



C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT

EUROPEAN REITS - THE CHANGING LANDSCAPE

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European REITs – The Changing Landscape

The European landscape for real estate investment trusts (REITs) is undergoing profound change. Within the next two years, the United Kingdom and Germany are expected to pass legislation that will allow for their creation, while the Netherlands and Belgium will probably liberalize their REIT regimes as well. The specific features of each country's vehicle will be the product of the often competing interests of government, industry, corporations, and investors. However, these varied interests are operating within the larger backdrop of an increasingly unified regional market that compels each country to adopt a REIT structure that responds to competitive pressures in similar ways.

In each country, governments are searching for ways to reduce budget deficits, while the property industry wants a vehicle that will be attractive to investors and flexible enough to promote a dynamic sector. In addition, many corporations hold enormous amounts of real estate on their balance sheets; these assets tend to have low returns on equity as well as enormous unrealized capital gains. Motivated by a desire to return to their core activities, companies want to offload these holdings in a tax-efficient way. For their part, investors are searching for tax-efficient ways to receive steady cash-flow streams as well as to invest in a sector that is considered stable and relatively risk averse.

This paper will provide an overview on the likely shape of REIT legislation, focusing on the United Kingdom and Germany. It is crucial to review the details of these structures, because it is here that the success or failure of REITs as an investment vehicle will be determined.

What's a REIT?

While the specific features and regulations of REITs vary from country to country across the globe,¹ in general they are listed vehicles that invest in and own properties. In return for special tax considerations—usually tax exempt at the corporate level—they are required to distribute profits from income and capital gains in the form of dividends, which are taxed at the investor level. There are also restrictions on development activities, management, financial structure, and operations, though regulations vary substantially across countries.

The Precedent of France

France introduced its version of REITs—Sociétés Immobilières d'Investissement Cotées (SIICs)—in 2003. SIICs are listed companies whose income from leasing and capital gains of real property are exempt from corporate income tax. SIICs must distribute to investors 85% of rental income and 50% of capital gains. Tax is levied on these profits only at the shareholder level, and nonresident shareholders are subject to a 25% withholding tax, which may be reduced by tax treaties to 15% or 5%. Upon transferring its status from a

¹ An upcoming report will focus on REITs in Asia.

property company, the SIIC must pay a one-time tax of 16.5% of unrealized capital gains, which was half the rate of normal capital gains tax, payable over four years.

By some measures, the SIIC legislation has been quite successful. All listed French property companies decided to become SIICs, and their share prices have risen significantly; in the second half of 2004 they traded at an 8% premium to net asset value (NAV), far above their post-1990 average of a 26% discount to NAV.

However, Treasury coffers have suffered significantly in the aftermath. Spain's largest real estate group, Metrovacesa, acquired a French SIIC, Gecina, for US\$10 billion, creating the continent's largest real estate company, while another Spanish company, Inmobiliaria Colonial, took controlling stake in Société Foncière Lyonnaise for nearly US\$1 billion. SIICs do not pay income or capital gains tax, nor does France tax their dividend distributions to overseas investors; furthermore, Spanish tax authorities will not tax this dividend income. These takeovers, therefore, have highlighted a possible withholding tax leakage issue for REITs in the United Kingdom and Germany. Purchasing real estate assets directly requires overseas investors to pay tax on rental income stream, while purchasing real estate assets via a REIT transforms the rental income stream into a dividend income stream, which is usually taxed at a significantly lower rate to international withholding tax agreements.

United Kingdom and Germany – How to Avoid Tax Leakage

The U.K. government has been quite sensitive to avoid a similar situation, and HM Treasury has been trying to devise ways to ensure nonresident investors do not manipulate the system to avoid taxes. The environment is further complicated by the enormous growth in offshore property companies. Over recent years in order to avoid paying corporate or capital gains taxes, an increasing number of U.K. property companies have registered in Jersey or Luxembourg and listed their shares on the London Stock Exchange. Unlike REITs, these vehicles are not subject to restrictions on management, operations, or financial structure. The size of this offshore property market is estimated to range from £35 billion to £100 billion, up from virtually nothing in 1998. HM Treasury is pressuring the property industry to induce these offshore vehicles to return to onshore status.

In March this year, HM Treasury released a discussion paper that outlined its thoughts, intentions, and concerns about U.K.-REITs.² While primarily concerned with tax issues, Treasury also wants to avoid creating legislation that will allow property companies to increase their risk profile and discourage active investment by retail investors. In addition, Treasury wants to alleviate a shortage in the underinvested residential property sector by encouraging institutional investment; although this priority has been downplayed as the consultative process with industry has evolved, it is expected to be present in some form in the final legislation. While the recent consultation paper is vague on specifics, it mentions the following broad elements.

² March's discussion paper adopts the industry-favored term, U.K.-REIT, rather than property investment funds, which it had used in prior documentation.

U.K.-REITs will be tax exempt at the corporate level and will be required to distribute a certain level of income and capital gains to investors, who will pay taxes. The most prominent sticking point is how to tax non-U.K. residents, while also avoiding replicating the SIIC precedent, and upholding its international treaty obligations.

HM Treasury seems to have focused on two ways to resolve this situation: offering a tax credit on dividend distribution, or granting REITs “trust” status. Each alternative comes with its own problems, however. For example, current regulations forbid U.K. pension funds from utilizing a tax credit, nor is it certain that this method will avoid tax leakage. Trust status would circumvent the problem of levying tax on overseas investors because they are not subject to international tax treaties on withholding tax on dividend payments or EU law on mergers or on taxation on distributions from subsidiaries to overseas parent companies. However, establishing and managing trusts will be complex and possibly discourage companies from transferring to REIT status.

The government will probably limit the scope and type of development activities undertaken by U.K.-REITs. Although specific regulations have not been publicly disclosed, HM Treasury has stated it does not want them to engage in speculative projects. Relatedly, the government believes that permitting too high a degree of gearing (leverage) would impede the goal that U.K.-REITs be income, not capital growth, generating. It is contemplating setting a maximum gearing limit, though industry is concerned that restrictions will limit their potential profitability.

HM Treasury wants to require U.K.-REITs to be listed on a public stock exchange in order to ensure they will be easily accessible by retail investors and attract market and listing authority scrutiny. While industry does not object to this proposal, it is concerned that listing requirements will impose overly burdensome compliance costs on companies, preventing smaller companies from converting to U.K.-REITs.

HM Treasury intends to require U.K.-REITs to distribute at least 95% of income, though it is vague whether this is before or after depreciation, which is a key concern for industry. Government and industry are both aware that setting a payout ratio that is too high would risk undermaintenance of asset and accumulation of massive deferred maintenance issues.

In order to ensure that the introduction of U.K.-REITs will not reduce the tax contribution from the property investment market, HM Treasury intends to charge a conversion fee for companies that transfer their status to U.K.-REITs.

Germany

The potential for G-REITs (as they are commonly known) is enormous, though whether investors will find them attractive depends on specific legislation. Germany has the greatest volume of company-owned real estate in Europe; about 70% of companies own properties that are essential or nonessential, compared to about 30% of companies in the United Kingdom and United States. In most cases, tax and legal

obstacles discourage them from selling these holdings. Germany has well-established tax-transparent property vehicles in the form of open-ended real estate funds (Offene Immobilienfonds, or OEFs³) whose market value totals about US\$80 billion to US\$100 billion. In some respects, OEFs meet the needs of retail investors, but they are generally considered a less-than-optimal real estate investment vehicle and have substantially underperformed equities in recent years, and therefore are suffering from significant capital withdrawals; several recent scandals have also severely tarnished their image.

The government is studying several structures for G-REITs, particularly ones that do not violate double taxation treaties, while also ensuring that nonresident investors are taxed. Germany currently taxes income from real estate assets, while taxes from dividend income are subject to international dividend withholding tax treaties. This means that buying assets via a REIT transforms rental income into dividends, which would potentially reduce withholding tax.

How Will Smaller Countries Compete?

In the Netherlands, REITs (Fiscale Beleggingsinstelling, or FBI) have been in existence since 1969, and the Finance Ministry is expected to liberalize the regime in the next few years in order to increase their attractiveness to foreign investors and their operational flexibility in the face of the increasing competitive global environment. Regulations are quite strict, and industry has recently complained about prohibitions on development, which hinders its ability to compete against foreign companies that are not encumbered by such restrictions. In addition, industry wants the government to modify the required payout ratio (100% of taxable profit), as well as restrictions on foreign shareholders (they are subject to a 25% withholding tax and ownership has been set at a maximum 25% of an FBI's market cap).

Similarly, Belgium is considering liberalizing its REITs (Société d'Investissement à Capital Fixe en Immobilier, or SICAFI), which were established in 1995. The SICAFI does not qualify as a tax-transparent vehicle and must pay taxes at the normal corporate rate (34%), though some income streams are tax exempt. Current regulations allow limited development activity. The payout is set at 80% of net profit before depreciation, and gearing at 50% of total asset value.

Governments and property industries have been negotiating for years about how to create a real estate investment vehicle that investors find attractive and one that does not erode the tax base. While the consultative process continues, it is crucial to monitor whether the details of the anticipated legislation adequately strike this balance or not.

³ While they are tax exempt at the corporate level, their activities are also highly regulated, including comprehensive restrictions on licensing agreements, organizational structure, permitted investments, investment restrictions, and valuation. OEFs are open-end, therefore do not have a fixed number of units, nor are they traded on a secondary market; they are liquid like traded stocks because redemption prices are determined on a daily basis and are determined by appraisal value of underlying properties. At least 51% of the fund's capital must be invested in properties, and in practice funds hold considerable portions of interest-bearing assets, such as deposits and bonds. Therefore, their return characteristics do not represent a pure property portfolio, but rather a multi-asset portfolio consisting of cash, government bonds with different durations, and properties.