The REIT Niche and the UK REIT Market

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ABSTRACT

The purpose of this paper is to examine the hype surrounding REIT regimes around the world, and to analyze whether REITs are the right vehicle to hold all commercial real estate. More than people realize, REITs are a niche play in the commercial real estate market and as we examine the case of UK REITs, we discuss the limitations and the challenges of the REIT structure.

INTRODUCTION

Within the last decade, the global real estate market has experienced a substantial transformation. The increase of capital flows into the real estate sector, the growth in the variety and number of investment vehicles, and the increased recognition among institutional investors of the potential of real estate within a multi-asset portfolio, all have contributed to the worldwide expansion of both the private commercial real estate and public real estate equity markets. In particular, the growth of the global public real estate market (real estate investment trusts or listed property companies) has been dramatic. The total market capitalization of the FTSE EPRA/NAREIT global listed real estate index (composed of 300+ publicly traded real estate companies around the world) more than tripled within the last seven years with the total market capitalization at the end of 2007 at approximately $800 billion.

This remarkable development in the development of the global listed property market was in large part due to significant overall capital flow into European real estate in the last few years (an estimated €270bn in 2006). Although listed property companies have a long history in Europe, tax-transparent vehicles such as real estate investment trusts (REITs) account for less than 10% of the global total compared with European direct real estate market that accounts for over 30% of the global market. In 2007, the European REIT market gained momentum, however, as UK and Germany adopted REIT regimes. These countries comprise top two European countries in terms of total real estate market size.

The potential impact of the introduction of REIT regimes in Europe has been demonstrated by the case of France, which introduced SIICs (the French version of REITs) in 2003. The introduction of the REIT regime in France dramatically increased the scale and liquidity of the market. With much room for growth in securitization and with the introduction of REITs in UK and Germany, many experts anticipate a European version of the REIT revolution experienced by the US in the late 1990s. The positive aspects of REITs include transparency, liquidity, low leverage, and high income payouts. Furthermore, the portfolio diversification benefits of REITs have been well-documented, as well as historically strong risk-adjusted performances.

But how far will the REIT revolution go? The following article examines the key elements as well as the limitations of the REIT structure and the challenges facing the UK REIT market.

LITERATURE REVIEW: THE US REIT EXPERIENCE

The inherent characteristics of real estate – heterogeneity, the requisite large illiquid investments with corresponding risk, and the necessary skills for development and management – have traditionally prevented small investors' access to the benefits of large-scale, income producing real estate. In an effort to encourage small investors to participate in the type of real estate investments traditionally available only to institutions or wealthy individuals, in 1960 the U.S. legislature passed the REITs Act, allowing for the creation of Real Estate Investment Trusts ("REITs"). Essentially, REITs were investment vehicles structured to do for real estate investors what mutual funds did for investors in securities; REITs provided the benefits of a corporation as well as the pass-through nature of a partnership by giving investors the advantages of liquidity, limited liability, and professional management, without incurring the costs of double taxation.

Despite the clear theoretical benefits of REITs, the growing pains of the REIT industry in the U.S. lasted over 30 years. The REIT revolution in the U.S. came in the early 1990s, only after numerous tax and regulatory reforms, combined with market conditions that provided the impetus for massive public capital inflow into REITs. Through the last 48 years, the Congress paved the way for the REIT industry to become a mainstream global investment vehicle, by making necessary adjustments in line with market needs.

1960s: The Growth and Decline of Mortgage REITs

In its inception in 1960, the REIT was intended to be a passive investment vehicle making long-term investments that would provide relatively safe and steady streams of income with potential for capital appreciation (Wern, 2000). Due to a lack of familiarity by the investing public and the stock market decline in 1962, REITs did not begin to really grow in popularity until the late 1960s. Even so, REITs in the 1960s provided investors with an average annual total return of 11.5% (Block, 2002). Mortgage REITs drove the REIT growth late in the 1960s. The REIT industry's total assets grew from $1 billion in 1968 to $20 billion by the mid 1970s, with 60 mortgage REITs established (Block, 2002).

1970s: The Rise of Equity REITs

In 1973, the oil crisis led to severe inflation and economic recession, and an increase in interest rates. By the end of 1974, over 50% of REITs assets were concentrated in C&D loans, non-performing assets increased to 73%, vacancy rates soared, and over 30 mortgage REITs went bankrupt (Block, 2002). During the period from January 1973 to January 1975, the Share Price Index of the NAREIT dropped by about 56.2% (NAREIT, 2008).

On the commercial property investment side, however, the Employee Retirement Income Security Act OF 1974 ("ERISA"), required that pension funds to be invested for a long periods of time; this, along with the development of modern portfolio theory and the benefits of diversification, caused the pension funds to invest vast amounts of capital in the commercial real estate sector (Wern, 2000).

The Tax Reform Act of 1976 ("TRA 76") was passed in part to help with some of the mounting pressures of bank debts and losses faced by the REIT industry during 1973-1975 (Wern, 2000). Evidence suggests that the adjustments to the laws governing REITs in TRA 76 improved REIT performance and effectively reduced REIT risk relative to the overall securities market (Sanger, Sirmans, and Turnbull, 1990). Yet, by 1981, the total REIT assets had fallen to one third of what it was in 1974 (NAREIT, 2008). Many equity REITs, on the other hand, which had bought low priced properties from distressed mortgage REITs around this period, performed well, leading to the rise of equity REITs. Despite turbulence, the REITs in the 1970s produced a compound total annual return of 12.9 percent (Block, 2002) compared to 5.8 percent for the SP500 (NAREIT, 2008).

1980s: Tax Shelter Driven Real Estate Boom

The Economic Recovery Act of 1981 ("ERA 81") provided significant new tax breaks for property investors in the ability to write off passive losses against active income and shortened depreciation periods (Cornell, 1997; NAREIT, 2008). Such tax breaks propelled the popularity of Real Estate Limited Partnerships ("RELPs"), which drew away funds from REITs, although REITs were producing high returns in the early 1980s (Chan, Erickson, Wang, 2003). RELPs allowed high tax sheltered returns and tax write off opportunities, while losses could not be passed through to investors in REITs.

Despite the lack of transparency and liquidity of RELPs, the RELPs fueled the 1980's real estate boom. RELPs could gear up and pay high prices for properties without the need to pay positive cash flows to the shareholders, as the shareholders were mainly interested in the tax sheltering effects of real estate properties. Such activities in turn led to inflated prices and excessive construction (Chan, Erickson, Wang, 2003). During this era, it has been estimated that $80 to $100 billion in excess commercial real estate was constructed (Hendershott and Kane, 1992).

The Tax Reform Act of 1986_("TRA 86") eliminated the tax advantages held by RELPs by eliminating accelerated depreciation and passive loss deduction against active income (Singer, 1996). In addition, TRA 86 also improved the competitiveness of REITS by eliminating the external manager requirement, and allowing REITs to directly own, operate, and manage most types of income-producing commercial properties (NAREIT, 2008). The REIT industry achieved total annual compound returns in excess of 15% in the 1980s. (NAREIT, 2008).

1990s: The Real Estate Bust and the REIT Revolution

By the late 1980s the extent of overbuilding in the space market and the financial crisis in the overextended savings and loan industry, coupled with the stock market drop and economic recession in 1990 led to the bottom falling out of the property market in the early 1990s. Commercial real estate prices fell 30 to 50% in the span of two years, the largest drop in property values in the US since the Great Depression (Geltner and Miller, 2001).

Government actions stimulated the remarkable development of the public capital market as a source of real estate investment money during the 1990s that led the recovery of the real estate sector. On the debt side of this market, the development of Commercial Mortgage Backed Securities ("CMBS") was rooted in the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 ("FIRREA"). FIRREA bailed out the savings and loan industry, through the establishment of the Resolution Trust Corporation. FIRREA also imposed risk-adjusted capital requirements on financial institutions, providing them the motive to hold securitized assets such as CMBS.

On the equity side, the reemergence of REITs was propelled by the Omnibus Budget Reconciliation Act_of 1993 ("OBRA 93"). OBRA 93 modified the five-or-fewer rule of REITs to facilitate pension fund investment into REITs. The increased investment by pension funds spurred unprecedented growth in REIT capitalization (Wern, 2000; NAREIT, 2008). To pension funds, REITs represented stable, long-term, yet liquid form or real estate investments, with the benefit of portfolio diversification.

OBRA 93 also created Umbrella Partnership REITs ("UP-REITs"). As opposed to a traditional REIT where real estate was directly owned, in an UPREIT structure, a REIT could own a controlling interest in an operating partnership that owned the real estate. Property owners could now transfer their real estate holdings in exchange for operating units of the operating partnership, which could later be converted to REIT shares (a taxable event) when the tax benefits of such conversion were the greatest, thus deferring capital gains tax (Singer, 1996; Cornell, 1997). Such motivation allowed more and more commercial property owners to sell their properties to REITs.

A combination of the above factors assisted in REITs flourishing in the 1990s: pension fund involvement, public capital as the source of funds, creation of UPREITs, alignment of interest between management and shareholders, vertical and horizontal integration of REITs, and high returns as a result of purchasing bargain properties following the Savings and Loan crisis (Chan, Erickson, Wang, 2003).

The REIT IPO market exploded with 113 new issues coming to market that raised over 18billion$ in equity capital by 1996 (Chan, Erickson, Wang, 2003). Between 1996 and 1997, the REITs delivered a stunning 63% total return, and the REIT market capitalization was near \$160 billion, up from \$5.6 billion at the end of 1990 (NAREIT, 2003). By 1997, through growth and through a persistent volume of merger activity among REITs, the REIT industry finally had over 30 REITs with a market capitalization of over \$ 1 billion (Chan, Erickson, and Wang, 2003). In terms of performance, the REIT industry ended the 1990s with an average annual total return of 12.4% (Chan, Erickson, Wang, 2003).

2000s: REITs Have Arrived

With the stock market crash of 2000, REITs bounced back in 2000, as the investors left the tech industry in favor of more defensive REIT stocks. By the end of 2006, the REIT market in the US grew to over 180 publicly listed companies with market capitalization of \$440 billion. Within the last few years, the international market has experienced a similar transformation. Institutional investors have poured capital into the global indirect property market, and as a result the global REIT industry has experienced exponential growth. The total market capitalization of the FTSE EPRA/NAREIT global listed real estate index more than tripled within the last six years with the total market capitalization at the end of 2007 at approximately \$800 billion. Global real estate securities have delivered outstanding performances over the past decade. Before the sub-prime crisis, global real estate securities have outperformed both global equities and global bonds in each of the 1, 3, 5 and 10 year timeframes.

While REITs have significantly changed during the last four decades, the researchers have now come to some general conclusions about REITs:

- REIT returns are relatively uncorrelated with those of other stocks and bonds, which provide strong source of portfolio diversification (Pienta, 2003).
- Low correlation of less than 0.5 between REITs and the stock market imply portfolio diversification benefits (Ghosh, Miles and Sirmans, 1996).
- Correlation between S&P 500 and REITs was 20% between 1993-2000 (Rosen, 2001).
- Between 1972-2000, inclusion of REITs would have increased the return on a portfolio (Pienta, 2003).
- Size is the most important factor driving institutional demand for REITs (Crain, Cudd and Brown, 2000).
- Larger REITs appear to have a more stable long-term performance (Chan, Erickson and Wang, 2003).
- However, based on the most recent sample of a large number of REITS, there is not much gain from a REIT's conducting merger activities (Campbell, Ghosh, and Sirmans, 2001).
- REITs are good defensive stocks (Glascock, Michayluk and Neuhauser, 2004).
- REITs are less risky than other stocks (Glascock and Hughes, 1995).
- REITs share similar fundamental properties with real estate, especially in the long run (Gyourko and Keim, 1992).
- The return behavior of equity REITs is similar to that of a mixed portfolio of stocks and bonds, with a stronger relationship between REITs and a portfolio of small stocks in recent years (Glascock, Lu, and So, 2000; Oppenheimer and Grissom, 1998; Sanders, 1998).

THE GLOBAL REIT REVOLUTION

The US REIT experience has shown the potential benefits of including public real estate assets in a mixed-asset portfolio: enhanced returns, lower trading costs compared to direct real estate investment, liquidity, accessibility and diversification. The key lessons learned from the US REIT experience have shaped the development of other REIT regimes around the globe, including the UK and Germany, the latest significant countries that have joined the global REIT revolution.

Table 1: Growth in Number of REIT Regimes

1960	1969	1971	1994	1995	2000	2001	2002	2003	2004	2007
USA	Netherlands	Australia	Canada	Belgium	Japan	Korea	Singapore	France	Hong Kong	UK
			Italy					Taiwan		Germany

However, is REIT the right structure for all global commercial real estate to be owned and managed? Although investors are protected by the strict regulations surrounding the nature of these vehicles, the same regulations also cause REITs to have very specific uses, more than is commonly realized. The European REIT regimes are becoming more unified with the general framework as well as the same set of key elements that comprise almost all REIT regimes around the world:

Income Distribution

High payout requirement for REITs (usually 90% of net income) generally means long-term passive investments that ensure steadier and more stable income to the investors. However, this requirement also means that it is more costly for REITs to raise capital. As REITs are in a capital intensive business and are prohibited from retaining most of their earnings, they need funds from external sources to grow. Typically, companies prefer internal sources of funding since these are more flexible and less costly than issuing new debt or equity securities. However, private real estate firms can grow more efficiently than REITs as they are not under pressure to pay high dividends, thus making cash available for additional acquisitions.

Management Requirement

When the US Congress originally created REITs, REITs were required to hire external managers to provide management and operations services. These external managers did not have ownership shares in the REIT. The restriction was removed in 1986. Thus by effectively allowing REITs to directly hire and compensate internal managers, the conflict of interest that existed between the REIT and the shareholders was eliminated. This incentive alignment, however, does not necessarily mean that REITs have the flexibility to extract maximum performance from their internal managers. REIT regimes that are intentionally structured to impose passivity and narrow bandwidth of operational activities for managers do not allow for pay structures that will motivate mangers to hit home-runs. The REIT managers are not paid to squeeze out maximum profit from every deal. Instead, they must think constantly about how to convert even a home-run opportunity into a string of base-hits.

Leverage Limitation

One of the concerns of using debt is that it increases the leverage of REITs. This can be profitable when the interest rates are low and real estate yields are high, but can be risky during declining markets when interest rates rise and margins disappear. Through the years, the US REIT industry experienced several painful lessons on leverage and as a result went through significant structural changes. Thus, some REIT regimes have imposed restrictions on leverage. In addition, it is generally inadvisable for REITs to use too much debt because they have to compete in the debt market with taxpaying firms, whose interest payments are tax deductible. In 2006, North American REITs had an average gearing ratio near 55%, while REITs in other global regions were in the low 30% range. From a risk-and-return framework, REITs are considered to be between core and value-added within the wide range of real estate investment strategies. This is due in large part to the low average debt levels of REITs. The flipside of limitations on debt is that sometimes high leverage is warranted. Also, low leverage does not necessarily indicate low risk. Practically speaking, the leverage restrictions imposed on REITs could prevent them from acquiring highly attractive assets with high-quality tenants and long-term leases where the right financial structure involves 90% gearing rather than the customary 50% REIT gearing. Private investors, on the other hand, often utilize a much higher debt-to-equity ratio in order to maximize returns while balancing the risk of higher interest rates with the quality of tenants and lease terms.

Development/Asset Limitation

As an indirect real estate investment vehicle, the REIT's primary purpose is to invest and hold income generating real estate assets. This requirement makes REITs prefer acquiring income-generating assets while not preferring high option value properties. The rise of the REIT industry only makes the competition for REIT-suitable assets more intense, which drives up prices and lower yields on such properties. As mentioned previously, the management also lacks the incentive to seek high option value assets that could potentially create huge returns for the REIT shareholders. REITs are efficient and effective vehicles to hold and manage established real estate assets – from quality offices to industrial property. But REITs are not development-oriented, nor are they agile in terms of making deals. Thus, we expect that REITs will hold the cash-flow-oriented market in Europe and Asia – REITs will be a target for income yield seekers and the REIT prices will be based upon a spread over Treasuries or gilts. If a deal requires structured elements and high gearing, REITs cannot and should not be expected to compete – it is not their market. The recent private buyout of Equity Office showed that quality assets can be geared more effectively in the private market –and that in such deals there is still tax transparency (and more management flexibility).

THE CASE OF UK REITS

After nearly 4 years speculation and negotiations, the UK – REITs were launched on January 1st of 2007. The first group of UK listed real estate firms that chose to become REITs include: British Land, Land Securities, Liberty

International, Hammerson, Brixton, Derwent London, Great Portland Estates, Primary Health Properties, SEGRO, and Workspace Group. Interestingly, the companies that chose to become REITs have the following similar characteristics: large market capitalization; lower than industry average leverage; relatively higher dividends with an upward trend during the last 3 years; narrower gap between the net asset value and market price, compared to other listed real estate companies; and higher price to sales ratio.

The phenomenon of UK-REITs began with favorable expectations as several existing listed property companies were set to become REITs upon legislative enactment. Amidst great anticipation, these companies enjoyed significant appreciation, but only right up until they officially became REITs! Shortly after introduction, UK REITS began to decline in market value and even began trading at discounts to net asset value.

Exhibit 1: UK-REITs Peak with Legislation

Source: Credit Suisse

There are three key factors that influenced the decline of UK REITS. First, despite the lessons learned from the US REIT experience (it took a significant amount of time to refine the US REIT legislation to effectively support and promote the REIT market) the UK legislation appears to be still evolving and still in the process of adjustment. Second, the market conditions in general have been unfavorable since the introduction of REITs to the UK (e.g. the decline of real interest rates and the overall market conditions, including the sub-prime issue, have tended disfavor real estate valuations). And third, UK-REITs have not yet fully evolved to become market efficient REITs in terms of expectations.

The UK Legislation's Limitation

The UK legislation requires that a standard UK-REIT to meet the following conditions: it must own and operate real estate and earn its primary income from leases or rental values; must not have too much debt (although not directly limited); must have broad ownership and not too much concentration in control; and must pay out most of its income as dividends. Additionally, a UK-REIT is required to pay an entry fee that allows it to have tax transparency (no double taxation) in exchange for an accumulated capital gain tax burden on the property held.

Although the legislation has favorable elements, it falls short in a critical area: the process of growth for REITs. The government initially articulated the hope that UK-REITs would help solve the housing shortage, especially in affordable rental housing. However, the legislation fails to specify how such goal can be achieved. The French helped to solve a similar issue by their first revision to their original SIIC legislation -- they introduced UP-REITs, as the Americans had done in the early 1990s. The UP-REIT, an umbrella REIT, allowed current property owners to exchange their real estate for partnership shares in the REITs that allow the deferral of capital gains taxes until later conditions were met. This encouraged the growth of REITs by giving them access to large estates of real estate without the owner having to bear the current burden of taxes. It also helped move assets from lower levels of management to stronger management inside the REIT. The legislation was beneficial for both owners and investors, and most of the REIT growth in the U.S. is attributable to the UP-REIT legislation. In fact, REITs were essentially not established in the capital markets until UP-REITs were created. As a result of adopting UP-REIT legislation, the French REITs have experienced growth. The current UK REIT legislation does not provide for such an option.

The Unfavorable Market Conditions

After the general market crash of 2000-01, real estate, including REITs, enjoyed significant market value appreciation. This outcome was as a result of two factors: First, the investors noticed that REITs did not fall as much as the market as a whole—they discovered REITs to be good defensive stocks. Second, real interest rates declined and debt was easily accessible. This meant the discount rates of real estate and REITs fell accordingly, driving up valuation. The by-word since 2001 in the real estate industry has been “cap-rate compression.” However, by 2007, capitalization had very little room left to compress; rates across European markets from Poland to France were extremely tight. Especially in the UK, the rates had experienced strong compression and there was no room for further compression. Furthermore, higher debt levels were being structured and when the sub-prime mortgage crisis arrived, by December of 2007 the real values in London fell by more than 10 per cent. By then deals were not able to be structured at (for example) 85 per cent debt. The ceiling came down to about 70 per cent, and the cap-rates in deals also rose. In such an environment, REIT shares declined in value and looked low compared to their net asset values (“NAVs”). Additionally, since 2001, the market was in a low inflationary environment. Currently, however, inflation is more likely to increase. In such environments, real estate and REITs have historically suffered.

The UK-REITs Have Not Yet Become Market REITs

Historically, the UK property companies have behaved differently than the US REITs. The UK property companies on average have tended to have more debt, payout less cash dividends, and be involved in more development. These factors help explain why the listed UK property companies from 1989 through 2002 have underperformed the FTSE all-shares index while the US-REITs performed substantially better than S&P 500. While in the past the driver of investments in UK listed real estate companies has been to obtain capital appreciation and thus lower taxes, REITs historically have been driven by cash dividends, at least in the USA. The UK-REITs have not yet become cash driven, nor have they shed much of their preference for development. Thus, on a yield basis, the UK-REITs do not yet resemble REITs from the US. Although the UK REITs have raised their dividend levels significantly, the yields are still too low to be considered cash-driven. Typically, a well-performing REIT carries a yield on a cash basis of 100 to 200 basis points more than the ten-year treasury or gilt rate.

If we compare US-REITs that are listed on S&P 500 with key UK-REITs such as British Land, Hammerson, Land Securities, Liberty International and Segro (the average market cap for the UK-REITs is $8.6 billion while the S&P 500 listed US REITs is $10 billion), we find that the US-REITs have a dividend rate of 4.42 per cent while the UK-REITs have a dividend rate of 2.88 per cent. The US-REITs have also fallen in price as their relative dividend has taken a downturn against the ten-year treasury rate. However, such adjustment has not yet occurred in the UK market, and the UK-REITs are still not as cash driven as the market would likely prefer.

In the US, REITs that are focused in a particular sector of investment have proven to be high-performing in the market. In contrast, the UK-REITs are still essentially conglomerates of real estate activities—some office, some retail and some development. Land Securities have made a move toward focus by its trade with Segro before it became a UK-REIT; it has since announced that it will have three core divisions (retail, office, and Trillium). Despite the move toward focus, Land Securities is still structurally one company.

GOING FORWARD

The REIT legislation in the UK clearly divided the listed real estate market—today the UK-REIT market is over ten times the market capitalization of the remaining listed real estate sector. The UK-REIT sector appears to be reducing debt, increasing dividends and adopting specialization. These changes dictated by the market will go far in reaching the government's goal of creating a more stable listed real estate sector. However, the sector still faces the key challenges of adopting a legislation to allow for an UP-REIT structure and to allow for ways to start up new REITs without excessive tax penalties. Although the UK property companies have historically excelled at accumulating strong asset bases, they need to produce higher cash flows that can be distributed as dividends to shareholders. Furthermore, it is advisable for UK REITs to be less debt driven in order to provide for more stability and efficiency in operations. Even though it could be argued that UK-REITs require less dividend yields than US-REITs primarily due to stronger leasing laws which make property investments safer than in the US, current yields are still too low for UK-REITs to be considered a cash driven investment. Already, there are strong non-European and non-British REITs operating in Europe and the UK. Some of these REITs are more global and have better financial attributes than the UK-REITs, and the competition will be high for the REIT investor and for property. For UK-REITs to survive, the UK must adjust its legislation to accommodate and encourage REIT competition, growth and innovation in the market.

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