduced, with the primary purpose of creating a new structure for professional firms (surveyors, accountants etc.). Astute investors thought the proposed LLP might also present sufficient flexibility to allow shares to be traded. The UK Limited Partnership had been a highly successful tax transparent entity,

²⁸ Property Securitisation, IPF, November 1995

²⁹ Estates Gazette, 18 March 1998

³⁰ Estates Gazette, 03 December 1999

limited to 20 partners overall, with a single Managing Partner. The new LLP proposals did not moderate an upper limit to the number of contributory partners, and suggested that all partners would be vested with equal management powers. Industry leaders such as Alastair Ross Goobey³¹ commented on the potential for the LLP, although others took a more cautious approach. Angus McIntosh, then Head of European Research at Richard Ellis St. Quinton, acknowledged the industry excitement but warned,

“(The LLP) may create more confusion. We are looking for parliament to give us a clear legal framework for a tradable securitised vehicle, which would create market certainty, so people know what they are buying into.”³²

Although Limited Partnership shares have been traded on a rare few occasions, neither the LP nor the LLP has provided a viable solution to the REIT issue.

In March 2000, the IPF presented their “Property Securitisation in the UK” report to the Government. Arthur Anderson, London Business School and Cambridge University’s Land Economy faculty had prepared the report and it was presented to a combination of ministers and civil servants from HM Treasury, the Inland Revenue and the Department for the Environment Transport & the Regions (DETR). The report analysed the potential effect of a UK REIT on Government tax revenues. The impact was found to be on ‘the positive side’ of neutral, and the debate remained open.

Amidst the buoyant property market, the use of limited partnership funds and property unit trusts grew significantly from 1998-present day. They are now widely referred to as the Private Property Vehicle (PPV) market. Fund managers such as Schroders, Morley Fund Management and Standard Life are the industry leaders in a sector of the real estate market that comprised 186 vehicles worth an estimated £29billion in June 2003³³.

³¹ Then Chief Executive of Hermes and President of the IPF – Estates Gazette 07 January 2002

³² Estates Gazette, 07 January 2002

³³ Property Vehicles Databank, Oxford Property Consultants & IPD

The poor performance of equities over the past three years has caused many fund managers to increase their portfolio weighting in property from less than 5% to between 7.5% and 10%³⁴, through a combination of direct and indirect investment. The growth of innovative funds and trusts is an indication of the private investor demand for a tax transparent, tradable, liquid vehicle. In the absence of a REIT these various funds present the best alternative and have prompted new market entrants such as Close Brothers and Matrix.

Despite industry developments, the PPV market shows very little uniformity across vehicle structures. Descriptions of the competing entities use labels that include managed funds, unitised funds, pooled pension funds, unit trusts and limited partnerships. Most of the vehicles are tax transparent at the corporate level although others are entirely tax exempt, depending upon the unique characteristics of their investors. There is a combination of onshore and offshore activity within the PPV market and very few entities publish their data.

As a result of the sheer variety of entities and the lack of widespread disclosure it is difficult to carry out an “apples versus apples” performance comparison. In providing investors with tax efficient indirect property ownership, funds have been forced to forego many of the benefits that a true REIT would offer. Informational efficiency is generally poor. In a heterogeneous industry where data analysis is complex at best, performance statistics are the domain of professionals and are relatively inaccessible to private investors.

Unlike other countries’ REITs or the UK’s own property stocks, the Private Property Vehicles are highly illiquid. Secondary trading data for Limited Partnerships is rare and unit trusts rely wholly upon market makers to facilitate sales. In November 2002, Schroders’ Jersey-based Hercules Unit Trust began trading units “on-screen” through a system devised by Cazenove. Despite this development, the trust denied intentions to create a fully tradable market, as the spread would not justify the efforts of the market maker. The lack of widespread liquidity, informational transparency, low entry-barriers for private investors and a uniform regulatory framework all serve to dispel any comparisons with a typical securitised vehicle.

³⁴ William Hill, CEO Schroders Real Estate, quoted in the Estates Gazette, 21 June 2003

Equity Securitisation - The Current Outlook

The UK Government now appears to be more receptive toward calls for an objective, meaningful debate about the introduction of real estate equity securitisation³⁵. Tax revenues are no longer touted as the primary issue and the Government has asked the property industry to prepare, “a robust macroeconomic case for a tax transparent property vehicle”³⁶. It is assumed that in order to be successful, any proposal will have to present a united industry case, and demonstrate the potential benefits of a UK REIT to private investors, property occupiers, the pensions industry and Government.

Accordingly, the Property Unit Trust market is conscious of exploiting its relative, and perhaps temporary, competitive advantage. As the Association of Property Unit Trusts states on its website,

“Unauthorised PUTs are currently the closest to offering a truly tax effective property investment vehicle. The Treasury has recently announced that it will not support the creation of US style REITs (Real Estate Investment Trusts) which means that PUTs are now ideally placed to take full advantage of this market place.”³⁷

The interpretation can be argued semantically, but by discussing REITs and PUTs in this manner, it almost appears that the Association is acknowledging that if a REIT *was* available, it would be a better choice for the private investor!

³⁵ June 2002 – June 2003

³⁶ Estates Gazette, 28 April 2003

³⁷ <http://www.aput.co.uk/faqs.html>

Debt Instruments

The first UK ‘asset-backed’ securities were Residential Mortgage Backed Securities (RMBS) issued by National Home Loans in 1987³⁸. The majority of early securitisation involved residential mortgages, although home equity loans, car loans and credit-card payments were soon accepted as suitable securitisation receivables. Approximately £21 billion of asset-backed securities had been issued by early 1996, of which approximately half could be attributed to residential mortgages³⁹. Outside of the United States, the UK is the most developed securitisation market in terms of both volume and variety of assets. High-profile transactions range from the 1999 asset-backed securitisation of British Land Plc’s Broadgate Centre, to the securitisation of future revenues generated by Bernie Ecclestone’s Formula One in 2000. Morgan Stanley and WestLB advised the respective parties in each case.

It is important to address the issue of unclear terminology within the UK property securitisation market⁴⁰. There appears to be a lack of consensus amongst market players, banks and rating agencies on the exact definitions of mortgage-backed, asset-backed and income-backed securitisation. A lack of precise terminology is partially attributable to the nature of the underlying assets and the common law governing securitisation structures and collateral assets⁴¹. The following paragraphs provide an indication of the poorly defined boundaries.

Commercial Mortgage Backed Securities (CMBS) are supported by collateral in the form of loans on income producing properties. They can comprise newly originated loans or seasoned loans, single loans or (more commonly) pooled loans, loans from the originators or from conduit lenders and loans underwritten by single or multiple borrowers⁴². The credit structure defines the claims over the underlying property asset(s) in the event of default.

Asset Backed Securities and Income Backed Securities often describe similar structures when viewed in the context of commercial property. One example applying to both is the securitisation of a lease structure - a somewhat ‘grey’ area in terms of exact definition.

³⁸ Handbook of Structured Financial Products, Fabozzi, 1998

³⁹ National Home Loans, the Mortgage Corporation and the Household Mortgage Company. Source, Hand book of Structured Financial Products, Fabozzi, 1998

⁴⁰ Financial Innovations in the Property Market, Corporation of London & RICS Research Foundation, Lisieri, Ward & Palmer, 2001

⁴¹ Asset Backed Securitization in Europe – Baum and Wymeersch, 1996

⁴² Handbook of Structured Financial Products – Fabozzi, 1998

In terms of an Income Backed Security, the asset would be the lease itself. In the case of an Asset Backed Security, the asset might be the lease and / or the underlying property. In the case of a Sale & Leaseback the asset can be the lease obligation itself or the underlying property. To complicate matters further, the term ‘Commercial Mortgage Backed Security’, as well as referring to mortgages, is sometimes applied to the pooling and securitisation of rental income derived from the underlying property asset.

Fortunately, this thesis does not focus on the semantics of debt securitisation. Whatever label is applied to the various types of transaction, the ownership of future cash flows is sliced and diced according to uniform rating principles. The potential risks associated with credit, liquidity, revenue, maturity and collateral are all accounted for when the security is priced.

The early 1990s saw the UK property debt securitisation market gather momentum. In 1994, Goldman Sachs advised United Bank of Kuwait and Bristol & West on CMBS placings, raising £108m and £150m respectively against pools of largely ‘AAA rated’ loans⁴³. In August 1999 Morgan Stanley became the first US bank to issue a bond supported by UK commercial property debt⁴⁴. By mid-2001 Morgan Stanley had issued five further bonds secured against UK properties with a total value in excess of £2.5billion. In early 2002, Fitch, Moody’s and Standard & Poor’s each noted the tremendous growth in the European CMBS. They predicted total issues that year in excess of £15-16billion and the UK was identified as the primary focus for this activity.

Over a similar period, Asset-Backed securities also gained in popularity. Between 1997 and 1999 Nursing Home Properties conducted three Asset-Backed Bond issues secured against leases on care-homes in their portfolio. Advised by JP Morgan and Dresdner Kleinwort Benson⁴⁵, they raised a total of approximately £560m. At the same time, a number of large transactions raised the public profile of Asset-Backed Securities. In November 1997 £550m was raised in the Eurobond market on the back of the rental stream from Canary Wharf Plc’s Financial Centre⁴⁶. Again, Morgan Stanley underwrote the bond. Shortly thereafter, in early 1999, Morgan Stanley advised British Land Plc on raising a £1.54billion bond issue backed by income from the Broadgate Estate in the City of London.

⁴³ Financial Innovations in Property Markets – RICS Foundation, 2001

⁴⁴ Estates Gazette, August 1999

⁴⁵ Estates Gazette, November 1999

⁴⁶ Estates Gazette, November 1997

In 2001, British Land Plc followed up the Broadgate deal with the £575m securitisation of thirty-five Sainsbury's supermarkets and a £900m bond-issue supported by the rental income of the Meadowhall Shopping Centre, Sheffield. However, the market did not comprise Morgan Stanley and British Land alone.

From 1999-2003 the UK and European debt-securitisation market grew exponentially. Bonds have been used to finance Private Finance Initiatives (PFI) and corporate outsourcing for a variety of government departments and private sector occupiers. These transactions have been devised and structured by an increasing variety of British, American and German banks as well as the 'Big 5' accounting practices. In June 2003, GMAC Commercial Mortgage, a US lender with a global property loan-book in excess of \$134billion, expanded its UK activity with the securitisation of UK property loans in a joint venture with Deutsche bank. The continued interest of global players such as GMAC, which only committed to the UK market in 2001, will undoubtedly continue to drive and develop the role of securitisation in commercial real estate.

Debt Securitisation - The Current Outlook

The European debt-securitisation market has grown exponentially over the past decade, unifying global capital markets and enhancing opportunities for private and institutional investors. Commercial Mortgage Backed Securities are unique in the manner by which they allow investors to access the cash flow components of underlying mortgages on a risk-targeted basis. The various tranches are rated and priced according to maturity and likelihood of credit default.

At the bottom of every pool is the Interest Only (IO) tranche. It has no par value and no claim to cash flow from the principal loan capital. The IO tranche receives superfluous cash flow, unclaimed by the other tranches once they have honoured their coupon obligations. Although the IO tranche is highly sensitive to default and prepayment risk, when market interest rates rise causing a lower incidence of prepayment, the IO tranche can actually grow.

The result is a debt-based security whose value actually increases with an interest rate rise⁴⁷. This type of hedging instrument is illustrative of the innovations offered by the debt securitisation market. It is necessary to question why the equity side of the market has lagged so far behind.

Critics suggest that until recently the UK Government was relatively content with the status quo in the commercial real estate market. The residential market has often been a priority, and commercial investors have been content to work within the established industry framework. As the market has become increasingly sophisticated, it has exploited loopholes in the legal and regulatory framework in an effort to compete for fiscal efficiency.

The increased threat of foreign competition, an alarming pension crisis and the forthcoming Basel Accord regulations are now forcing the Government to consider its options a little more carefully. The objective of this study is to clarify these issues and consider whether a REIT might be a natural progression for the UK economy.

⁴⁷ Commercial Real Estate Analysis & Investments, Geltner & Miller

CHAPTER 2 -

A BRIEF HISTORY OF REAL ESTATE INVESTMENT TRUSTS

US REITs

The Real Estate Investment Trust (REIT) is a securitised vehicle that facilitates indirect ownership of real property, mortgage assets, or a combination of both. It can be held privately or traded publicly. US Congress created the first REIT vehicle in 1960 as a means to enable widespread public ownership of large commercial real estate assets. For the purpose of this report, the United States will be treated as “the benchmark” case study, due to its status as the birthplace of the REIT and its current position as the world’s most developed REIT marketplace.

The US REIT concept dates back to Massachusetts in the mid-1800s, at which time corporations were prohibited from investing in real estate under State law. The Massachusetts Trust was designed to facilitate real estate investment through a structure of transferable ownership shares and centralised management⁴⁸. The Massachusetts Trust was originally embraced by ‘wealthy’ investors but it was made available to public investors soon thereafter. To differentiate the Trust from an operational corporate entity The Massachusetts Trust was exempt from Federal Taxation, allowing rental income to flow directly to investors, as if the property was held directly. This form of Trust spread to other States throughout the early 1900s, bolstered by the favourable single layer tax status. In the 1930s and ‘40s, however, federal tax benefits were reduced in a move to encourage the adoption of the newly created Closed-End Mutual Funds⁴⁹. Over the next 20 years the few remaining Massachusetts Trust owners, and a vocal real estate industry, lobbied Federal Government for the equitable tax treatment of real estate investors. In 1960, US Congress finally levelled the playing field by creating the Real Estate Investment Trust, a vehicle dedicated to the real estate industry with a similar tax ideology to that of a Closed-End Mutual Fund.

⁴⁸ Real Estate Investment Trusts, Chan Erickson Wang - 2003

⁴⁹ Governed by the Investment Company Act of 1940

The Committee Report that supported the congressional legislation stated,

“...equality of tax treatment between the beneficiaries of real estate investment trusts and...regulated investment companies is desirable since in both cases...the methods constitute pooling arrangements whereby small investors can secure advantages normally available only to those with large resources.”⁵⁰

Most early REITs invested in real property, and were classed as “Equity” REITs. The economic landscape of the early 1960s was not ideal for the launch of a new investment product due to poor market conditions. Simultaneously, the need to educate investors and financial advisors about the new product caused REITs to get off to a fairly slow start. By the mid-1960s there were approximately 65 Equity REITs in existence and both investors and managers were learning the importance of cash flow. The majority of new REITs created towards the end of the 1960s were Mortgage-focused, often with the purpose of funding development and construction, but also looking to take advantage of property’s depreciation and tax shelter attributes.

The 1970s ushered in an era of high interest rates and increasing construction costs⁵¹. These were risky investment times with high occurrences of default and bankruptcy. The 1976 Tax Reform Act allowed REITs to carry losses forward over 8 years, providing increased flexibility to survive the worst of times. Most equity REITs survived the downturn but the mortgage and hybrid REITs, due to their exposure to default, suffered many casualties. Many foreclosed on loans, and either sold collateral cheaply to balance their books or re-established themselves as Equity REITs with their new real property portfolios.

Until the mid-1980s REITs had operated as fairly passive investment vehicles, in keeping with the Closed-End Mutual Funds they had originally been designed to compliment. However, the 1986 Tax Reform Act altered the original “REIT-Rules” to help the REIT develop into a more active vehicle. The Act enabled REITs to own, operate and manage properties, catering to the managerial opportunism that was typical of real estate ownership then - as it is now⁵².

⁵⁰ Real Estate Investment Trusts, Garrigan & Parsons, Chapter 1 – Mark Decker, 1998

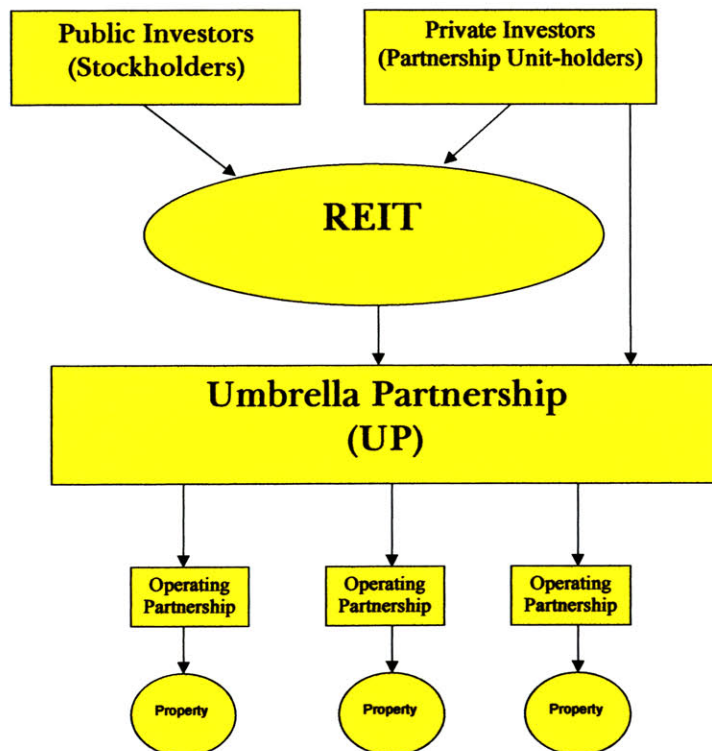
⁵¹ Real Estate Investment Trusts, JK Lasser Pro, Richard Imperiale

⁵² Real Estate Investment Trusts, JK Lasser Pro, Richard Imperiale

The REIT could now manage its own properties, creating competition between ‘internal’ and ‘external’ managers. This set the stage for a new REIT model, discussed later in the Chapter.

The end of the 1980s witnessed another downturn, resulting from a combination of over-construction, the Savings & Loan crisis and foreclosure by lending institutions. The real estate industry was hit particularly hard. Not only had investors lost equity through massive devaluation, but debt sources had also dried up, causing what is now referred to as the ‘credit-crunch’. Many private real estate companies were forced to consider the equity markets as a way to raise capital, but investors were cautious and demanded increased corporate governance and managerial accountability. Many industry commentators refer to this period of the early 1990s as the onset of the “Modern REIT Era”.

Two factors were critical in the recovery and subsequent growth of the US REIT industry in the early 1990s. The first important factor was the creation of the Umbrella Partnership REIT (UPREIT) structure⁵³. The structure is illustrated in Diagram below⁵⁴.



⁵³ First used in the 1992 Taubman Centers Initial Public Offering, Real Estate Investment Trusts, Garrigan & Parsons

⁵⁴ Diagram courtesy of Geltner, 2003

The UPREIT created an additional layer within the REIT structure that proved very popular. Operating Partners could swap real estate assets into the REIT in exchange for Operating Partnership Shares under the Internal Revenue Service tax-deferred exchange rule⁵⁵. In turn, these OP Shares could be converted to REIT shares, although the conversion is treated as a fully taxable event. The introduction allowed non-REIT real estate companies to swap property holdings into REITs, consolidating them into the public market whilst deferring their capital gains liabilities. The investors could hold OP Shares until the conversion to REIT shares maximised the tax benefits of the transfer. The same period saw the introduction of the DownREIT. This is similar to the UPREIT, but is able to own multiple partnerships and assets at the same time⁵⁶.

The Omnibus Budget Reconciliation Act 1993⁵⁷ also changed the ownership structure of REITs significantly. Before 1993 the “5:50 Rule” had prevented fewer than five individuals owning more than 50% of a REIT’s shares. Previous to the Act, the Rule had regarded a pension fund as a single investor. This caused a reduction in the weighting that pension funds committed to REITs. The 1993 Act changed the interpretation of a pension fund to allow each of the pension investors to be viewed as a separate REIT investor. The REIT was still obliged to have at least one hundred shareholders⁵⁸.

Following these changes, the capitalisation of the REIT marketplace swiftly expanded from approximately \$20billion in 1992 to £160billion in 1997. Estimates place the current market capitalisation at around \$180billion⁵⁹.

Other more recent developments in the US REIT industry include the REIT Simplification Act (REITSA, 1997) and the REIT Modernization Act (RMA, 1999). The RMA reduced the income distribution requirement for REITs from 95% to 90% of taxable earnings. In 2001, the Internal Revenue passed a ruling confirming that a REIT ‘can operate an active trade’ as part of its typical real estate activities⁶⁰, possibly in recognition of activities that were (tacitly) already widely practiced.⁶¹

⁵⁵ Inland Revenue Rule 731

⁵⁶ A DownREIT is structured much like an UPREIT, but the REIT also owns and operates properties other than those included under the controlled partnership, source www.nareit.com

⁵⁷ Sometimes referred to as the “Pensions Rules Change”

⁵⁸ Real Estate Investment Trusts, Chan Erickson Wang, 2003

⁵⁹ NAREIT – www.nareit.com

⁶⁰ Real Estate Investment Trusts, Chan Erickson Wang, 2003

⁶¹ The implication of the US Jobs & Growth Act 2003 will be discussed in Chapter 4

Definitions & Terminology

Types of REIT

REITs can be divided into three main types: those that own real estate equity, those that own mortgages and those that own a hybrid of both. The Mortgage REIT, although it once dominated the US REIT industry, never really recovered from the setbacks of the late 1960s and early 1970s. Today, just 22 out of the 180 or so US REITs are Mortgage REITs and they account for just 4% of the value of the NAREIT index. Increased competition in the lending markets and developments in Mortgage-Backed Securities have also contributed to their demise. As a consequence, Mortgage REITs are now more specialised in their approach, distinguishing themselves from the plethora of alternative mortgage investment vehicles. Discussions with NAREIT⁶² suggest that the majority of Mortgage REITs now focus on ‘non-conforming’ loans that might not be suitable for traditional CMBS parcels. These include short-term construction and bridging finance, adjustable rate mortgages and participating mortgages. All require a more ‘hands-on’ approach than a traditional, ‘vanilla’ mortgage. As the wider US REIT industry has expanded its coverage of geographical and property sectors, the Mortgage REIT has gradually become viewed as another niche market, rather than the REIT sub-sector that it was in the early days.

The next section explains the regulations governing REITs, however, the main differences between equity and mortgage REITs can be summarised in a few brief sentences. Whereas Equity REITs have to hold at least 75% of their assets directly in real property, Mortgage REITs have to hold at least 75% of their assets directly in real estate mortgages and loans. It is widely acknowledged that the underlying REIT asset has a substantial influence on the investment characteristics of the REIT. For this reason, a number of studies have discussed the inflation hedging capabilities of Equity REITs over those of Mortgage REITs⁶³. The most notable difference is the Mortgage REIT’s increased sensitivity to interest rate rises, entirely in keeping with the majority of debt-income instruments.

⁶² Telephone Conversation with Abby McCarthy – 9 July 2003

⁶³ Peterson & Hsieh - 1997

Tax & Regulatory Constraints

Although REITs benefit from exemption from corporate income tax, they are also subject to some significant regulatory constraints to counter-balance this advantage. Prevailing constraints in the US include the following:

- A REIT must meet two ownership criteria – to have at least 100 shareholders, and to have no less than 5 shareholders owning 50% of the total stock⁶⁴.
- A minimum of 75% of a REIT's gross income must be derived from real property or real estate related activities. No more than 5% of a REITs income can be derived from non-real-estate related activities. The balance can be made up through passive income such as dividends and bank interest.
- A minimum of 75% of a REIT's assets must be real property, or loans secured against real property.
- A REIT must distribute at least 90% of its taxable income (after depreciation). In fact, as the exercise in Chapter 4 illustrates, the depreciation significantly effects the payout.
- To qualify as a REIT, the entity must elect REIT tax status, year on year, at the end of the tax calendar.

The regulation regarding the distribution of income is one of the fundamental factors contributing to offsetting the corporate tax advantages of the REIT. A REIT must pay out 90% of its gross receipts, putting this income back in the hands of the shareholders. This satisfies two objectives: from the investor's perspective, it reflects the income of the underlying property; and from the government's perspective, it advances the cashflow into a tax-generating arena, at the shareholder level. The distribution requirement also makes the REIT somewhat reliant on an efficient marketplace for raising both debt and equity. New projects often require a combination of fresh capital, since the REIT can only reinvest a small proportion of income for the purpose of future growth. By the same token, REITs have a lower impetus to utilise debt. A normal C-Corporation is incentivised to use debt due to the sheltering characteristics of interest against corporate income tax to reduce agency costs. However, since a REIT is not subject to corporate income tax, the same motivation does not apply.

A REIT's reliance on equity and debt markets can be viewed as a negative constraint. When combined with the restriction administering that 75% of assets that must be held in real property, it is easy to see how important market timing is, both for acquisition and disposition purposes. A successful REIT is a careful balancing act between the property and capital markets.

Valuation

As discussed earlier, REITs can be held privately or traded publicly on an over-the-counter (OTC) public stock exchange. At the most simplistic level, REITs are valued on a similar basis to other equities, through a present value discounted cashflow model that takes account of risk and projected future growth. The most common valuation tool is the Gordon Model, or the shortcut Gordon Growth Model (GGM). The formula for the shortcut can be written as:

$$E = \frac{DIV_1}{r - g}$$

The GGM Model is a calculation of the value based on the initial income dividend 'Div₁', capitalised at a rate equivalent to 'r-g'. The average equity cost of capital is represented by 'r', whereas 'g' is the projected future growth rate. Both 'r' and 'g' comprise subsidiary factors; 'r' is the risk-free rate plus a risk premium, and 'g' is the projected future growth rate plus any opportunity related growth. The equation focuses on the importance of income as opposed to capital growth.

The majority of REITs are income stocks, as a result of their distribution requirements. Certainly, those that are more development focused often experience higher capital growth, but this activity is the exception that proves the rule. The other factor leading to significant growth of REIT stock values is the re-valuation of the property asset market. The underlying asset market experiences periods of growth and decline in accordance with population changes, demand, interest rates and construction costs⁶⁵.

⁶⁴ As previously discussed, revisions to the pensions allowances etc

⁶⁵ Wheaton DiPasquale Four-Quadrant Model

The stock market favours the potential for future growth in its pricing of any industry, and real estate is no exception. Accordingly, it is to a REIT's considerable benefit to try to identify positive NPV and future growth opportunities.

Earnings Measures

Two descriptions of earnings have evolved in the USA, and are unique to REITs. The first is Funds from Operations (FFO) and the second is Funds Available for Distribution (FAD). Funds from Operations (FFO) is a concise definition of REIT net income in accordance with the US Generally Accepted Accounting Principles (GAAP). Traditional GAAP earning measures have not generally been applied to REITs. They do not take account of net income in a sense that accurately applies to a real estate company, primarily due to the treatment of depreciation and capital gains. Funds from Operations are defined as follows:

$$\begin{array}{r} \text{GAAP Net Income} \\ + \text{ Real Property Depreciation} \\ + \text{ Preferred Stock Dividends \& Distributions to the Operating Partnership} \\ - \text{ Gains From Property Sales OR + Losses From Property Sales} \\ \hline = \text{ Funds from Operations} \end{array}$$

The FFO represents the annual income from all the firms operations. In a real estate company, both depreciation and sales can contribute substantially. Funds Available for Distribution (FAD) is also adjusted to accurately represent the idiosyncrasies of the property industry:

$$\begin{array}{r} \text{Funds From Operations (FFO)} \\ - \text{ Capital Improvement Expenses} \\ - \text{ Amortisation of Debt Principle} \\ +/- \text{ Any Adjustment for Converting the Rents to a Straight-Line Basis} \\ \hline = \text{ Funds Available for Distribution} \end{array}$$

The aforementioned adjustments reflect different aspects of the property business that allow REITs to be assessed on a similar ‘operating-cashflow’ basis to alternative stocks. For example, FAD takes account of the need to maintain underlying asset value through capital improvement costs. This methodology also allows for differentiation between real estate sub-sectors. One property type may have a heavier capital requirement than another, and therefore the two should be valued on a different basis. Whereas FFO represents the net income from a REIT, the FAD represents the cash income that is actually available for distribution purposes. It is this ‘bottom-line’ figure that investors are primarily interested in.

Disclosure

In terms of disclosure, publicly quoted REITs are bound by rigorous reporting requirements. Virtually all the important information relating to a REIT or its underlying properties must be reported in the public domain, including: financial information, investment policy, valuation, leases, occupancy rates, financial arrangements and outstanding liabilities. REITs have to file financial reports semi-annually and disclose the details of any joint venture transactions. Private REITs, akin to Limited Partnerships are not subject to this type of scrutiny.

Typical REIT Models:

The Closed-End Mutual Fund vs. the Operational Property Company

US REITs were initially designed to be a real estate equivalent to the closed-end mutual fund. Corporate taxation benefits reflected the passive nature of the REIT. At that time, external management teams operated REITs, akin to mutual fund managers. The management team was accountable to shareholders, but faced a number of potential conflicts of interest⁶⁶, often a result of the payment structure. The managers were paid according to assets under management and this could easily conflict with the objective analysis of a potential acquisition or disposition. Accordingly, there was little incentive for managers to sell properties. By the same token advisors could split their time between various REIT clients, leading to professional bias in a number of areas of the business and preventing them acting in the best interests of the shareholders.

⁶⁶ Also referred to as “agency costs”

The changes instigated by the Omnibus Budget Reconciliation Act 1993⁶⁷ and the REIT Modernisation Act of 1999 learnt from these mistakes and improved the system as a whole. Increased Pension Fund attention encouraged investment from a variety of funds, in turn instigating greater institutional research regarding the operation, analysis and understanding of REITs. This scrutiny, by well-informed and influential shareholders, resulted in increased corporate governance across the REIT industry as a whole. For the first time REITs were allowed to manage themselves ‘internally’, although this could also create other conflicts between Operating Partners and shareholders. Clearly, no system would be watertight.

The Closed-End Mutual Fund Model

Some REITs still take a relatively passive ‘fund-led’ approach to real estate ownership. They are generally typified by the presence of external management. It can be argued that their more cautious approach to investing often produces lower returns that are further compounded by the additional risk and cost of the additional layer of management. The costs can be viewed both financially and in terms of potential agency-costs. As a result of management structure and investment policy, the closed-end mutual fund REIT model tends to trade at a discount to Net Asset Value (NAV) reflecting the additional perceived risk.

The Operational Property Company Model

The majority of REITs now undertake a more proactive, opportunity-led stance, permitted by the RMA 1999. Many REITs now conform to a typical operating company approach to business strategy. The benefits of internal management have led to more entrepreneurial policies towards expansion and added value through acquisitions, development and asset and facilities management⁶⁸. This model has produced increased competition for product and services. Darwinism now has a firm foothold in the REIT industry! As Sam Zell comments overleaf,

⁶⁷ Actually implemented in January 1994

⁶⁸ Along the lines of a typically vertically integrated business model - Porter

“The process of survival of the fittest will ultimately prevail...and then at some point, maybe 5 or 10 years from now – we’ll have probably 15 to 20 relevant REITs, all specialising in different sectors”⁶⁹

The operational property company model provides access to the growth opportunities that investors want to see, whether by development or an alternative strategy. Future growth is reflected in the share price, which the market often values at a premium to Net Asset Value.

Conflicts of Interest

This report aims to learn from the experiences of other countries. The USA, with its longstanding REIT industry, provides some of the best evidence. Continuing management issues include conflicts between the interests of shareholders and operating-partnership unit-holders within the UPREIT structures. OP unit-holders’ policies are often aimed at maximising the tax benefits in the course of converting partnership shares to REIT shares. This might be at a cost to the shareholders. It is also widely acknowledged that internal REIT management often recruits real estate professionals with experience as principals, brokers, bankers and consultants. The purpose of this recruitment pattern is to maximise the REIT’s breadth and depth of experience. It is no great leap of the imagination to understand that these individuals may face certain conflicts regarding *resource allocation* and *competitive affiliates*⁷⁰. It is the responsibility of the REIT managers to ensure that all transactions and service contracts are dealt with at the required ‘arms length’.

Typical REIT Strategies

The strategy of the original REIT was constrained by the closed-end mutual fund model but the USA has ‘rolled with the times’. Congress largely took the view that if direct investors could be proactive regarding their real estate ownership and development, then REITs should have largely the same benefits. A number of REIT business strategies have developed over the years. These trends have been classified by Geltner, as well as other industry commentators and analysts⁷¹. The strategies are discussed briefly below⁷²:

⁶⁹ REITs, Garrigan & Parsons, 1997

⁷⁰ *resource allocation* and *competitive affiliates* both identified by Sagalyn (1996)

⁷¹ D’Arcy, Garrigan, Imperiale etc.

⁷² Commercial Real Estate Analysis & Investments – Geltner & Miller

Financial Strategy

Of course, financial strategy is important to all companies but sound financial planning is particularly critical to REITs due to the onerous dividend distribution requirements. To maintain a constant leveraged position and to balance their weighted average cost of capital (WACC), it is necessary for REITs to continuously monitor both the asset markets and the capital markets. NAREIT suggests that US REITs, on average, are only around 50% leveraged. Despite a lack of restrictions on gearing, it can be assumed that shareholder opinion plays a key role in maintaining 'acceptable' levels of debt / risk. For those REITs looking to expand, a rights issue is normally the first course of action and preference-shares and 'convertibles' are becoming more commonplace. If there is a lack of capital in the equity markets, REITs can enter into joint ventures, de-list to enable higher (private) gearing or seek shareholder approval if a policy change is required to significantly adjust leverage.

Management Specialisation

Following the changes of the early 1990s, the market has seen REITs become more specialised, both geographically and by market sector. This trend originated as investors welcomed the ability to differentiate between sectors. Naturally, the REITs reacted to shareholder approval. REITs presently specialise in sectors including residential, office, industrial, retail, hotels and healthcare. Some of the more oblique market segments include golf courses, vineyards and prisons, as well as the mortgage-REIT sector that was discussed earlier.

Branding & Franchise Value

Branding is one of the newest trends to become noticeable in the US REIT market, through high-profile shopping-mall operators (e.g., Simon), and numerous hotel and healthcare groups. This strategy is already integrating itself in the UK property market through the likes of Capital & Regional's "Escape" Leisure Parks, and Benchmark Group Plc's "Nexus" serviced-office brand. It can be argued that this trend is more attributable to the marketing mentality of the late 1990s than to groundbreaking REIT-led business policy. The benefits of an effective brand name are best demonstrated by the hotel industry, but US REITs such as Equity Office are also using branding to help build corporate relations with global occupiers.

Vertical Integration

A vertically integrated strategy relates to the provision of goods and services such as development, property and facilities management, marketing and other business lines associated with real estate ownership. The trend is quite easy to spot in the UK, where quoted companies exploit ‘add-ons’ to their primary service line to good effect, perhaps best illustrated by serviced-office and PFI full-service contracts. Similar development in the USA has happened relatively recently, although this is possibly due to the restrictions of the Closed-End Mutual Fund model.

Economies of Scale

Sam Zell’s earlier comment outlines a clear trend toward economies of scale, and the likely future scenario of a few super-large REITs owning the vast majority of stock. It is feasible to suppose that larger capitalisation stocks benefit from increased liquidity, and therefore a lower cost of capital. The outstanding question is whether scale benefits filter into other areas of the business? If this is the case, similar trends might be visible in the UK marketplace. Empirical studies of the US property market found evidence of fairly minor administrative and management savings due to scale⁷³. However, it has been suggested that there are wider benefits associated with perceived power in the market place. Rosenthal (1996) proposed that scale might simply be a conduit to larger and more lucrative transactions (i.e., the discount attributable to purchasing an entire portfolio, as opposed to the sum of its parts). The performance of Sam Zell’s ‘uber-REITs’, Equity Office and Equity Residential, also seem to support this theory,

“I think scale is also an issue. I’m sitting here in a... \$30billion company, which means that we can have all kinds of economies of scale, of purchasing, of management...there are lots of reasons for big companies to have the advantage.”

Even with such a vocal and experienced exponent of the scale argument, there is a counter-argument. Prevailing issues that concern large REITs include internal communication barriers, additional management layers and increased staffing costs. This suggests that where small REITs are footloose, large REITs tend to be sluggish and bureaucratic. The fact that growth relies upon opportunities also plays a role in this debate. For a medium-sized specialised REIT, the sub-market in which it is specialised may not provide the necessary number of opportunities for continued growth. However, expansion into other arenas can lead to the dilution of the specialist knowledge, increasing systematic risk and causing investor concern.

⁷³ Bers & Springer (1998)

To believe both sides of the argument would suggest there is an optimum size for a REIT, dependent on certain macro-economic variables. This issue is currently undergoing research, although qualitative studies provide the best guide to date. Unfortunately their findings have been, at best, inconclusive⁷⁴!

Power in the Market-Place

The final categorised strategy relates to a REIT using its sheer size to monopolise a particular market sector. Although Sam Zell's comments support the concept that a REIT can exploit a market power strategy, the property industry is heterogeneous in terms of its assets and the investors competing for ownership. Such idiosyncrasies make it fairly difficult to truly monopolise a target market. Systems governing capital flows and zoning ensure the continuance of 'checks and balances' to counter the likelihood of market dominance by any single company. However, historic landlords and estates have built or inherited massive portfolios in specified geographic areas. To the extent that this dominance has created a positive value differential is undocumented, but goes largely against the precepts of a free-market economy. The market-dominance model works conceptually, and may show some degree of efficacy in certain 'restricted' or niche markets. However, it is likely that antitrust mechanisms would prevent any real market exploitation.

REITs Around the World

Real Estate Investment Trusts and other tax transparent indirect investment vehicles have been introduced all over the world over the last twenty-five years. The evidence is quite startling. Countries that have adopted this type of vehicle have witnessed a +830% aggregate increase in their total property market capitalisation since 1989. On the other hand, countries that failed to introduce such a vehicle experienced a -28% decline in total property market capitalisation over the same period⁷⁵.

⁷⁴ For further discussion of REIT economies of scale see Mueller (1998)

⁷⁵ Property Forecast, Volume 6 -No.7 , July 2003

The volatile performance of world equity and bond markets over the last 5 years has caused property to become the asset of choice for many investors. The Independent Property Databank (IPD) collects data on approximately £102billion of UK property. As IPD recently stated,

“It is extraordinary to think that every fund in the IPD Universe has achieved a return in excess of the average for equities over 1, 5 and 10 years. Even over 15 years, the proportion of property portfolios outperforming (equities) on an annualised basis is over 70%.”⁷⁶

Perhaps it is not surprising that the trend has been global, influencing increased property weightings in institutional portfolios. In response to this trend, additional countries have integrated, or are integrating, vehicles to allow smaller private investors to gain the benefits from investing in large-scale commercial real estate.

This portion of the chapter examines a number of countries’ REIT vehicles and compares them to one another, with particular reference to the original motivations behind their introduction. This brief summary examines the variety of restrictions that REITs face, governing issues including dividend distributions, leverage, permitted business activities and the composition and trading of assets,⁷⁷.

NORTH AMERICA

USA

The US REIT is discussed in some depth throughout this report. This narrative therefore deals primarily with statistics. The US is the largest REIT market in the world, with an estimated market capitalisation of \$173-180billion across approximately 173 REITs⁷⁸. A minimum of 75% of REIT assets and income should be held in, or derived from real estate, mortgages secured on real estate or other real estate related holdings. The REIT must be owned by at least 100 shareholders, with no fewer than 5 people owning in excess of 50% of the REIT’s shares. REITs must annually payout at least 90% of taxable income to shareholders, although this figure is revised downwards when taking account of the American straight-line depreciation of assets

⁷⁶ Source – ipdindex.co.uk – quote from Investment Director, Kevin Swaddle

⁷⁷ References regarding international vehicles include: the RICS Securitisation Paper 2003; Merrill Lynch Global Realty 31, May 2003; Deutsche Bank Pan European Property, May 2003

⁷⁸ Source, Merrill Lynch and NAREIT

(over 27 years for residential property and over 39 years for commercial property). The 90% required payout is often closer to 70% of the Equity Before Tax Cash Flow. This can equate to over 150%+ of the minimum payout level, since depreciation is not a cash flow item.

US REITs have no restrictions governing investments in foreign assets or 'active' business, such as development. There are no limits on gearing, and average debt is around 35-40%. The average dividend yield is 6.7%, and the majority of REIT investors are institutional (55%), followed by private individuals (25%). The balance comprises REIT sponsors and foreign investors. The recent US Jobs & Growth (Reconciliation) Tax Act 2003 has been designed to incentivise private investment in the equities markets through a reduced personal income tax rate (15% from 35%). REITs are exempted from this legislation, as discussed in Chapter 4.

CANADA

Canadian REITs were established in 1994, drawing inspiration from the success and development of the US REIT. They had the similar goal of introducing a mechanism to allow smaller investors to reap the benefits of a largely inaccessible asset class. Canadian REITs can opt for an internally or externally managed structure. Development activities are permitted on a case-by-case basis, provided the inherent risk will not significantly jeopardise potential distributions to the investor. The Canadian REIT cannot be more than 50% geared.

At least 95% of income must be derived from real estate rental income or dispositions, and a minimum of 80% of held assets must be located in Canadian territory. The Canadian REIT must have at least 150 shareholders, of whom 51% must be Canadian nationals. The REITs must distribute at least 85% of income to shareholders, although in many cases distribution is often closer to 100%. Capital gains tax can be avoided if the proceeds are distributed directly to shareholders within the same financial year.

EUROPE

HOLLAND / THE NETHERLANDS

The Dutch Fiscale Beleggingsinstelling (FBI) evolved in 1970, again as a conduit for engaging private investors in the commercial real estate market. The Dutch FBI market is worth approximately US\$9.5 billion, split between 10 vehicles. The FBI can use an internal management structure and is permitted to invest at home or abroad, so long as the target asset is ‘immovable’ and no single asset accounts for more than 20% of the entire FBI portfolio. The ‘immovable’ clause prohibits the FBI from undertaking development.

Leverage is limited to 60% (of fiscal value) and at least 30% of shares must be sold to private individuals. No individual may hold more than 5% of an FBI and no foreign entity can own more than 25% of the total shares. Each FBI must distribute all 100% of its income and it can avoid capital gains tax on the proviso that the gains are also distributed.

FBI's have grown more specialised over the years, focussing predominantly on office and retail assets. They experienced considerable growth during the early to mid 1990s as the absence of widespread debt facilities encouraged real estate companies to explore the public equity markets. FBI's have been positive net investors in the UK, Spain and France, where their tax-advantaged status has allowed them to compete more effectively for acquisitions.

Although the sector has traditionally performed well, trading close to NAV with average dividends in the order of 7.8%, it has diminished over the past 2-3 years through consolidation and de-listing. Notable recent exits include Rodamco and Haslemere. The potential “next step” for FBI's involves obtaining unrestricted permission to develop real estate. It will be interesting to observe how this issue, the subject of much debate in the Netherlands, could alter the make-up and performance of the Dutch REIT market.

BELGIUM

Belgium introduced the Societe d'Investissement a Capital Fixe Immobiliere (SICAFI) in 1990 as (you've guessed it) a vehicle to divest real estate ownership to the masses. In a move similar to the introduction of the US UPREIT, changes in legislation allowed existing taxed corporations to redefine themselves as SICAFIs and swap assets into the new vehicle (1995). Like the Dutch FBI, the SICAFI is prohibited from developing, and cannot hold more than 20% of assets as a single investment. The minimum share capital for a SICAFI is a diminutive €1.2million, and the public must own 30% of the total shares.

Leverage is limited to 50% of the total Net Asset Value but there is also a Debt Service Coverage Ratio requirement of 125%. Income distribution must be 80% (post depreciation) and capital gains that have not been reinvested within 4 years must be distributed to shareholders or taxed accordingly. Although SICAFIs account for only approximately 1.7% of the entire Belgian stock market capitalisation, they account for almost 50% of all commercial property turnover. At least 60% of all SICAFI assets must be in Belgium.

GERMANY

Although Germany does not have a REIT-style vehicle, it has a strong open-ended real estate fund market, with a current capitalisation in excess of €80billion and significant growth in new investment. The bank-operated open-ended funds have a strong presence in certain markets due somewhat to their sheer scale, in turn due to their growing middle-class investor base. The funds invest in all major asset classes. To obtain full corporate level tax shelters and partial exemptions at the investor level at least 51% of a fund must be invested in real estate. Unlike REITs, the German vehicles are not liquid, unitised or tradable. They have been the subject of fierce criticism as a result of poor disclosure and benchmarking, and a perceived lack of risk analysis and coherent strategies. Funds tend to be opportunity led. They are generally not geared and are unambitious in respect of their target returns, often happy to simply outperform current cash returns.

FRANCE

The French introduced the Societes d'Investissements Immobiliers Cotees (SIIC) in January 2003 with a number of objectives; to encourage industry investment (domestic and foreign), to raise short-term capital gains revenues and to facilitate public investment.

The market features 7 major players with a total market capitalisation in the order of €9billion+. To transfer to SIIC status, the companies have paid a one-off 16.5% tax, based on unrealised capital gains levied against their portfolio. This tax will be paid over a 4-year period and could raise approximately €1.4bn from the 6 largest participants alone, significantly helping the ailing French budget deficit.

A SIIC must have a market capitalisation of at least €15million and will distribute at least 85% of earnings (after depreciation). Traditionally, the French companies have had low dividend payouts, so the income-led SIIC is likely to positively impact investor take-up. To date, no restrictions have been implemented with regard to leverage, foreign investment or activities such as development, but it is early days and the vehicle will no doubt undergo some refinement. The management structure is internal. This is possibly due both to overwhelming global evidence supporting the success of internal management, and due to the fact that the market consists of previously listed property companies that have transferred their status. To require a change of management would have been a time-consuming and controversial measure.

Leon Bressler, CEO of the French company Unibail stated,

“The change will put us on a par with Euro-zone investors, alongside Dutch (F)BIs, Belgian SICAFs and German Open-ended Funds. We are not ahead. We are late. It does not create a competitive disadvantage but eliminates a competitive disadvantage.”

ASIA & THE FAR EAST

JAPAN

Japan implemented the J-REIT in 2000 and it was launched in 2001. It now boasts six REITs with a market capitalisation of approximately US\$4.5bn. The vehicle displayed a cautious start, primarily as a result of its external management structure leading to potential conflicts of interest.

At least 75% of J-REIT assets must be real property and 50% of assets must be income producing, thus restricting the amount of development activity in which a J-REIT can become involved. No fewer than 3 individuals can own more than 50% of a REIT's shares. Within the current market, approximately 40% of shares are owned by institutions, and private investors have bought a further 25%. The remainder is split between sponsors and foreign investors. J-REITs must distribute a minimum of 90% income (after depreciation) and are 82% geared, on average. It was originally thought that no J-REIT managers would wish to lever to more than 70%. It might be construed that positive leverage is the only way to achieve the required returns in Japan's low interest rate, deflationary environment. To date, the average J-REIT has produced a 5.1% annual dividend yield. J-REITs can be held privately or traded publicly, and further public offerings are expected in 2003.

SINGAPORE

The SingMall Property Trust was launched as the first REIT, in November 2001. It was sponsored by CapitaLand and had an intended offering size of circa US\$410million, grounded in 3 retail malls. The model was based closely on that of the Australian Listed Property Trust.

The first REIT was withdrawn from the market following a lack of investor interest. Although world markets were anomalous after September 11th, some lessons can be learned from this example⁷⁹. Potential mistakes included unattractive pricing comparative to other global REITs and potential overvaluation of the underlying assets. A lack of experience in distributing shares and running a REIT was self-evident. The external management was supposed to have been undertaken by Lend Lease, but they walked out on the deal less than 2 months before the IPO.

⁷⁹ Is There a Business Case for REITs in Singapore?, Mei Hwei Ngen, 2002

After this bumpy start Singapore now has two S-REITs, with a combined value of approximately US\$700million. Singapore's REITs have inspired investor confidence with dividends of 6.9% and projected growth of around 6% per annum. Around 4-5 other real estate companies are currently considering transferring all or some of their assets into a REIT.

S-REITs are restricted to investing no more than 20% of their funds in development, and although gearing is limited to 35%, the average level is only 26%. S-REITs are tax in the same way as normal corporations. However, if they distribute 100% of earnings, the tax that has already been paid becomes a positive credit at the investor level. The make-up of investors is approximately 34% private individuals, 18% institutions, with the remainder split between the REIT sponsors and foreign investors.

HONG KONG

Hong Kong is still considering introducing a REIT-type vehicle, and published a consultation document in March 2003 describing its intentions and summarising the proposed regulations⁸⁰. Unlike some of the previous examples, the Hong Kong REIT will target Hong Kong real estate only. It will have a maximum 35% gearing, hold assets for no less than 2 years and will not participate in activities that cannot produce recurrent, predictable rental income (e.g., hotels with management contracts). Hong Kong REITs will be managed externally, possibly creating additional agency costs. Departing from the traditional model, the structure is based on Trust as opposed to a Corporation with procedural restrictions. In terms of market fundamentals, Hong Kong has a huge asset-base and strong investor demand for liquidity, both of which will undoubtedly help a REIT to flourish.

KOREA

The CR (Corporate Restructuring) REIT was launched in 2001 as a 5-year entity to acquire real estate assets from troubled institutions⁸¹. It features an external management structure, distributes 100% of income as dividends and is exempt from corporate tax. The market currently comprises 3 REITs with a market capitalisation of approximately US\$235million. Investor response was lukewarm, due to concerns over questionable corporate governance and low projected returns.

⁸⁰ Hong Kong Securities & Futures Commission, A Consultation Paper on the Draft Code for REITs, March 2003

⁸¹ *Ibid.*

AUSTRALIA

Aside from the US, the Australian Listed Property Trust (LPT) market is the most developed REIT market in the world, dating back to 1980. It experienced major growth in 1991 when new legislation allowed unlisted Real Estate Unit Trusts to convert to LPTs to improve their liquidity. Although the Unit Trusts had been fairly successful in their own right, one of their regulations allowed investors to redeem Units within a 60-day period. The credit-crunch of the early 1990s left investors unable to sell units and LPTs provided the natural solution.

The early 1990s also saw Australia introduce compulsory personal superannuation, making individuals responsible, in part, for their own pensions. This move was a driving force for the LPT market. Underpinned by real assets, LPTs provided strong income and low volatility - a combination that proved popular with investors. The positive portfolio diversification benefits of the LPT encouraged institutions to follow suit, which added credibility to the growing market.

Australia has 30 LPTs with a market capitalisation of approximately US\$29billion. They are not restricted in terms of development activity or overseas investment, although they must invest in real property or land. Borrowings are unrestricted although the average gearing is only 42%. The LPT model provides for either internal or external management, as well as a unique 'Stapled-Trust' arrangement (where the Manager has an equity interest in the Trust). It is possible that the external management model will be phased out entirely in the future.

LPTs account for nearly 10% of the capitalised value of the Australian stock market and it is estimated that they own more than 70% of all investible real estate in the country. Institutional investors own around 55% of the LPT stock, with a further 30% held by private investors. The LPT market has performed well, consistently producing dividends of 7-9% with annual capital appreciation growth of around 3%. LPTs distribute a minimum 95% of net earnings.

The relative lack of 'home-grown' property is leading more LPTs to invest overseas. In response to investor demand, LPTs have grown significantly sector focussed over the past decade. Many have also consolidated, in an effort to achieve scale benefits and reduce their overall cost of capital.

OVERVIEW OF THE UK PROPERTY MARKET

The UK quoted and institutional commercial property markets are estimated to have a value in the order of approximately £136bn⁸². The wider UK ‘investible’ commercial stock totals some £430bn, of which £220bn is in primary investor portfolios and £210bn is either owner-occupied or privately held⁸³. The UK Office of National Statistics estimated the residential market to be worth approximately £1397billion (1999).

The Investment Property Databank (IPD) is probably the most reliable benchmark of direct property performance in the UK. It monitors 232 portfolios with a total value of over £102bn as of December 2002⁸⁴. Although, the index comprises a mix of assets in terms of geography, property sector and financial structure, any debt has been factored out of the indexed returns to provide an ungeared reference tool.

IPD calculate that around 25% of their UK Index by value is located in Central and Greater London. The Index covers three major property types: retail, office and industrial. They account for 47.8%, 34% and 15.1% of the market respectively. The remaining 3.1% is classified as ‘other’ and includes smaller sectors such as leisure, hotels and healthcare.

As the diagram overleaf illustrates, the market can also be segmented by investor type⁸⁵. The Financial Institutions comprise insurance funds, pension funds, managed funds and trusts. The institutional market typically invests in large-scale assets and portfolios, driven by active management and maturity matching strategies. However, managed funds, unit trusts and other syndicates can be opportunity-led, with short-term horizons driven by target returns. The most entrepreneurial investors tend to be vertically integrated and involved in a combination of development and investment activity. They are typified by property companies, limited partnerships and private companies.

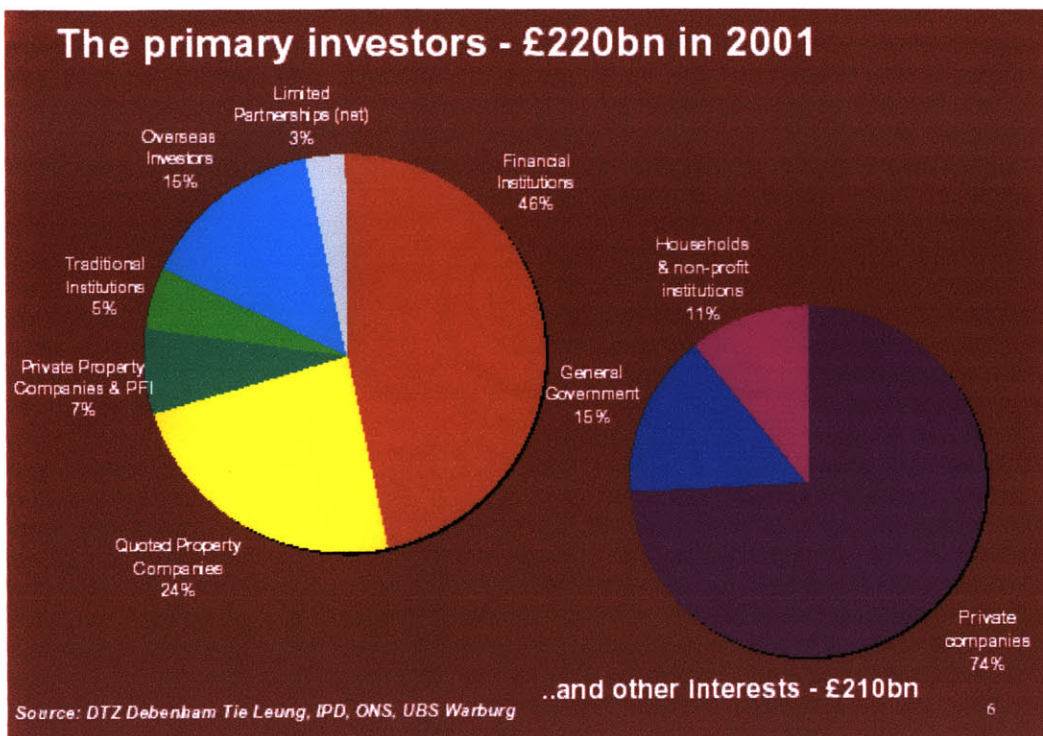
Over recent years, all vehicle types have found themselves competing for popularity (in the form of increased equity investment), and product. Their attractiveness to investors is largely related to their liquidity, tax transparency, limited liability and security of income.

⁸² Source – Knight Frank, via the IPD Index

⁸³ Source – IPF, DTZ Debenham Tie Leung, IPD, ONS, UBS Warburg, www.ipf.org.uk (2001)

⁸⁴ Approximately 75% of quoted property company and institutional investor property holdings

⁸⁵ Source – IPF, DTZ Debenham Tie Leung, IPD, ONS, UBS Warburg, www.ipf.org.uk



Quoted Property Companies

As discussed earlier in the report, Quoted Property Companies (Plcs) offer a form of securitised equity. Unlike the typical REIT, they are subject to corporate taxes on income and capital gains. Interest offers some shelter against tax but there is no significant depreciation of assets in the UK.

Investment Trusts

Property-led Investment Trusts are also quoted. They can invest in a combination of quoted property companies, direct property and non-property assets. They receive corporate tax exemption but must derive no more than 30% income from direct property and distribute 85% of income as dividends. Although it appears the Investment Trust is a good mechanism for investing in the quoted property sector, the aforementioned double taxation is intrinsic to the quoted company rather than the trust. Property-focussed Investment Trusts never developed substantial investor support, due to onerous restrictions and regulations, and a necessity to derive some portion of income from residential properties⁸⁶. The most notable current vehicle is Henderson's TR Property Investment Trust.

⁸⁶ A taxing issue – Estates Gazette, 07 December 2002

Limited Partnerships

Limited Partnerships (LP) are governed by the original Limited Partnership Act of 1907. They enable investors to pool resources, whilst exposing only the General Partner to liability.

Historically, the total number of contributing partners in an UK LP was restricted to 20, although this was sometimes ‘massaged’ through the addition of partnership layers. Following the Limited Liability Partnerships Act 2000, the revised Limited Partnerships Regulations (No.4, 2002) delimited the potential number of partners. In order to qualify, a partnership had to be a “collective investment scheme” maintained by an Operator or Managing Partner approved and authorised by the UK Financial Services Authority.

Around the time of these changes, certain lobbyists felt that Limited Partnership Shares had the potential to become fully tradable, along the lines of a REIT. However, tax liabilities regarding what constituted a ‘trading’ partnership put pay to these aspirations. A Limited Partnership is a pass-through entity offering similar investment characteristics to direct property. If properties are sold during the life of the partnership, however, the tax-paying partners are subject to onerous Capital Gains taxes, even if the gains are subsequently reinvested.

Property Unit Trusts

Property Unit Trusts are discussed earlier in the Chapter, in terms of both the ‘Authorised’ and ‘Unauthorised’ varieties. PUTs are not exempt from corporate taxes, unless 100% of their investors are tax exempt (ie. pensions, charities). Both types of PUT can be held offshore and are subject to the Financial Services & Markets Act (FSMA) 2000 regulation. Units rarely trade in a secondary market. Although this is possible, it requires the services of a market maker.

Authorised Unit Trusts were designed for public trading, but excessive FSMA regulations have dissuaded the vast majority of Trusts from listing.

Topical Issues in the UK Property Market

A number of issues currently face the UK property industry. They range from macro-economic factors such as the current pension crisis to the forthcoming legislation of the Basel Accord. All of these issues may play a role in considering the benefits of a UK REIT.

The Myners Report, 2001

This Treasury document was prepared by Paul Myners to advise on state of institutional investment in the UK. “Institutional”, as a category, covers pension, insurance and life funds. In total, these funds account for some £1,500billion of total wealth - equivalent to 50% of the total capitalised UK stock markets. Institutions bear a great burden: to protect the savings of millions of people and invest them in accordance with pre-determined targets for risk and reward. The report primarily comments on the governance and appropriation of funds within the existing UK framework but it also discusses facilitating modern markets, and instruments, to allow “effective and efficient investment”.

Given Australia’s prolific superannuation investment in Listed Property Trusts, it is reasonable to assume that a similar UK vehicle might offer the same benefits to pension savers. UK pension funds currently invest only 5-7.5% of their wealth in property despite the superlative returns the asset has achieved over the short and medium terms. A lack of liquidity is the primary restraint, preventing the funds from accurately timing their investment flows.

Pension Crisis

The majority of UK private and stakeholder pension funds seem to be facing concerns over meeting their future obligations. Armando Iannucci recently wrote in *The Daily Telegraph*,

“Pensioners may have to wait until they are dead before they can receive their pension - the Work and Pensions Secretary, Andrew Smith, today refused to rule out the possibility that to pay for long-term retirement provisions, people may be obliged to work until they drop dead.... passing their pension on to their next-of-kin.....subject to Inheritance Tax, of course”⁸⁷.

The UK is facing a mounting catastrophe. Interviews with 250 FTSE companies, conducted by the National Association of Pension Funds in June 2003, suggest that over 40% have now shut the doors to employees wishing to participate in corporate pension schemes. Accounting regulation FRS17 now obliges companies to reflect their pension fund deficits on their balance sheets. In lieu of governmental assistance, many companies are asking their employees to radically increase their monthly contributions in an effort to remedy projected shortfalls.

⁸⁷ Daily Telegraph, Friday 20 December

The Government has blamed this crisis on 3-4 years of declining share prices but people need a solution, not a culprit. The Government is seeking new methods to allow both companies and individuals to invest in their futures through stakeholder and Self-Invested Pension Plans (SIPPs) respectively.

The Basel Accord

The Basel Accord comprises a doctrine of international banking regulations. They are designed to prevent banking disasters that result from a failure to assess the availability of adequate capital to cover outstanding liabilities. The potential outcome of such a failure is well illustrated by the collapse of Barings. The Basel Accord will be enforced in 2006, with three guiding principles. The first is to ensure 'capital adequacy'; ensuring minimum capital requirements to cover the banks' own levered positions. The other two regard establishing a system of 'best practice' for evaluating credit analysis and reviewing the banks' total exposure⁸⁸.

Different investment sectors will be classified and regulated under a standardised rating system. For example, vanilla residential and commercial mortgages will be subject to different maximum loan-to-value ratios. Jones Lang LaSalle recently commented on the potential effect of the Accord,

“The allocation of capital resources to the more secure types of lending might eventually cause some banks to withdraw from certain types of lending, or to undertake it only at high margins. Against the background of the ongoing consolidation process in the banking industry, this will eventually result in lower access to debt combined with higher costs to the borrower.”

G8 Policy & European Union Directives

Although neither G8 nor the EU has implemented specific regulations applying to the securitisation of real estate, both bodies are committed to creating a contiguous global framework to facilitate cross-border trade and investment. Both agree that standardisation is a necessity for the global financial marketplace, although it is the responsibility of each member country to ensure sound policies for its own banking reform, transparency and accountability⁸⁹.

⁸⁸ Jones Lang LaSalle European Capital Markets Research, July 2002

⁸⁹ www.g8.utoronto.ca

The loosely implemented doctrines are vague but the underlying message is implicit. If other world-leading countries are creating vehicles to facilitate the liquidity of real estate ownership and increase cross-border investment, the UK should at least be making an informed decision regarding whether or not to follow suit.

CHAPTER 3

THE ROLE OF SECURITISED PROPERTY IN A PORTFOLIO

This Chapter uses Modern Portfolio Theory to analyse the role of securitised real estate in a typical mixed asset portfolio. The risk and return characteristics of a UK Public Limited Company are compared to those of a US REIT and an Australian Listed Property Trust. Each security is examined within the framework of a national mixed-asset portfolio comprising stocks, bonds and direct real estate.

Modern Portfolio Theory

In the early 1950s, Harry Markowitz introduced the world to his theories of the relationship between risk and return and his model of Portfolio Selection⁹⁰. The model presents a method for constructing an optimal portfolio by understanding the diversification effects that different assets can have on one another.

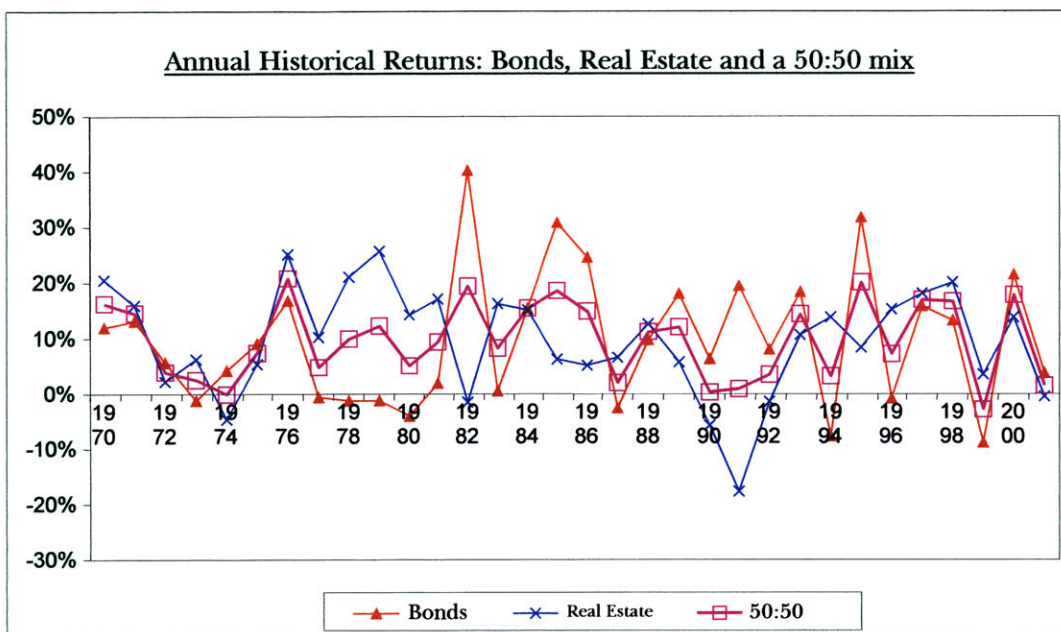
Markowitz was effectively quantifying the virtues of the well-worn adage, “Don’t put all your eggs in one basket”. His theory provides a mechanism for weighting a range of assets in a given portfolio to maximise return and minimise risk. In other words, “*How many* eggs should be put in *which* baskets?”⁹¹.

Markowitz defined the ‘risk’ of an asset or a portfolio as its volatility: the standard deviation from the mean. In turn, the standard deviation is the square root of the variance from the mean. Standard deviation is a more intuitive yardstick than variance, and over time it has become the more commonly used measure.

Markowitz saw that some assets’ returns exhibited complimentary or contrasting patterns. This led him to measure the correlation between the returns. The combination of two risky assets that exhibited a low correlation had the effect of reducing overall volatility. He called this the Diversification Effect. His experiments showed that the lower the correlation between assets, the higher the diversification benefits.

⁹⁰ When he published ‘Portfolio Selection’ in the Journal of Finance, March 1952

Markowitz's theory revolved around an asset's inherent risk (variance), and its relationship to other assets within a portfolio (covariance). He used this logic to design an "efficient" portfolio. The graph below illustrates total returns to US bonds and real estate over the period 1971-2002⁹². If the assets are combined on a 50:50 basis, the result is the less volatile overall return (shown by the pink line).



Markowitz used this knowledge to create the 'Efficient Frontier'. The Efficient Frontier is a single parabola, plotted to represent all asset allocation combinations that maximise returns or minimise risk, given specific risk or return parameters. A portfolio is 'efficient' if it sits on one of the theoretical 'points' along the frontier.

Markowitz worked with Bill Sharpe and John Lintner to develop a series of individual theories, known collectively as Modern Portfolio Theory (MPT)⁹³. This groundbreaking work finally won them a Nobel Prize in 1990. The Capital Asset Pricing Model (CAPM), the Two-Fund Theorem and the Sharpe Ratio are just a few of the models and theories encompassed by MPT.

⁹¹ Commercial Real Estate Analysis & Investments, Geltner & Miller

⁹² Geltner 2003.

⁹³ Also sometimes referred to as Mean-variance Portfolio Theory, or Markowitz Portfolio Theory.

Other academics and theorists continue to research and develop these and other portfolio theories under the same broad banner of MPT⁹⁴.

The Capital Asset Pricing Model

This static model describes how the expected risk premium of a particular security varies in relation to its volatility (Beta). The model assumes homogeneous investor expectations to hold efficient portfolios and the existence of a single, universal ‘market portfolio’. The CAPM formula defines the risk premium of a security as the difference between the expected return on the security and the return on a riskless asset (risk-free rate). It describes a linear relationship that is written:

$$\textit{Expected Risk Premium of a Security} = \textit{Beta} \times \textit{Expected Risk Premium of the Market}$$

.... Assuming the “Expected Risk Premium of the Market” is the difference between the overall market return and the risk-free rate.

The Two-Fund Theorem

This theory introduces a riskless asset as a benchmark for portfolio analysis. The return profile of a riskless asset, such as a Treasury bill (T-bill) is known with certainty and can theoretically be viewed as having no discernible volatility.

As discussed, two risky assets can positively diversify one another through their negative covariance. However, if one of those assets is riskless, then the return possibilities of the two combined assets lie on a straight line, since only the risky asset is volatile. Accordingly, the combination of a riskless asset with a risky asset (or risky portfolio) produces a single optimal portfolio. The riskless asset represents a ‘short’ position. Therefore, the single point of optimisation, in terms of both risk and return, will vary according to the investor’s appetite for risk and whether they choose to take a ‘borrowing’ or ‘lending’ (short) position in the riskless asset.

⁹⁴ Examples include Ross’s ‘Arbitrage Pricing Theory’ and Arrow’s ‘Impossibility Theorem’

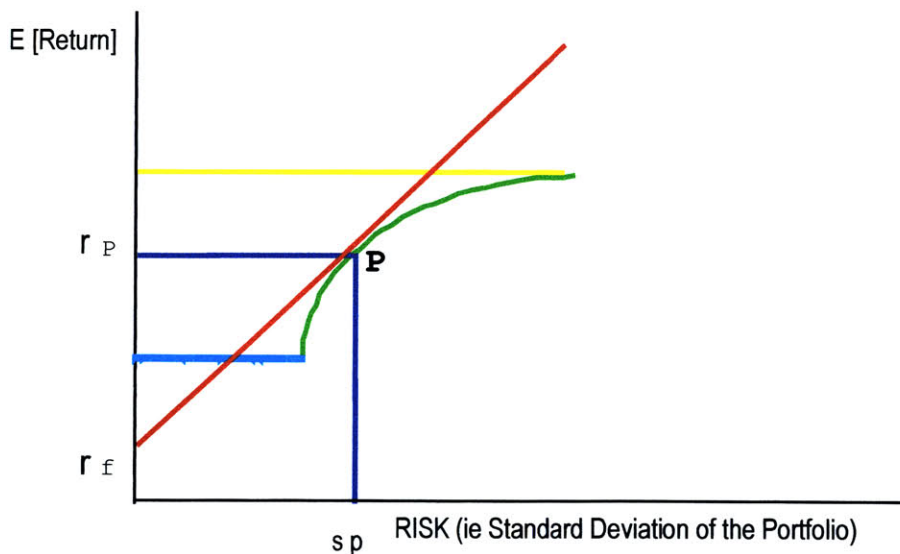
The Sharpe Ratio

The Sharpe Ratio is a measure of risk-adjusted return that builds on the principles of the Two-Fund theorem. Again the return profile of the risk-free (rf) asset is entirely predictable, as it has no volatility. If the slope of the risk-free return line is maximised, the ratio of return (rp) to risk (sp) will be at its greatest where it crosses the risky portfolio line (point P).

The Sharpe Ratio defines the optimal portfolio, regardless of the investor's risk preference or target return. Theoretically, the Sharpe Ratio should represent a constant relationship between additional risk and excess return, although this has only been proven over a long-term investment horizon. As a formula, it is expressed as follows:

$$\text{Sharpe Ratio} = \text{Risk Premium} / \text{Volatility}$$

...where the Risk Premium equals the difference between the Expected Return and the Risk-free Rate. The volatility is expressed by the Standard Deviation. The Sharpe Optimisation is presented graphically below with (rf) representing the risk-free return and (P) representing the portfolio return. The optimal portfolio is described in terms of risk (sp) and return (rp).



Modern Portfolio Theory & Property

Real estate is generally thought to be a good portfolio diversifier. It tends to have lower correlations with stocks and bonds than they have with each another. Real estate has traditionally shown stable, low volatility returns, reasonably well correlated with inflation. This 'inflation hedge' has made the asset a popular portfolio 'stabiliser' for pension and insurance funds as they take account of Retail Price Index adjustments in forecasting their future liabilities.

The heterogeneity of real estate has never allowed it to be wholly compatible with Modern Portfolio Theory. Direct ownership of real estate is still burdened by lumpy capital flows, significant management costs and relative illiquidity. The degree of illiquidity is rarely quantified when property is analysed in comparison to liquid stocks and bonds. Nonetheless, real estate's overall diversification characteristics certainly justify its inclusion for analysis within a mixed asset portfolio.

Modern Portfolio Theory *within* a Property Portfolio

Modern Portfolio Theory was first used extensively in practice during the early 1970s. Avid supporters of the Theory used it not only to optimise real-estate's asset weighting within a mixed asset portfolio, but also to test the optimal mix of different classes of real estate. The main problem with this use of the Theory was that it drew attention away from the main issue: the effect of a 'whole' asset class on the whole portfolio. Real estate also suffered from a lack of widespread, reliable data. Data collection within the industry has considerably improved over the past 20 years but some of this accuracy is lost when analysing sub-sectors, whether geographical, or by property type.

Widespread Application of MPT

Fund weightings in property have generally been lower than portfolio theory would class as "optimal". Although a typical portfolio optimisation exercise might recommend a fund to hold 15%+ in direct property due to its strong returns and low volatility, many funds have never invested more than a weighting of around 5-7.5% in property.

This is due in part to illiquidity, and the fact that property is mostly traded as large assets, not neat, divisible shares. Finally, the lag of the property market prevents the speedy application of decisions based on portfolio theory. This holds true whether an investor is buying or selling. A lack of informational efficiency in the property market causes investors to rely on specific market expertise, an additional management cost.

The Current Role of Property within a Portfolio

Real estate's role within a mixed asset portfolio is multi-faceted due to the many ways in which property can be owned: directly, through a trust, a partnership or a quoted vehicle.

Fully let 'Grade-A' property exhibits the most robust characteristics of the asset class, often providing bond-like income combined with inflation resistant capital growth⁹⁵. Its main role is that of a shock absorber⁹⁶ but it would be naïve to think that quoted property companies or REITs only invest in secure, income producing stock. However, not all real estate investment is income-led, and some companies chase capital growth or value-added opportunities, placing additional risk and uncertainty on future cashflows. Niche strategies are common in the US, with easy access to specific sectors through specialised REITs.

Direct real estate ownership has suffered from a lack of informational transparency, causing cyclical swings between supply & demand that have caused the market to be very sensitive to capital surpluses. In the US, the large publicly traded REIT market generated attention from stock market analysts and improved the quality and availability of research. In turn, this helped raise private and institutional equity, reducing industry leverage and overall cost of capital.

Hypothesis

This exercise explores whether the regulatory differences between the REIT structure and UK Plcs cause significant variations in the performance of the vehicles, per se.

⁹⁵ This is especially true in the case of FRI or Triple-Net Lease arrangements

⁹⁶ In vestment Strategy Annual Review 2002, Real Estate's role in a 2002 Portfolio, Jones Lang LaSalle

Corporate tax exemption has helped REITs to trade close to their Net Asset Value and the distribution of nearly all income has offered investors regular, predictable and healthy dividends. It is assumed that the UK property Plc will possibly display lower returns and higher volatility than US REITs and Australian LPTs. In particular, the exercise examines the potential benefits that securitised property can offer to a mixed asset portfolio.

The Traditional View of Securitised Property

Historically, US REITs have performed in closer correlation to Small-Capitalisation (Small-Cap) Stocks than direct property⁹⁷. Although underpinned by real estate assets they are exposed to factors that only affect a quoted market. Factors include the speed with which they can absorb market information, versus the sluggishness of the real asset market in reacting to “news” or “shocks”.

It has been tested and proven that US REITs, through their competitive returns and average volatility can increase total return or lower overall volatility in a mixed asset portfolio⁹⁸. Furthermore, commentators have argued that a REIT allocation of between 5-20% will increase return and lower risk in most portfolios⁹⁹. It is important however, to understand how the overall portfolio composition influences these results.

Whereas direct real estate ownership provides certain hedging characteristics against inflation, it is thought that REITs do not behave in a similar manner. However, after removing the effects of stock and bond markets on the performance of equity REITs, Gilberto (1990) proved a strong positive correlation between REITs and unsecuritised property over both the short and long terms. Relative to treasuries and bonds REITs are shown to offer greater security against inflation, possibly due to the capital growth qualities of their underlying assets.

Although they are not as efficient at hedging inflation as direct real estate¹⁰⁰, REITs offer a better alternative than typical fixed-income instruments¹⁰¹. Inflation comprises expected and unexpected elements.

⁹⁷ Glascock, Lu & So 2000

⁹⁸ Ibbotson study, www.nareit.com

⁹⁹ REITs, JK Lasser Pro

¹⁰⁰ Hartzell, Hekman & Miles (1987)

¹⁰¹ REITs, JK Lasser Pro p81

Expected inflation is the component often built into required returns by investors, whereas Unexpected inflation represents the difference between Expected and *actual* inflation. A number of studies prove that REITs offer a relatively good protection against expected inflation, although they offer little or no security against unexpected inflation¹⁰².

Data Analysis Issues

In considering the return characteristics of different asset classes' historical returns it is important to understand limitations in the accuracy of the data. As Warren Buffet drily observed,

“If past issues were all that there was to the game, the richest people would be librarians.”

The exercise in this Chapter relies upon inflation and treasury-bill data for benchmarking purposes, and then uses two types of stock, bond and real estate, for the investments themselves. Two ‘sub-classes’ represent each asset type to prevent the arbitrary asymmetry that might occur if there were two types of real estate competing with only a single type of bond. This potential ‘granularity’¹⁰³ could bias the results against the asset class that is under-represented.

Stocks, bond and REIT data provide real-time evidence, supported by transactions and market indices. Direct real estate data, on the contrary, is often subject to errors. Transaction and appraisal data reflect an ‘expected’ value due to imperfect information in the market. Buyers, sellers and valuers can only ever estimate values due to the uniqueness of property and informational constraints of the market¹⁰⁴.

Property data is subject to two types of error: random noise and temporal lag. Transaction values are effected by noise only, whereas appraisals are effected by both.

¹⁰² Chan, Hendershott & Sanders (1990), Gyourko and Linneman (1998), Goebel and Kim (1989)

¹⁰³ I am indebted to Rob Callagy, my Real Estate Finance TA for raising this issue and introducing me to the term ‘granularity’ to describe this scenario!

¹⁰⁴ As Geltner discusses, given a lack of independent impartiality, one side gets a better deal in a transaction. Also, it is rare that two independent valuers ever derive exactly the same value for an asset.....

Noise

Noise contains a purely random error that can be somewhat diminished by the sheer weight of transaction evidence. Noise leads to a dispersion of values around the 'true' empirically unobservable value. In the UK, this problem is accepted by RICS valuation guidelines, which allow the valuer a degree of standard error. Transaction evidence is subject to the 'square root of n' rule¹⁰⁵. This implies that the larger the sample of comparative evidence, the greater the accuracy of information and the lesser effect of random noise. The standard deviation of the dispersion of the mean of a sample around the mean of the 'universe' from which the sample is taken, is inversely proportional to the square root of the size of the sample. It's a mouthful, but in short, - the larger the universe of evidence, the lower the noise.

Lag

Temporal Lag describes the effect of time in the appraisal process. Appraisers are forced to look back in time to derive comparable and transactional data. In turn, the appraisal values upon which they are relying will probably also suffer some systematic error due to lag. Lag can be partially countered by disregarding stale appraisals and using a repeated measures regression to fill in any 'missing' appraisals.

A market learns about values from itself, and the property market is inherently slow moving due to limited transactions, a lack of exact timing information for appraisals and the inefficient aggregation of information. This can lead to uncertainty about exact market information. In the securitised property market, information is available immediately to all participants and can be quickly disseminated. Since both the securitised and unsecuritised markets trade in the same underlying assets, there is also a relationship between the two markets. In an effort to enhance price discovery, studies have shown that the securitised market normally leads the unsecuritised market, with varying degrees of lag¹⁰⁶.

Temporal lag produces a 'moving average' trend over time, as current appraised values draw from the previous periods. In turn, this creates smoothed values, which do not accurately represent the true volatility of the marketplace, and tend to be (highly) positively autocorrelated. Appraisals often respond sluggishly to changes in market condition. This might be partially due

¹⁰⁵ Also known as the law of large numbers

¹⁰⁶ For more information on this subject, see Barkham & Geltner, Price Discovery in American and British Property Markets, 1995

to the ‘carry over’ of historic values, excessive appraisal reliance on ex post data or the influence of a reticent owner over his appraiser¹⁰⁷!

One recent approach to increasing the accuracy of appraisal based values is to ‘reverse engineer’ appraiser behaviour to reduce the effects of both noise and lag. The combined effects of noise and lag are noticeable on the capital appreciation returns, as opposed to the income element or total return. The reverse engineering is not an exact science, but uses assumptions regarding appraiser behaviour to diminish any appraiser bias in capital values. In the Chapter a ‘simple one-step reverse engineering model’¹⁰⁸ is used to ‘unsmooth’¹⁰⁹ the real property capital returns data for the USA, Australia and the UK. The one-step method deals with the effects of stale appraisals and microlevel appraisal lag, and is applied to annual-frequency capital appreciation returns. Noise is less of an issue when viewed in terms of annual frequency returns. The exercise examines returns to ‘all property’ and each of the data sources is statistically large enough to reduce the overall effects of noise.

The partial adjustment formula is based on a first-order autoregressive valuation equation. The purpose is to redress the lag by balancing both old and new comparable evidence. It can be written as:

$$UV = (SV_t - (1 - \alpha) SV_{t-1}) / \alpha$$

Where UV = Unsmoothed Value
SV = Smoothed Value
 α = Confidence factor
t = Time period

The ‘true’ value target is based on the Quan Quigley model of rational appraiser behaviour. The model takes a normative view of valuation, assuming the values take a ‘random walk’ and appraisals are subject to standard error. To assume zero-autocorrelation between consecutive returns is not pragmatic in the consideration of real estate markets.

¹⁰⁷ Issues identified by David Deutsch in his 1993 thesis “The use of Equity REIT Returns for Deriving a Discount Rate for Unsecuritized Real Estate”, MIT 1993

¹⁰⁸ Geltner (1993b), based on the Quan Quigley model of rational appraiser behaviour

¹⁰⁹ Also called ‘de-smooth(ing)’

The value of the confidence factor is largely subjective and is based upon the degree to which appraisal values are stale, or lagged. This can be observed by auto-regressing the data for a single period and observing the first order auto-correlation coefficient, or by applying the objective observable lag between direct and securitised markets. The observed beta of the data series also provides an indication of the effect of lag within the series.

The Portfolio Exercise

Ibbotson Encorr Data Analysis software was used to analysis the performance characteristics of securitised and unsecuritised real estate in the USA, Australia and the UK. Each scenario tested the real estate asset classes to discover their individual properties, as well as the role they would play in a notional mixed asset portfolio. An effort was been made to utilise contiguous asset class data for each country to ensure as fair a comparison as possible.

USA

As the software was an American product, it contained a large amount of US benchmark data, which facilitated the analysis process. Since the purpose of the exercise was to examine the characteristics of direct and securitised real estate investment, this naturally created two real estate asset classes. In the interests of an equitable study two classes of stocks and bonds were used to avoid granularity. Inflation and 30-day Treasury-bill data were used for benchmarking purposes.

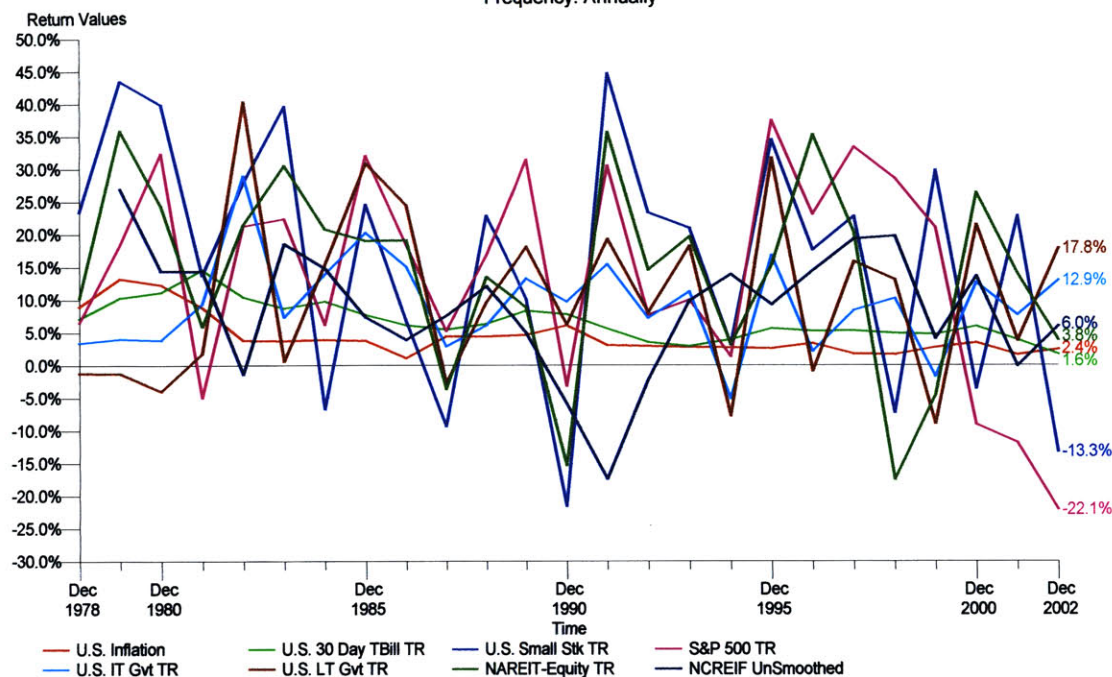
Small-cap stocks and S&P500 stocks represented the stock market. To give a well-rounded view of the yield curve (versus T-bills) intermediate-term and long-term government bonds were used. In terms of securitised real estate, a NAREIT¹¹⁰ total return for equity REITs was used, since equity REITs are more comparable with UK Plcs and Australian LPTs than mortgage or hybrid REITs. Data relating to returns to direct property were obtained from the NCREIF Index of Institutional Property Returns¹¹¹. The graph below shows the overall asset mix:

¹¹⁰ National Association for Real Estate Investment Trusts

¹¹¹ National Council for Real Estate Investment Fiduciaries

USA Mixed Asset Portfolio 1978-present

Frequency: Annually



The analysis dated back to 1978 as NCREIF began collecting data in 1977. NCREIF's data 'universe' includes existing investment grade, income-producing properties only. Performance data derives from the retail, office and industrial sectors for the purpose of this study. Each property is regularly appraised, in line with what NCREIF describes as a 'real estate methodology'.

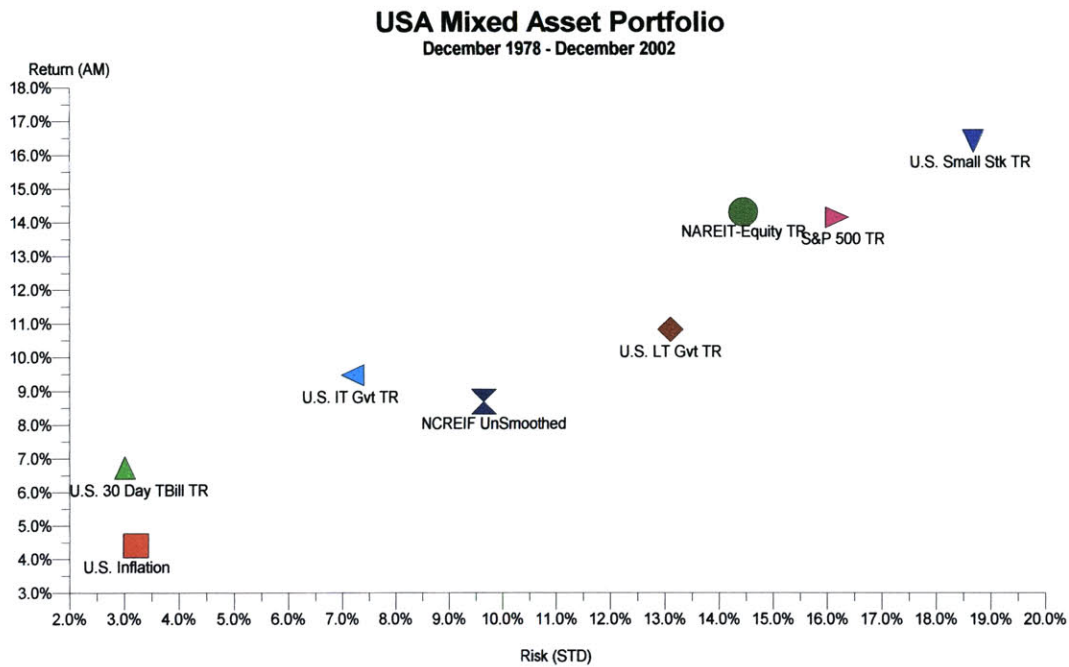
Annual NCREIF data for the subject period showed a geometric mean¹¹² total return of 9.35% against a standard deviation of just 6.35%. This low volatility was possibly due to the appraisal smoothing effect, as the autoregression showed a high 80.15% beta coefficient. This is possibly due to irregular appraisals. An 18-month average lag can be empirically observed between securitised and non-securitised performance in the US market¹¹³. In turn, this relates to a 6 period lag on a quarterly basis. The Geltner 1-Step Unsmoothing formula was applied with a 0.4 confidence level to reflect this lag¹¹⁴.

¹¹² Geometric mean is preferred to Arithmetic mean as it reflects the compounding of returns, distinguishes between income and capital returns and is less affected by volatility.

¹¹³ Barkham & Geltner

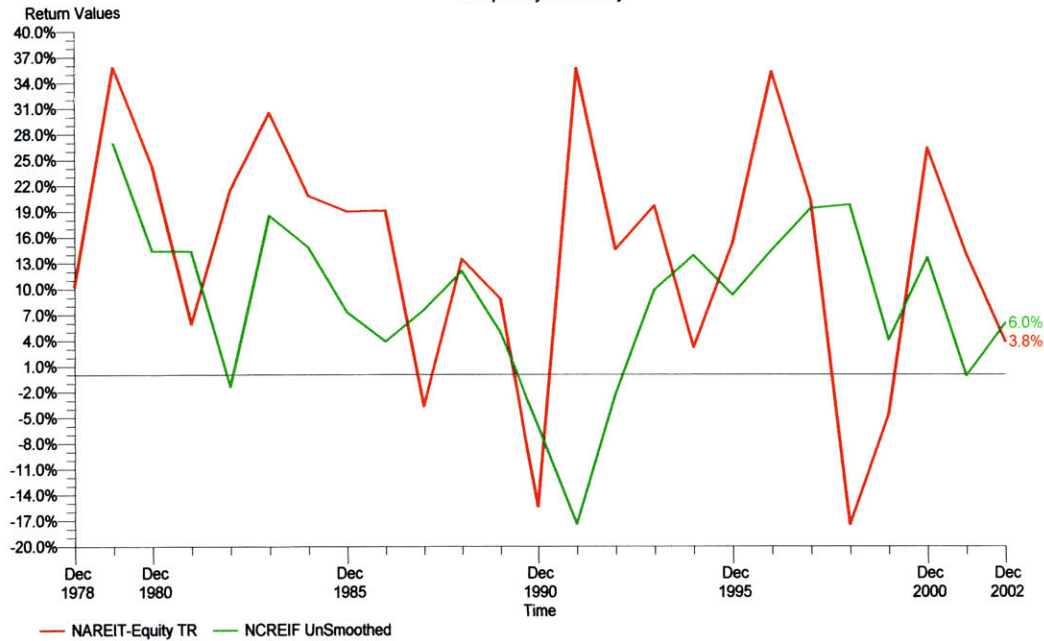
¹¹⁴ To the Capital Appreciation element alone

The unsmoothed NCREIF showed a lower geometric mean of 8.35% against a standard deviation of nearly 10%. This put the volatility inline with intermediate-term government bonds and still some way below all stocks (circa 15%+). A graph indicating the mean risk and return characteristics of each asset is displayed below:



The relationship between NCREIF direct property returns and NAREIT securitised property is illustrated by the graph below. In fact the assets only correlate to a factor of 11.6%. NAREIT's equity REITs showed a mean of 13.36% and a 14.4% standard deviation versus the 8.35% mean and 10% standard deviation of NCREIF. The lag is observable in the graph overleaf, alongside the increased volatility experienced by the securitised market.

NAREIT vs Unsmoothed NCREIF Frequency: Annually



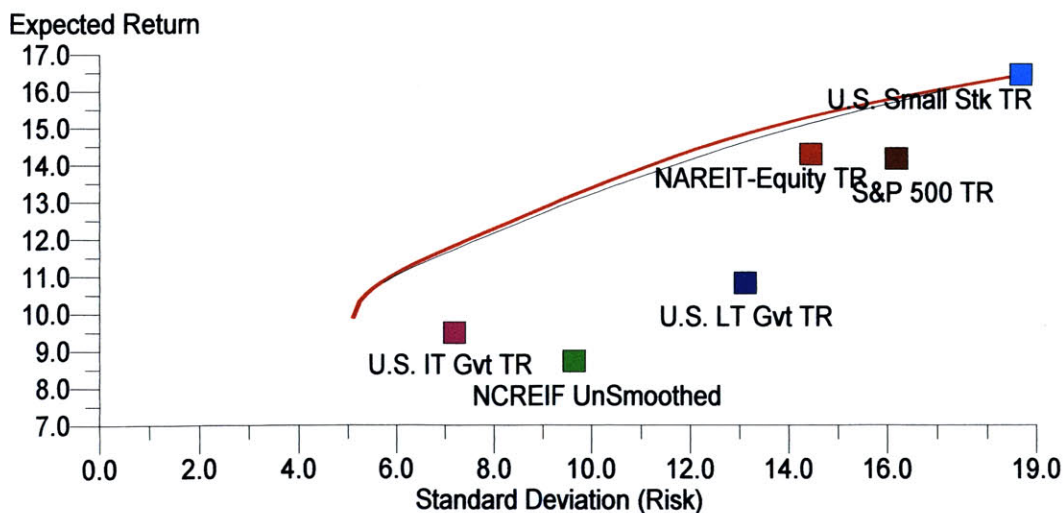
The portfolio was analysed to discover the optimum mix of assets, according to a specific range of target returns. For this exercise, target returns of 10%, 12% and 14% were chosen for benchmarking purposes, and T-Bills were included in the portfolio as the risk-free asset. Two portfolios were analysed: one of which included REITs, the other of which did not but was otherwise identical. Direct property, represented by NCREIF, was restricted to a maximum portfolio weighting of 20%. It is largely unrealistic to expect an institutional investor to commit more than this level of resources to direct property¹¹⁵.

¹¹⁵ In fact, even this level is generous, since most funds openly admit that they would not hold more than 10% in property due to management and liquidity issues, but the exercise is for illustrative purposes only.

At the median portfolio return, 12%, the results were as follows:

Statistics & Assets	Portfolio 1 – without NAREIT	Portfolio 2 – with NAREIT
<i>Target Return</i>	12.00%	12.00%
<i>Sharpe Ratio</i>	1.58	1.61
Weightings		
30-day T-Bills	0.00%	0.00%
US Long Term Govt Bonds	12.42%	5.13
US Intermediate Term Govt Bonds	29.07%	30.19
US S&P 500	7.70%	11.34
US Small Stocks	30.81%	19.02
US Unsmoothed NCREIF	20.00%	16.94
US Equity NAREIT	N/A	17.38

The evidence suggests that REITs have justified their role as a portfolio diversifier, holding target returns constant and improving the Sharpe ratio, thus lowering overall volatility. The two efficient frontiers are shown on the graph below - the red line shows the graph including NAREIT.



The introduction of REITs attracted 17.38% of portfolio investment, reducing the small-cap stock holding, with its higher volatility (19%). The weighting to S&P500 also increased, enabling the ownership of more “blue-chip” stocks at a lower volatility of just 14%. NCREIF direct property weighting also reduced.

The portfolio was also tested with NCREIF direct property holdings ‘locked’ at a maximum 10%. The maximised portfolio produced a Sharpe Ratio of 1.79, and an expected return of 10.65. In this case, intermediate-term bonds dominated the overall investment mix (60%) although REITs still accounted for some 7% of the portfolio.

Ibbotson Associates carried out a similar study in May 2001, on behalf of NAREIT¹¹⁶. To quote their findings,

“A sample portfolio prepared by Ibbotson consisting of 40% bonds, 50% stocks and 10% Treasury Bills provided an average annual return of 11.8% and a risk level of 11.2% between 1972-2000. When the asset mix was adjusted to include 35% bonds, 45% stocks, 10% T-Bills and 10% REITs, the average return increased to 12% and the risk level declined to 10.9%. The Ibbotson analysis shows that, given their low correlation, real estate stocks are an important and effective source of diversification”¹¹⁷.

AUSTRALIA

In an effort to approximate a similar portfolio of mixed Australian assets, a variety of sources were utilised. The Property Council of Australia (PCA)¹¹⁸ provided annual income, capital and total return data for all Listed Property Trusts and all direct property over the period 1985-2002. PCA data was also used for 90-day Treasury-bill benchmarking purposes¹¹⁹. JP Morgan (JPM) provided data relating to 5-7 year (intermediate-term) government bonds, and the International Monetary Fund (IMF) were quoted for inflation and long-term government bond data.

¹¹⁶ REITs’ Low Correlation to Stocks & Bonds is a Key Factor for Portfolio Diversification, NAREIT, May 29, 2001 www.nareit.com

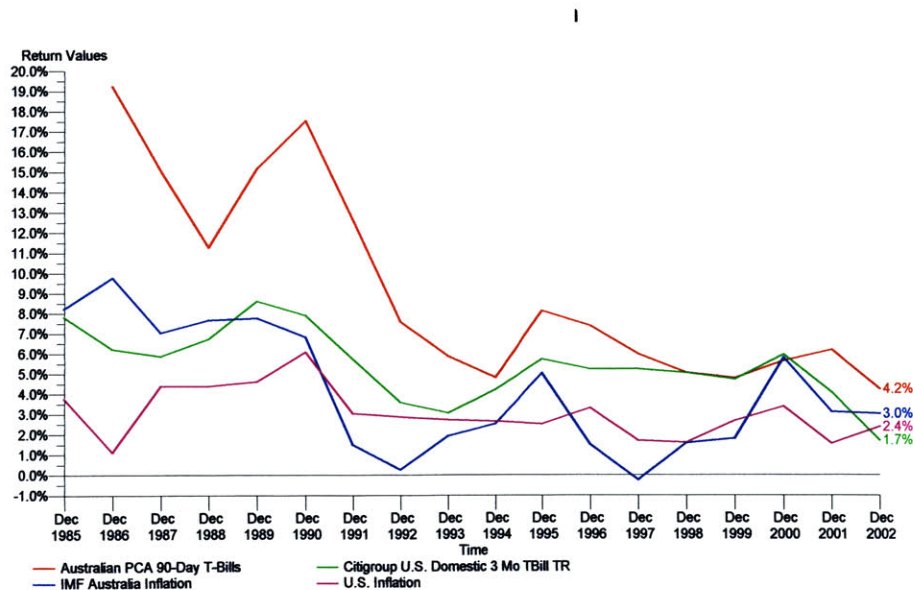
¹¹⁷ Ibid.

¹¹⁸ www.propertyoz.com.au

¹¹⁹ This data was cross-checked against IMF data for the same period, and found to be identical (99% cross-correlation).

Morgan Stanley Capital International (MSCI) provided small-capitalisation stock returns¹²⁰, and the Dow Jones (DJ) Global Indexes¹²¹ provided large-cap data in the form of “DJ Australia Titans 30”. The PCA all direct property returns showed a geometric mean total return of 10.02% against a standard deviation of 9.8%. The low volatility was possibly due to the appraisal smoothing effect, although the autoregression showed a relatively low first-order autocorrelation-coefficient (+0.69). The Geltner 1-Step unsmoothing formula was applied to the capital appreciation element of the return, but this time with a 0.8 confidence level. The 0.8 level reflects a lag of just a single quarter, and the smoothed 9.8% standard deviation suggests that the data was already probably fairly accurate. The Australian requirement for the annual appraisal of institutional property holdings probably contributes to this accuracy. The unsmoothed data showed a slightly lower geometric mean (9.44%), against a higher volatility (standard deviation 10.81%).

The portfolio was analysed over the period 1985-2002 to reflect that all figures (barring the small-cap returns) dated back to this time. Once again, two portfolios were tested: one of which included Listed Property Trusts, and one of which did not. Target returns were fixed at the same 10%, 12% and 14% levels. However, as the graph below illustrates, Australia experience far mores expensive short-term cash during the late 1980s, and this will have had a considerable effect on the overall market.



¹²⁰ Unfortunately, only available from 1999-2003

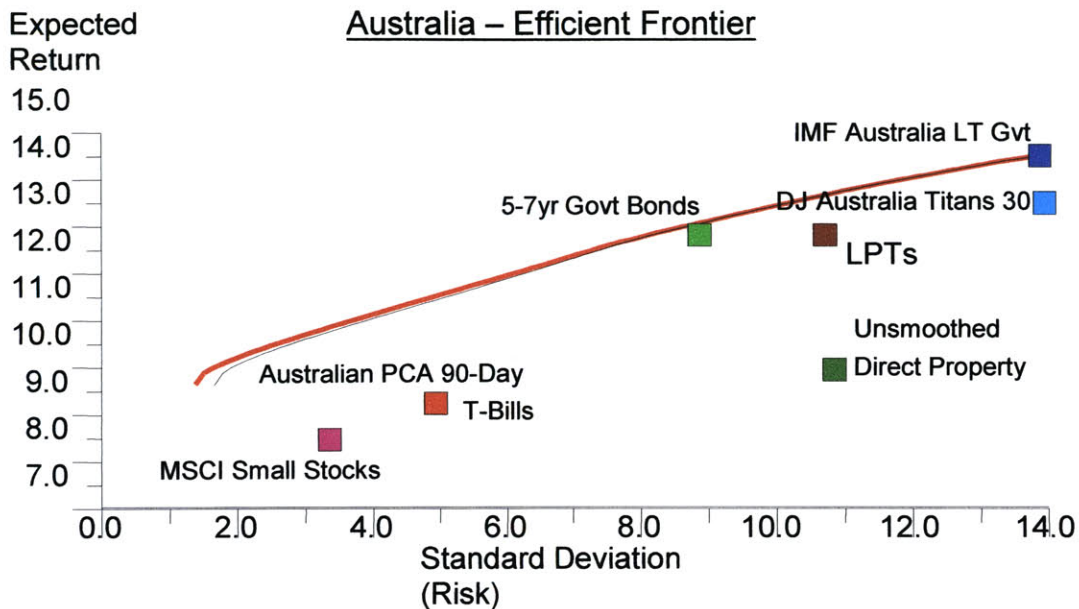
¹²¹ Sic.

At the median target portfolio return of 12%, the Australian results were as follows:

Statistics & Assets	Portfolio 1 – without LPTs	Portfolio 2 – with LPTs
<i>Target Return</i>	<i>12.01%</i>	<i>12.01%</i>
<i>Sharpe Ratio</i>	<i>1.91</i>	<i>1.96</i>
<i>Standard Deviation of Portfolio</i>	<i>6.29</i>	<i>6.12</i>
Weighting		
PCA 90-day T-Bills	0.00%	0.00%
IMF Long Term Govt Bonds	0.00%	0.00%
JPM 5-7 yr. Govt Bonds	68.76%	56.61%
DJ Australian Titans 30	7.96%	3.06%
MSCI Australian Small Stocks	13.28%	12.37%
Unsmoothed PCA Direct Property	10.00%	10.00%
PCA Australian LPTs	N/A	17.96%

The direct property holding was restricted to just 10% for this analysis, with good reason. Aside from the liquidity and management factors, this low limitation is representative of the relative lack of stock, since Australian LPTs own more than 70% of the entire commercial real estate market. There is not very much property in Australia that can be owned directly.

It was observed that the Listed Property Trusts behaved in a similar manner to the USA REITs. The LPTs immediately accounted for 17.96% of the portfolio value - US NAREIT had accounted for 17.38%. However, the insertion of the LPT had the primary effect of reducing, or replacing, the intermediate-term government bonds and large-capitalisation stocks. The direct property contribution remained constant, at the maximum 10%, throughout. This is due to its low volatility and steady pattern of returns. The frontier graph overleaf illustrates how the addition of LPTs improved overall efficiency. The red line indicates the efficient frontier of the portfolio including securitised property.



The maximised portfolio for the asset mix, including LPTs, produces a Sharpe Ratio of 7.00, and an expected return of 9.66. Small-cap stocks dominate the portfolio (60%), although LPTs still account for some 11% of the portfolio. This is a substantially higher weighting than direct property (5.85%). Without the securitised LPTs, the Sharpe Ratio falls to 5.8, and the portfolio generates a lower expected return, 9.63% overall. Reflecting the same pattern as the American example, any shortfall in LPTs is replaced largely by intermediate-term government bonds.

In terms of annual total returns, Australian LPTs have outperformed direct property, shares and bonds over 1,5 and 10 years. This is due to a variety of factors including; the growth of the industry, the introduction of compulsory superannuation, new capital raisings, the recovery of the underlying property market and an overall increase in the quality and spread of properties, amongst others¹²².

In 2002 Australian LPTs had a 0.64 correlation with the All-Share Index, 0.44 with bonds and just 0.06 with direct property. Australian LPTs are a positive portfolio diversifier and, despite their low correlation with direct property, they have represented the underlying assets in terms of capital and income growth. They have a low correlation with inflation (0.06) and a high correlation with long-term government bonds (0.73).

¹²² N.B. University of Singapore & University of Western Australia data.

This evidence raises a number of questions about the nature of LPTs. Direct property correlates with inflation to a factor of 0.63, emphasising its hedging benefits. LPTs, however, behave more like fixed-income instruments. They benefit from long-term, strong credit investments and a low turnover of underlying assets. The lack of active trading has invoked criticism of the LPT market, but management has largely responded to the needs and wants of shareholders. It is important to consider the extent to which the demand for long-term security by pension investors has created a 'buy and hold' market.

UNITED KINGDOM

Evidence from both the American and Australian studies was used for 'control' purposes in examining the role of UK Property Plcs within a mixed asset portfolio. International Monetary Fund indices were used to supply the data for Inflation, the 30-day UK Treasury bill and long-term government bonds. Independence International Associates¹²³ provided data on both large-capitalisation and small-capitalisation FTSE stocks. The JP Morgan Index was used as the reference for 5-7 year (intermediate-term) government bonds. The Independent Property Databank supplied income, capital and total return data for all UK commercial property performance. Finally, Datastream provided the performance of FTSE Property Stocks on a daily, monthly and annual basis.

The IPD all-property data showed similar trends to the PCA Australia data. It was therefore unsmoothed using the same 0.8 confidence factor, reflecting a single quarter's lag behind the securitised market. The smoothed data showed a geometric mean of 12.07% and a standard deviation of 10.72. After unsmoothing, the mean had reduced to 11.61% and the standard deviation had increased to 13.19%.

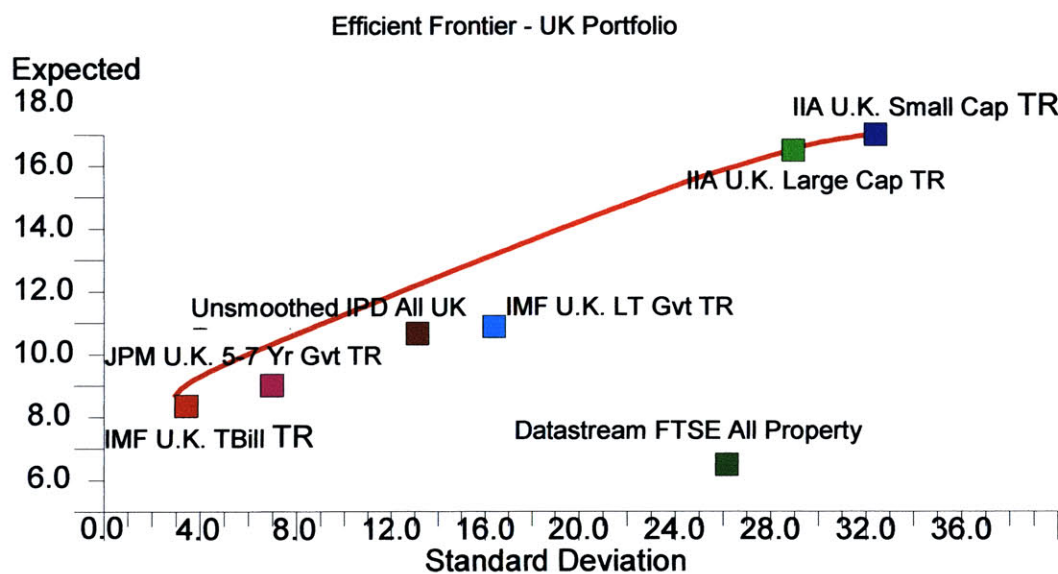
The results could not have been more different to those of the USA and Australia exercises, largely due to the low returns and high volatility of FTSE property stocks. The initial property Plc data, supplied by Datastream¹²⁴, showed a geometric mean return of just 7.6% against an overall volatility of 26.16%.

¹²³ A joint venture between Morgan Stanley Capital International and an unnamed Boston based fund (Ibbotson)

¹²⁴ Kindly provided by Rothschild, since Datastream is a subscriber service.

The large-cap and small-cap FTSE standard deviations are also very high, at 28.92% and 32.42% respectively. However they produce higher respective returns of 17.5% and 18.0% to balance this additional risk. After executing the same portfolio optimisation exercise, securitised property Plcs were not included in the optimal portfolio at all, even when direct property holdings were restricted to 7.5%.

The results generated some concern that the data contained some errors, or represented a pricing index as opposed to a return index. The FTSE all-property data was cross-checked against alternative Datastream evidence¹²⁵ and found to be accurate in every respect. For some reason, quoted property provides relatively low returns at excessive risk. As can be seen from the following efficient frontier diagram, its position in comparison to alternative asset classes is weak in every respect.



Explanations for this performance might include two economic recessions over the 1985-2002 sample test period, and the relative proliferation of small, risky companies within the sector. However, the statistics should provide a weighted average of the entire quoted property sector and institutional giants such as British Land, Land Securities, Canary Wharf and Hammerson will all influence the data considerably.

¹²⁵ Kindly provided by IPD, JP Morgan and CSFB analysts.

Whereas REITs as a whole tend to have a rough balance between their equity and debt, and invest in income producing property, Plcs engage in more long-term development activity and tend to be far more highly geared. Direct property in the UK performed very strongly over the same period however.

It seems possible that the structure of the quoted property vehicle is contributing to this relative discrepancy. To investigate this hypothesis, studies are carried out in Chapter 4 to quantify the effect of single layer taxation and substantial distribution of dividends on company value.

Discussion

Direct property has performed well in the USA, Australia and the UK over the past 2-3 decades. The optimal portfolio weightings recommended by this study are rarely practical due to the inherent restraints of the underlying property asset. Evidence suggests that the USA and Australia have successfully introduced a REIT vehicle to offer investors the income benefits of direct property ownership, together with the securitisation benefits of liquidity and informational efficiency. Although some of property's characteristics do not translate directly to a securitised market, REITs and LPTs have certainly justified their inclusion in a mixed asset portfolio - on the basis of their diversification benefits alone.

In contrast, the UK property Plc displays a positive correlation with the unsecuritised property market¹²⁶ but is unable to contribute positively to a mixed asset portfolio. Its volatility appears in keeping with the equity market as a whole, and in fact property Plcs are less volatile than either large-cap or small-cap stocks. It can be assumed therefore that the Plc's distinguishing feature is its low return profile. In turn, it is necessary to examine the low returns might be the result of taxation at a corporate level and company discretion regarding the payment of annual dividends.

¹²⁶ Price Discovery in American and British Property Markets, Barkham & Geltner, 1995

Chapter 4 Assessing the Magnitude of the REIT Tax Advantage

Since real estate is an asset, and not a corporate entity, rent constitutes ordinary income and is not subject to taxation at a corporate level. The US REIT was originally subject to corporate tax exemption to transfer the identical characteristics as private real estate ownership. Over time, restrictions on the operational activities of US REITs have become more flexible, allowing management to engage in real estate related activities typical of a vertically integrated strategy.

Drawing inferences from the findings in Chapter 3, US REITs and Australian LPTs exhibit certain trends that make them attractive to investors. Not least of these is their ability to allow income to “pass-through” at the corporate level, provided a proportion of the income is then distributed to shareholders. Equally, REITs are allowed to depreciate their real estate assets over time, which provides a ‘shelter’ from additional taxation. As a result of these benefits, REITs’ and LPTs’ shares have often traded close to their Net Asset Value.

UK property Plcs exhibit vastly different investment characteristics. Unlike typical REIT structures, they are subject to full taxation at a corporate level, and management is not bound by any specific guidelines regarding the distribution of income in the form of dividends. This Chapter investigates the guiding principles of public finance regarding taxation policy, and develops a simplistic model to value the magnitude of the REIT tax advantage.

The Founding Principles of Public Finance

In every country the Government bears a responsibility to define and enforce a framework for the “rules of the economic game”¹²⁷. These rules typically govern the overall performance of a private economy and include laws covering contracts, bankruptcy, liabilities, and property rights (in the widest sense of the word). To maintain this framework governments requires a wide range of mechanisms, which include direct controls such as planning or licensing, legislation in the form of statutes and case law, monetary policies for private and public spending and saving, and finally of course, taxation.

In essence public finance revolves around two ideologies: efficiency and equity.

“Efficiency” dictates that a free-market economy finds a state of equilibrium and becomes Pareto-efficient. This means that for someone to gain, someone else has to lose, or vice versa.

Theoretically there is no need for government, for an economy will find its own balance. Most commentators agree that no economies are truly efficient. In order to be so, an economy must be perfectly competitive, exhibiting complete markets, perfect information and no disinformative externalities. In the absence of efficiency there is the need for government guidance and regulation.

Pareto-efficient theory can be applied, at a micro-level, to REITs. Where a REIT benefits from corporate tax exemption, it is charged a ‘cost’ in having to pass its income through to the taxable shareholder. It also faces additional regulations and limitations on its wider business activities that might restrict its future growth and profitability. In a Pareto-efficient economy, an alternative vehicle would exploit the activities from which a REIT is prohibited. It would also generate tax revenues in some form. Theoretically, the US REIT is filling a market niche. Where its activities are limited, private companies and Real Estate Operating Companies (REOCs) undertake these activities and pay their respective taxes. It is both efficient and equitable.

The introduction of the French SIIC will provide a long-term benefit for the public, in return for a one-off tax cost and future tax revenues from shareholders and trading activity (at all levels).

There is no free lunch! If the government truly believed it would be out-of-pocket over the long-term as a result of the SIIC it is unlikely that it would have been introduced.

The concept of “equity” describes the manner by which a tax burden is distributed across a population. Vertical equity concerns itself with how the tax burden is distributed between people in different circumstances (i.e., the rich versus the poor). Horizontal equity confers that people who are in similar circumstances should bear the tax burden equally.

Horizontal equity is most frequently violated when administrative arrangements are unsatisfactory¹²⁸. Poor administration can lead to heavy taxes for some people and total avoidance for others. This inequity can be the result of more effective advice, expert knowledge or inadequate policing. It can even be directly attributed to the attitude of the individual; for example, where one person is happy to pay taxes, another devotes time and money towards minimising their tax liabilities.

Every tax should endeavour to be equitable in terms of both its underlying principles and its application across a population. The REIT principle enabled the population to benefit from a contiguous tax policy on real estate, creating ownership for the masses, despite economic disparities.

US Jobs & Growth (Reconciliation) Act 2003

In May 2003, President Bush signed the above Act, hoping to reinvigorate the economy by incentivising inward investment through the US stock markets.

The Act is a five-year plan. Over the period 2003-2008, it reduces capital gains liabilities from 20% to 15% and personal income tax on share dividends from 38.6% to 15%. In the absence of further Congressional revisions, in 2009 the maximum tax rate on capital gains will return to 20% and the maximum rate on dividends will move to 35%. This dividend rate will then rise to 39.6% in 2011.

¹²⁷ Atkinson & Stiglitz, Lectures in Public Economics

¹²⁸ The British Tax System, Kay and King

REITs have been excluded from the Act, since Congress has advocated the existing benefits (of corporate tax exemption etc.) in line with direct property ownership. REITs are viewed as a closer relative to the property market than the equities market. In addition, to allow REITs corporate tax exemption *and* just 15% tax on dividends would likely cause disparities between competing asset classes.

However, REIT dividends *will* benefit from a lower maximum rate of 35% as opposed to the current 38.6%. They will also qualify for a reduced tax rate in the following scenarios¹²⁹.

- I. When the REIT taxpayer is subject to a lower scheduled income tax rate
- II. When a REIT makes a capital gains distribution (i.e. 15% as opposed to previous 20%)
- III. When a REIT distributes dividends received from a taxable REIT subsidiary, or other corporation (15% only)
- IV. If a REIT, as permitted, pays corporate taxes and retains earnings (15%)
- V. In the event of the sale of REIT stocks a maximum capital gains rate of 15% will apply

As of May 2003 REITs boasted an average annual yield of 6.8%, significantly higher than the average S&P stock yield of just 1.7%. Despite any tax implications, it still makes perfect sense to invest in REITs.

The change has made, and will make no difference for tax exempt institutions and personal pension investors.

In response to The Jobs & Growth Act, Morgan Stanley and Banc of America Securities both extolled the virtues of REITs, commenting on their continuing high yields, low volatility and diversification benefits¹³⁰. Salomon Smith Barney's analysts commented, "REITs' after tax yield is still greater than over 1400 stocks in the S&P Index".

¹²⁹ NAREIT, REITs and the New Tax Law, June 2003

¹³⁰ Ibid.

Quantifying the Magnitude of the REIT Tax Advantage

One way to understand the implications of a future UK REIT, its trading characteristics and its attractiveness to investors might be to investigate the true advantages of the REIT tax break. Given the recent developments in the tax structure and its longstanding history of REITs, the US provides the best case study. The US REIT's tax basis has evolved over time, through trial by experience.

A number of UK press articles indicate that assumptions made about REIT tax benefits potentially overstate the impact of these advantages. For this reason, the REIT is often mistakenly portrayed as a panacea. This study sets out to show that the tax advantage is smaller than is commonly assumed.

This exercise calculates the approximate extent to which a typical US REIT's firm value (present value of net cashflow) is greater than that of typical corporation. In other words, it derives a true indication of the value of the REIT tax benefit.

Methodology

A typical REIT can be defined by its income statement, balance sheet and growth rate. This data enables the computation of a firm's net after-tax cash flow. The analysis is taken from a property level through the REIT entity level, to a shareholder level. This information can then be used to calculate the present value of the shareholder after-tax dividends, using a typical after tax discount rate. The same exercise is then undertaken for the same firm as if it was a C-Corporation treatment.

Investors each have an individual tax scenario, leading to a variety of capital costs that can be used for discounting purposes. The opportunity cost of capital used for the discount rate in this exercise derives from the capital market. This method draws on the theory that all investors in a given asset market use the marginal tax rate, and therefore they face the same cost of capital¹³¹.

¹³¹ Debt & Taxes, Geltner, 1997

The difference in the opportunity cost of capital for taxpaying and tax-exempt investors is implicit in the numerator (i.e., the post-tax dividend at the shareholder level). The opportunity cost of capital reflects risk over time, and the time value of money. It is more sensible to derive this from the capital market as opposed to considering all investors' potential risk preferences¹³². The issue of capital gains does not arise, since the value is calculated using a perpetuity model.

Assumptions

- Both the C-Corporation and the REIT receive the same net operating income, capitalised at the same rate to give an annual net asset value.
- Both companies are subject to the same leverage, debt service (interest only), depreciation and future growth rates.
- Both companies share the same target reinvestment as a percentage of net operating income.
- The REIT is subject to 0% corporation tax, 35% personal income tax and a minimum 90% payout of GAAP¹³³ net income whereas the C-Corporation is subject to 35% corporation tax, 15% personal income tax and no minimum payout. For an equitable comparison it is assumed that the C-Corporation distributes all available funds after reinvestment.

Step-by-Step Results

- The values for the parameters were chosen in consideration of NAREIT data and articles. For the ease of analysis, the notional companies received \$100 income. Leverage was fixed at 50% of the net asset value, charged interest only debt service cost at 6%. The capitalisation rate was fixed at 8%. Depreciation occurred on a straightline basis over a 39-year period, assuming 100% commercial real estate holdings. The depreciable basis of the portfolio was assumed to be 80% - the remaining 20% value was attributed to non-depreciable land value. All the assumptions are laid out in the table overleaf.

¹³² See Vizer and Liang-McIntosh provide further reading on this topic.

¹³³ USA Generally Accepted Accounting Principles.

<u>Assumptions</u>	<u>C-CORP</u>	<u>REIT</u>
Net Operating Income	100	100
Annual Income Growth	2%	2%
Capitalisation Rate	8.0%	8.0%
Capitalized Value (NOI / Cap Rate)	1250	1250
Capital Improvements Per Annum	0	0
Leverage	50%	50%
Debt Service Rate (Interest Only)	6.0%	6.0%
Value of Net Assets relative to Market Cap	100%	100%
Target Annual Reinvestment (% of NOI)	15%	15%
Amount of NAV comprising Depreciable Basis	80%	80%
Years of Commercial Property Depreciation	39	39
Corporation Tax	35%	0%
Personal Income Tax	15%	35%
Minimum Dividend Payout (as % of GAAP Net Income)	N/A	90%

Property Level

- At the asset level, both companies are subject to the same treatment; the focus is on the object (i.e., the property).
- In Year 1 both companies received \$100 net operating income. There was no reinvestment received in the first year and nor did the companies face any capital improvement expenses.
- Reinvestment for the following years reflects 15% of the previous year's net operating income.
- It can be assumed that the companies own a single property each and have no other assets or income. The value of this property, and therefore the company, is \$1250 (i.e., the income capitalised at 8%).
- The company is leveraged at 50% and interest is charged at 6%. There is no principle amortisation in this exercise. Both companies pay \$37.50 interest in Year 1, leaving the equity before tax cash flow at \$62.50.
- Both companies use full depreciation ($1/39 \times \$1250 = \25.64) to shelter income. This results in GAAP net income of \$36.86 for each company to begin the entity level analysis.
- The property level cash flow is presented in a table overleaf.

YEAR 1

YEAR 2

Property Level	<u>C-CORP</u>		<u>REIT</u>	
	<u>C-CORP</u>	<u>REIT</u>	<u>C-CORP</u>	<u>REIT</u>
Asset Value	\$1,250.00	\$1,250.00	\$1,305.00	\$1,305.00
Net Operating Income (ie EBITDA)	\$100.00	\$100.00	\$103.20	\$103.20
Income from Re-invested NOI	-	-	\$1.20	\$1.20
Capital Improvements	\$0.00	\$0.00	\$0.00	\$0.00
Property Before Tax Cash Flow (PBTCF)	\$100.00	\$100.00	\$103.20	\$103.20
Debt Service (Interest Only)	\$37.50	\$37.50	\$39.15	\$39.15
Equity Before Tax Cash Flow (EBTCF)	\$62.50	\$62.50	\$64.05	\$64.05
Depreciable Basis	\$1,000.00	\$1,000.00	\$1,012.00	\$1,012.00
Depreciation	\$25.64	\$25.64	\$25.95	\$25.95

YEAR 3

YEAR 4

<u>C-CORP</u>	<u>REIT</u>	<u>C-CORP</u>	<u>REIT</u>
\$1,331.28	\$1,331.28	\$1,357.91	\$1,357.91
\$105.26	\$105.26	\$107.37	\$107.37
\$1.24	\$1.24	\$1.26	\$1.26
\$0.00	\$0.00	\$0.00	\$0.00
\$105.26	\$105.26	\$107.37	\$107.37
\$39.94	\$39.94	\$40.74	\$40.74
\$65.33	\$65.33	\$66.63	\$66.63
\$1,024.38	\$1,024.38	\$1,037.02	\$1,037.02
\$26.27	\$26.27	\$26.59	\$26.59

Entity Level

- At Year 1, the C-Corporation’s GAAP net income is subject to \$12.90 corporation tax at 35%, the REIT is exempt. Funds Available for Distribution (FAD) are treated as the equity before tax cashflow less any corporate level tax. This leaves the C-Corporation with \$49.60, and the REIT with \$62.50.
- Depreciation is not treated as an actual cashflow event – it is a passive tax shelter.
- The REIT must distribute 90% of its GAAP net income, in this case equating to \$33.17.
- Both companies reinvest 15% of their net operating income, going forward year-on-year.

- Assuming both companies distribute all available funds after reinvestment, the C-Corporation will distribute \$34.60 and the REIT \$47.50. In the real world, the C-Corporation would be unlikely to do this. It would be more likely to hold funds back as retained earnings for future growth, however it is a necessary assumption for an "apples vs. apples" comparison.
- The REIT actually distributes 143% of its minimum required payout. Its \$47.50 dividend is 37% higher than the C-Corporation's \$34.60 dividend.
- The cash flows are detailed in the tables below:

YEAR 1

YEAR 2

Entity Level	C-CORP	REIT
GAAP Net Income	\$36.86	\$36.86
Corporation Tax say 35%	\$12.90	\$0.00
FAD - Funds Available for Distribution	\$49.60	\$62.50
Minimum Required Dividend Payout	<i>N/A</i>	33.17
Re-investment (% of NOI)	\$15.00	\$15.00
Total Paid Dividends	\$34.60	\$47.50
Net Dividend after Income Tax	\$29.41	\$30.88
Annual Dividend Growth (after tax)	<i>N/A</i>	<i>N/A</i>

C-CORP	REIT
\$38.10	\$38.10
\$13.34	\$0.00
\$50.71	\$64.05
<i>N/A</i>	34.29
\$15.48	\$15.48
\$35.23	\$48.57
\$29.95	\$31.57
1.8%	2.3%

YEAR 3

YEAR 4

C-CORP	REIT
\$39.06	\$39.06
\$13.67	\$0.00
\$51.65	\$65.33
<i>N/A</i>	35.15
\$15.79	\$15.79
\$35.87	\$49.54
\$30.49	\$32.20
1.8%	2.0%

C-CORP	REIT
\$40.04	\$40.04
\$14.01	\$0.00
\$52.62	\$66.63
<i>N/A</i>	36.04
\$16.11	\$16.11
\$36.51	\$50.53
\$31.04	\$32.84
1.8%	2.0%

Investor Level

- In Year 1, following the effects of respective personal income taxes, \$29.41 of C-Corporation income goes into the hands of shareholders, versus \$30.88 to REIT shareholders. This is only a 4.9% difference.
- The same exercise was carried out for the following three years, to assess the after tax dividend growth rate for valuation purposes. Gross income was inflated by 2% per annum, and 15% of this was reinvested. Of this, 80% contributed to the depreciable basis was also assumed to be income producing, at 8%.
- The REIT dividends grew at a faster rate, no doubt due to the arbitrage between corporate and personal level taxes.

Valuation

- The income was valued using the shortcut Gordon Growth Model (GGM), where **E** represents the firm's equity, **Div₁** is the Year 1 dividend, **r** is the required investor return and **g** is the long-run average growth rate.

$$E = \frac{DIV_1}{r - g}$$

- The GGM assumes a long-term average growth rate and avoids the need for explicitly forecasting each year's dividend through the use of a constant growth perpetuity formula. Although simplistic, the model is one of the most widely used methods for shortcut equity valuation.
- The long-term expected return comprises a risk-free rate plus a risk premium. It can be calculated using a number of assumptions. For benchmarking purposes, the expected return was taken to be the long-term average total return to equity REITs. This comprises a risk-free rate represented by the long-term average 30-day Treasury-bill rate¹³⁴.
- This long-term risk-free rate was substituted for the current equivalent.

¹³⁴ Source, Ibbotson

- Target returns for the C-Corporation and the REIT were tax-adjusted to represent the marginal investor – in this case by 20%. This represents the marginal premium between corporate and municipal bonds¹³⁵.
- The long-term average growth rate was taken to be the average post-tax dividend growth for years 3 and 4 in the model. The first year is not applicable, and the second year is anomalous due to the absence of reinvestment in the Year 1 dividends.
- ‘Other’ growth can be factored into this rate but that was unnecessary for this exercise.
- After applying the Gordon Growth Model to the first year’s dividend, the REIT had a value that was 8.93% greater than the C-Corporation. The table below presents these calculations:

R		C-CORP	REIT
	PRE-TAX Long-term average TOTAL return to Equity REITs*	11.34%	11.34%
	Long-term average riskfree rate (Annualized 30 Day T-Bill)* -	3.83%	3.83%
	Current riskfree rate (Annualized 30 Day T-Bill)* +	1.65%	1.65%
	ie: PRE-TAX adjusted required return =	9.16%	9.16%
	Effective tax rate prevailing for investors in Ccorps vs. REITs** -	20.00%	20.00%
	Required 'r' (post-tax OCC for the Marginal Investor) =	7.33%	7.33%
<hr/>			
G			
	Expected total average growth 'g' =	1.81%	2.01%
<hr/>			
R-G			
	r - g	5.52%	5.32%
<hr/>			
	Post-Tax Year 1 Dividend Payment	\$29.41	\$30.88
	E = Div / r - g =	\$532.97	\$580.58
	Difference	91.80%	108.93%

* Ibbotson

** Investments, Bodie Kane & Marcus

¹³⁵ Source, Bodie Kane & Marcus. The dividend is already post-tax, so the marginal rate applies equally to the REIT or C-Corporation dividend.

Further Discussions

- This model is intended for illustrative purposes only. It contains a number of assumptions that have been simplified to facilitate the observation of comparative trends.
- In year 1 the C-Corporation paid total tax of \$18.09 against the REIT's \$16.62, a difference of 8.8%, very close to the overall difference in value between the vehicles. However, since annual income grows at 2% per annum, so does the tax difference also grows, in perpetuity. In the real world, the C-Corporation is likely to shelter taxable income through the reinvestment of retained earnings, thus partially diminishing this disparity.
- Assuming both companies pay out total income after reinvestment (pre-personal income tax), the C-Corporation will consistently distribute approximately 72% of the REIT's payout. It would be interesting to examine whether the 28% difference might be responsible for a C-Corporation trading at a (similar) discount to net asset value. This could provide a strong case for understanding the way UK Plcs perform.
- Depreciation occurs at the property level and is not a cash flow event. It should have no bearing on the analysis other than to fix a minimum distribution level for the REIT according to GAAP principles. The minimum level in this exercise is exceeded by a 43% margin.
- Observable net dividend growth rates are affected by the choice of variables, in particular the leverage ratio, capitalisation rate and cost of debt. For the purposes of this exercise it has been assumed that both companies have identical leverage and the same overall Weighted Average Cost of Capital.

Chapter 5 A Qualitative Discussion of Key Issues

This Chapter is divided into two sections. The first section is an analysis of the potential benefits of the introduction of a UK REIT to different players in the property market. The second section highlights the primary relevant arguments for UK securitisation.

Potential Benefits of Introducing a UK REIT to...

The Economy – an overview

The UK property market is poorly regulated and inefficient in terms of both capital cost and transfer of information. The results of “The Anderson Report”¹³⁶ suggest that a UK REIT would engender more efficient asset pricing and reduce overall transaction costs. An efficient securitised market would pave the way for property derivatives. It would lower the property industry cost of capital and improve the wider economy in its role as a factor of production. The Anderson Report suggests that for every 1% reduction in property industry cost of capital would increase the overall output of ‘property-related’ business by 7.5%. Furthermore, it reports that the impact of a REIT on property-related tax revenues would be broadly neutral, or positive.

The introduction of a REIT would resolve the inequalities of real estate ownership, influencing the provision of pension income, affordable housing and Private Finance Initiative (PFI) schemes. Increased regulation would allow greater industry analysis. REITs could also reduce overall bank exposure to property and focus capital flows towards regeneration areas. The successful introduction of a REIT could allow UK property companies to compete on a level playing field with other international investors. It would also encourage repatriation of funds, preventing non-domicile tax avoidance measures.

¹³⁶ Property Securitisation in the UK, an analysis by Arthur Anderson, Donald Robertson & Andrew Scott, 2000

Private Investors

REITs would allow ‘the man on the street’ to invest personal savings and pension contributions in income producing real property shares with the same cashflow benefits as their directly owned counterparts. Money that is otherwise spent on tax avoidance advice and transaction and management fees could be invested in a liquid, transparent manner. Real estate accounts for approximately one-third of all UK wealth¹³⁷ and has become a popular asset class over the last 5 years, as it has outperformed stocks and bonds. Even the smallest property can require substantial investment and private investors have sought to raise debt to maximise their buying power (in the commercial and residential sectors). REITs could provide an equity investment without increasing personal and corporate debt obligations.

Pension & Insurance Funds

Over the period between 1981 and 1997 pension fund weighting in direct property was reduced from 14.8% to 4.1%. Life insurance fund weighting fell from 23.9% to 7.4%¹³⁸ over the same period. This trend can be partially attributed to illiquidity and exorbitant management costs. Most funds will probably agree that theoretical exercises advise them to hold more property in their portfolios, due to its inflation hedging and diversification benefits. REIT-style vehicles are now globally proven to provide a liquid medium for investing in property assets with predictable fixed-income and with low management and transaction costs. The predictable cashflow facilitates duration and cash flow matching strategies. Pension and life funds in the US and Australia each account for 55% of total REIT investment.

Banks & Investment Managers

As described in Chapter 1, international banks have led the growth of the UK and European debt securitisation business over the past decade. It can be assumed that their experience of US securitisation has helped develop their European expertise. With the forthcoming Basel Accord regulations, REITs would contribute reducing bank leverage and meet their capital adequacy targets.

¹³⁷ Knight Frank Research

¹³⁸ Property Securitisation in the UK, an analysis by Arthur Anderson, Donald Robertson & Andrew Scott, 2000

Those banks offering construction loans, bridging loans and mezzanine finance might find equity securitisation a viable new exit, in lieu of a more risky permanent loan¹³⁹. REITs will contribute to existing business lines including corporate finance, IPOs¹⁴⁰, mergers, acquisitions and research as well as debt and equity fund raising.

Property Occupiers

Through the reduction industry cost of capital, REITs will increase competition, driving down target returns and, in turn, occupancy costs. There is no quantitative evidence to back up this assumption but it is true from a theoretical economic perspective, *ceteris paribus*. Corporate occupiers could make tangible savings through the outsourcing of their property stock. Large properties often fail to maximise their true value due to their lot-size and the inherent risk that a single asset can present to an investor. Securitisation syndicates this risk across a multitude of investors. Outsourcing enables investors to benefit from the future income and allows the owner-occupier to release capital more effectively employed within its core business. One of the largest beneficiaries of this type of securitisation could be the UK Government, in the form of PFI transactions across a variety of property types.

Developers

It is commonly assumed that developers do not particularly benefit from REIT vehicles. This is certainly true in the countries that do not allow REITs to develop! In the US however, the market has proved that a REIT can be an effective developer. Notable examples of REITs with a strong track record of development include Equity Office, Boston Properties and Arden Realty. Regulations ensure that development is a limited component of a REIT's comprehensive strategy. Over the years REITs have experimented with more intricate financial securities to raise funds for development, generating future growth and higher gross returns. Mechanisms have moved away from common equity and commercial mortgages to include joint ventures, perpetual preferred stock, unsecured corporate debt, medium term notes, convertible preferred shares and convertible debentures - all with a view to using inherent 'latent' capital for a variety of development activities¹⁴¹.

¹³⁹ Property Securitisation, IPF, 1995

¹⁴⁰ Initial Public Offerings – floatation.

Current UK Issues in Relation to REITs

A number of the problems currently facing the UK economy may be partially solved by the introduction of a REIT style vehicle. These issues are addressed below in a similar point order to the 'Current Issues' section in Chapter 1.

Pension Crisis

The UK is in the midst of a serious pension crisis, affecting investors in company stakeholder and private pension plans. Investors widely believe in the benefits of investing in 'bricks and mortar', especially during periods of high volatility in the stock market. In the handful of countries proffering a developed REIT market, domestic individuals typically comprise 25%-35%¹⁴² of all investment. This is typified by the Australian market due to its compulsory superannuation laws. The US REIT is fully compatible with the 401(k) pension saving plans. If the UK is considering overhauling the pension industry in favour of increased self-invested plans, commercial real estate investment should be offered to the masses. To date, small investors have been restricted to 'trust' type arrangements offered by major funds.

In his 2002 lecture entitled "Property & Savings", Tom Laidlaw¹⁴³ describes the barriers to wider property investment by pension funds. The barriers include education, no tax efficiency, the need to go offshore, and a lack of derivative products.

Accordingly, he feels the UK requires a new commercial property product to fill this gap. A UK domiciled REIT would satisfy his requirements for liquidity, tax transparency, differential risk products, targeted diversification, regulation and expert management and data collection.

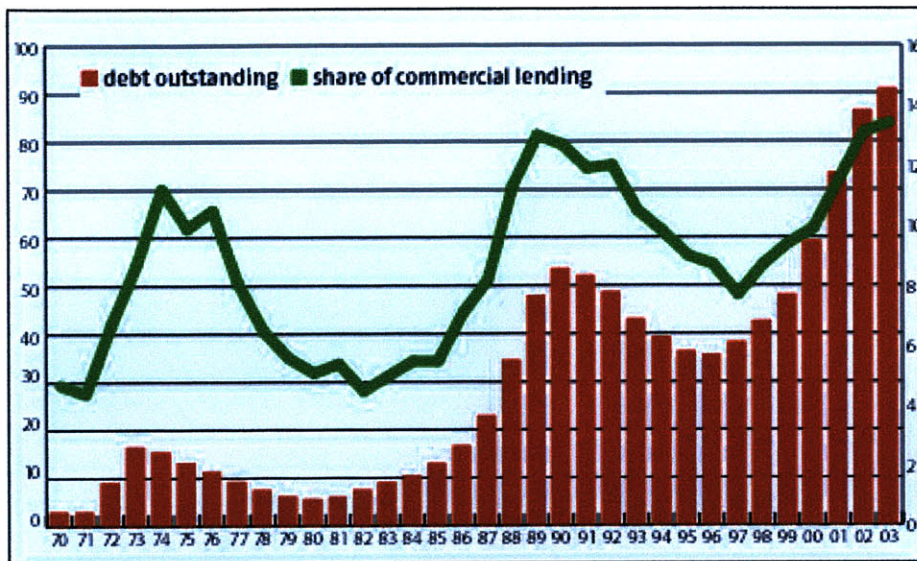
¹⁴¹ The viability of the REIT structure as a vehicle for Development, Gumbs, 2001

¹⁴² Global Realty 31, Comparing REITs around the world, Merrill Lynch, May 2003

¹⁴³ Head of Real Estate, Scottish Widows

Reduced Bank Exposure & The Basel Accord

UK property lending has reached an historic high, at over £90 billion, accounting for over 13% of all bank lending in the country. The graph below illustrates this¹⁴⁴. The Basel Accord will restrict bank exposure to property through regulations due to be implemented in 2006. A UK REIT would redistribute bank risk to the private investor and lower overall industry leverage. The increase in equity investment will also increase taxable revenues as debt interest shelters taxable income.



The Bank for International Settlements (BIS) has prepared the Basel Accord. It has conducted its own studies into the potential impacts of the regulations upon various industries. Regarding property, BIS acknowledges the important role that securitisation will play in lowering bank exposure through increased public equity investment. To quote the Bank of International Settlements,

“Securitisation has three major benefits: to even out the financing cycle by the introduction of additional funds; to enhance market discipline by improving informational transparency; and to facilitate improved risk allocation by reducing leveraged intermediaries”¹⁴⁵.

¹⁴⁴ DTZ Research, Property Week, 20 June 2003.

¹⁴⁵ The case of the missing commercial real estate cycle, BIS quarterly review, September 2002.

Many market commentators agree that property securitisation will strengthen the relationship between real estate and capital markets. The diversification of risk across a wide variety of investors will reduce loan sensitivity to swings in the property market. In turn, less reliance upon bank debt will reduce the volatility of the commercial property market, particularly since property price volatility has historically been exacerbated by the effects of coincident funding cycles. The consultation document for the new Basel Accord (III) states,

“The Committee recognises that securitisation, by its very nature relates to the transfer of ownership and / or risks associated with the credit exposures of a bank to other parties. In this respect, securitisation is important in helping to provide better risk diversification and to enhance financial stability”¹⁴⁶.

The Myners Report & The Carsberg Report

These reports respectively outline proposals and guidelines for improving institutional investment and property valuation regulations. In line with their joint aims, the introduction of a REIT will facilitate increased transparency of pricing and sector information. A larger over-the-counter market for property shares will encourage regular valuation and more rigorous public and institutional scrutiny. The Myners Report recommends the introduction of new mechanisms to facilitate institutional investment. The Carsberg Report encourages objectivity in valuation procedures to increase disclosure and public confidence. A UK REIT would meet the objectives of both documents.

Repatriation of Funds

A tax transparent securitised vehicle on a London stock market could help keep a greater proportion of UK property income in the UK, where it can be taxed in the hands of the shareholder. The last decade has witnessed the exponential growth in Limited Partnership vehicles, from approximately £1 billion to £13 billion. These can all be held offshore for tax purpose. Similarly, Single Purpose Vehicles (SPVs) also own a significant share of own UK property and many are held in tax advantageous locations.

¹⁴⁶ Basel Committee on Banking Supervision, Consultative Document, April 2003, Bank for International Settlements

Further resistance to a UK REIT could result in more concerted industry efforts to take funds offshore. Alternatively, UK companies might consider listing on foreign stock exchanges that *do* offer a REIT vehicle.

Global Competition

With more countries opting for a REIT vehicle, it is a real concern that UK companies may find themselves unable to compete with overseas operators to own UK property. Should such a scenario develop, it is important to understand how an ailing UK property industry would re-align itself to counter this competitive disadvantage. There is a risk that inefficient UK quoted property companies will find themselves the subject of take-overs by foreign, cost-efficient competitors, causing the sector to diminish further¹⁴⁷. The issue has now become a question of harmonisation, rather than the implementation of a perceived advantage.

Inequity in the Investment & Savings Market

It is a fundamental imbalance that a wealthy investor can invest in the commercial real estate market whereas a more modest investor is prevented from doing so with the same benefits. Although existing market vehicles such as Unit Trusts and Property PLCs offer a conduit for the smaller private investor, they do so at the sacrifice of contiguous tax treatment.

Limited Partnerships offer a viable mechanism for collective investment with the benefit of tax transparency but traditionally the stakes have been large. In principle, the provisions to allow more partners has increased the Limited Partnership market significantly through private syndicates and managed funds¹⁴⁸. The introduction of a REIT could redress the balance for the small investor.

¹⁴⁷ Pan-European Quoted Real Estate, Tax Harmonisation in the Evolving Market, Goldman Sachs, March 2003

¹⁴⁸ Current proponents include Close Brothers, Matrix and Pinder Fry & Benjamin.

Tax-Revenues over the Short, Medium & Long-Term

Following the French example, it is reasonable to assume that companies transferring to REIT status could contribute to government revenues by paying a one-off tax based on unrealised capital gains. Morgan Stanley and Deutsche Bank estimate this liability at £1.4billion and £1.4billion-£2billion respectively. In addition to the short-term gain, it can be argued that a larger quoted sector will produce long-term tax advantages in the form of stamp duty, income taxes and capital gains from shares in the hand of the investors. This, of course, would be in addition to stamp duty and capital gains from the underlying property assets.

Concerns over Institutional Weightings

As previously discussed, it is likely that the majority of UK institutions are currently underweight in terms of optimal real estate exposure. The government has expressed concern that the overall incentives offered by REITs might encourage an investment bias, resulting in a disincentive to invest in alternative asset classes. It has been suggested that pension funds, as the marginal investor, could drive up the price of REIT shares due to their lower cost of capital. In turn, they would become the preferred conduits for REIT investors. These concerns, although feasible, require quantitative investigation. These concerns emphasise the need for proactive government involvement, especially since regulatory measures can address and police these issues.

The current quoted property sector accounts for only around 1.5% of the UK stock market capitalisation. Even if the sector was to *double* in size as a result of a REIT, it is unlikely that increased institutional weightings could have such a detrimental effect on other industries.

The government needs to work with the property industry to agree suitable regulations for permitted REIT investors. In the Netherlands, for example, 30% of FBI shares must be owned by private, retail investors.

Outsourcing, PFI and Regeneration Areas

Which property sub-markets would benefit the most from a REIT structure? The government should consider working closely with the property industry to agree parameters or incentives to attract investment in a specific direction. The Private Finance Initiative was introduced in 1992 with the express purpose of divesting public property into the hands of private investors. In 2001 it was estimated that PFI contracts accounted for the development of over £8 billion of property *every year*¹⁴⁹. The initiative covers homes, schools, hospitals, government departments, military facilities and a whole host of other property types. Social housing alone accounted for over £23 billion of investment between 1992 – 2002, and a further £11 billion is required for the sector over the coming 3 years¹⁵⁰. To date, PFI has been controlled by a handful of specialist investors¹⁵¹ supported by massive bank debt and high loan to value ratios. US REITs have successfully developed healthcare facilities, schools and prisons. The government should consider which sectors are most in need of additional investment and might be suitable for securitised investment.

EU Directives

The European Union, The European Public Real Estate Association (EPRA) and The European Association for Investors in Non-Listed Real Estate Vehicles (INREV) are currently undertaking studies to assess the most suitable vehicle for pan-European property investment. There is not presently a single vehicle that offers a satisfactory pan-continental solution but the competition appears to be largely between REITs and Limited Partnerships, both of which would have to be adjusted to provide the optimal structure¹⁵². The EU has been the subject of widespread lobbying to create such a vehicle and is now considering the delivery of such a vehicle as a priority. The explicit goal is to develop a blue print for a “EuroREIT”¹⁵³ and if successful, the UK will be left somewhat out in the cold. The optimal vehicle will provide not only tax transparency at the corporate level, but also withholding tax incentives for global pension investors. Any vehicle will need to conform to International Accounting Standards (IAS) and would ideally be listed on the largest European stock exchange. One gets the feeling London might like to be in the running...

¹⁴⁹ The Private Finance Initiative, PFI, Market Report, AMA Research, 2001

¹⁵⁰ Past, present and future developments in the UK Social Housing Market, AMA Research, 2002

¹⁵¹ e.g., Mapeley, Trillium, London & Regional Properties, Mountgrange

¹⁵² Briefings in Real Estate Finance, Volume 2, No. 4, Henry Stewart Publications.

¹⁵³ Ibid.

Chapter 6 Conclusion

Summation

This Chapter directly applies the qualitative and quantitative findings of the study to the UK Government's present concerns regarding the introduction of a REIT vehicle. Suggested future studies are discussed at the end of each paragraph.

The role of a UK Plc within a mixed asset portfolio

The results of the comparative optimal portfolio analysis showed that whereas the US, Australian and UK direct property markets display similar risk and return characteristics, there is a marked difference between the relative qualities of US REITs, Australian LPTs and UK Property Plcs. The REITs and LPTs exhibited strong income returns and mediocre volatility but the UK Plc was seen to be a highly volatile, low return instrument. REITs and LPTs both exhibited positive diversification effects within a mixed asset portfolio, but the UK Plc was not a competitive asset within an equivalent environment. Further studies are required to investigate the exact reasons for this anomaly, and the potential influence on premium or discount trading values.

The magnitude of REIT tax advantage

This study showed that although the US REIT is exempt from 35% corporate income tax, it only pays 8.8% less tax than its C-Corporation counterpart, assuming that both vehicles distribute the same proportion of income. In the 'real world' it is very unlikely that both vehicles *would* distribute the same level of income since the C-Corporation is incentivised to reinvest and retain income, thereby reducing its overall tax burden. In the case study, the REIT can be valued at an 8.9% premium. This encourages a higher share price *and* predicts higher future growth than that of the C-Corporation. These characteristics will possibly increase levels of investor demand, driving the REIT market and creating more taxable revenues from the trading, investment and capital gain deriving from both the REITs' shares and the underlying physical property assets.

UK property market fundamentals

Taking the examples of the US and Australia as two countries that have introduced successful long-term REIT vehicles, it would appear that the UK has an institutional asset base entirely appropriate for securitisation. Long-term leases and upward-only review patterns offer some of the best security in the property world. The country has a well-developed multi-sector asset market that benefits from a framework of highly skilled principals, and legal and professional advisors. The investor market is highly sophisticated. Over the last 15-years the UK has grown to become the second largest debt-securitisation market in the world, and over the last decade the securitisation of property debt has grown exponentially. Current trends suggest strong private and institutional investor demand for a liquid, tax-transparent tradable property vehicle.

However, the quoted property sector fundamentals are poor. The quoted market is underperforming in terms of both income and capital growth. It is far too highly correlated with the general equity markets. Over the period 1990 – 2002, EPRA estimates that the UK quoted market has shown an average total return of only 1.1%. This comprises a –2.8% average capital return against a +3.9% average dividend-yield. This goes some way to explaining why investors are slowly retreating, and why approximately one-third of the market (by equity value) has been taken private over the past four years.

Additional studies are needed to quantify future trends in the total UK property market both with and without the benefit of a REIT vehicle.

Private Investors

The examples outlined in this thesis suggest that private investors will benefit from the introduction of a REIT vehicle. Regulations governing REITs facilitate equitable access to the commercial and residential property markets. Equally, REITs by their nature encourage an income-led strategy, producing a regular and predictable dividend yield for investors. In addition to the positive diversification benefits, REITs allow investors to differentiate between sectors, to make informed, risk-adjusted investment decisions. Hong Kong has provided a good example to the UK by virtue of its consultation document. Perhaps a similar study should be undertaken to assess the opinions of UK private (and institutional investors)?

Property Occupiers

In the short-term, owner-occupiers can benefit directly from the opportunity to outsource their property holdings in a securitised marketplace. It would be interesting to assess the opinions of owner-occupiers towards this strategy, and further studies into the potential size and scope of this market are required. For pure occupiers, the evidence suggests that greater market efficiency is one result of a fully functioning REIT market. In turn, this leads to increased availability of information and a lower industry cost of capital. The long-run effect of these improvements should decrease arbitrage opportunities between the capital and property market. Assuming a Pareto-efficient marketplace, finance theory suggests that this will lead to greater development, increased competition and lower occupancy costs.

Tax revenues

The Anderson Report suggested that the results of introducing a REIT would be tax neutral or marginally positive. In considering the results of the analysis in Chapter 4, this seems to be a fair assumption. The disparity of US REITs and C-Corporations is only 8%, assuming the C-Corporation does not exercise its right to reinvest (and therefore shelter) income. If benchmark REIT parameters can be agreed between the UK Government and industry representatives, further studies need to be undertaken regarding a similar UK example. As witnessed in France, substantial taxes can be raised from unrealised capital gains during the REIT transfer process.

Additional revenues are likely to be produced through increased property and share trading, all of which would go towards redressing the balance of lost corporate tax. Further study is required into the proportion of taxable UK income that is currently being sheltered 'offshore' and the degree to which this could be attracted back to the mainland. Equally important is an assessment of the lost revenue through increased foreign REIT involvement in the UK market, and the threat that these efficient vehicles may pose by acquiring less efficient UK quoted companies.

Current affairs

Assuming that primary concerns include the current pension crisis, the potential budget deficit and bank exposure to property, case studies can be drawn from other countries to show how the introduction of a REIT could possibly assist in these various matters. Australia's LPT provides the best example of a pension-led REIT market. Compulsory superannuation has driven the LPT market, which is now 85% owned by institutional and private investors. The only concern this raises is the reliance on steady income, and a reluctance to trade assets. Future studies might consider the effects of a similar UK demand profile.

In terms of the immediate budget deficit, studies have shown that up to £2billion could be raised by way of a tax levied on unrealised capital gains to permit property companies to re-list as REITs. Finally, divesting risk across private equity investors could substantially reduce bank exposure to property. It seems likely that the Basel Accord regulations will force a sea change in any case, so the UK only has three years to think of an alternative solution.

Property Companies

With some irony, it appears that the existing property companies will not be the primary beneficiaries of a UK REIT, although this is largely dependent upon the specifics of the particular vehicle. The companies will probably face a more secure future as REITs as opposed to Plcs. In the long-term they might even benefit from a reduced industry cost of capital. If predictions are correct, they will also benefit increased equity investment but, as new REITs, will also face increased restrictions and corporate governance measures. A more efficient market means increased competition for stock and less arbitrage between property and capital markets. Increased stock-market attention will also lead to informational transparency and additional public scrutiny.

A public market should be of interest and benefit to the public. At the moment, in the same way that Leon Bressler of Unibail commented about the French companies, UK Plcs are at a relative global disadvantage. The issue should be seen for what it truly is: one of creating a level playing field between international quoted property companies, rather than that of offering the quoted property sector an unfair advantage over alternative stocks.

Conclusion

The evidence, arguments and case studies presented in this thesis seem to paint the picture of a UK REIT as if it were a “no-brainer”, or an obvious choice. However, this study has only drawn conclusions from a very limited sample. As discussed in Chapter 1, the Singaporean, Japanese and Korean markets have all run into significant problems in implementing a REIT vehicle, and the French example is too young to yet draw any conclusions from.

What is certain, however, is that the UK should be *considering* the introduction of a REIT - drawing knowledge from the experience of countries that offer a similar structure and learning from their successes and failures. In order to analyse the potential impact of a UK REIT it is necessary to understand how the government views the dynamics of a potential vehicle. What tax benefits will it have? How much income will it distribute? What are the shareholder and activity restrictions, if any? There are many variables that could affect the overall impact of such a vehicle, but theoretical analyses cannot be truly reliable until a framework is agreed, in principle. The pattern of successful REITs provides some useful pointers regarding corporate tax exemption, majority income distribution and an internal management structure, however, until the UK government speaks clearly on the topic, it is difficult to discern their true intentions.

The development and implementation of a REIT structure will take a long time. A number of government departments are involved, and a number of different industry representatives will each wish to have their own say, too. Even if the government committed to the idea, the implementation could be viewed over a course of years rather than months, although encouragingly, the French set a rather speedy precedent. However, the procedure of proposals, refinements and consultation documents is not best known for its immediacy.

The development of a REIT can be looked at in two ways: as the introduction of a new vehicle or the modification of the existing Plc or Limited Partnership vehicle. Many of the strategies exhibited by REITs in terms of specialisation, economies of scale and vertical integration already apply to UK Plcs or Limited Partnerships so the latter might present an easier course of action.

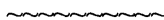
Together, these vehicles present a total capitalisation of approximately £36billion, but it is unclear whether there is any incentive for private property companies to shift into the public arena.

The evidence presented in this report suggests that a weak public property sector could be further damaged over the medium-term, as inefficient companies withdraw themselves from, or are bought out of, the public arena. If this did ever happen, the UK property market would be presented with the ‘original’ inequity that was first addressed by the Massachusetts Trust. Only institutions and the wealthy would have the resources to own real estate – placing the private investor at a further disadvantage.

The UK government might well agree that a preventative measure could be easier and less costly than a cure. At the time of writing, the industry lobby is once again working at full steam, led by the British Property Federation and the Royal Institution of Chartered Surveyors. The government, on the other hand, is taking a passive role, with the Office of the Deputy Prime Minister, HM Treasury and the Inland Revenue each preparing to evaluate the industry’s proposals.

The efforts of previous industry lobbies have enabled the protagonists to learn by experience, and it would appear that the case is far stronger this time than ever before. Let’s hope the government agrees. To quote Assar Lindbeck¹⁵⁴,

“The true test of a brilliant theory is what first is thought to be wrong
is later shown to be obvious”.



¹⁵⁴ Nobel Prize for Economics, Committee Member

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