

## Between a REIT and a Hard Place: 3 Years on and Still No Residential REITs

### OVERVIEW

- There remain no residential REITs, despite their introduction to the UK three years ago. Current REITs legislation does not align with the prevailing residential investment business model in the UK, which, because of low rental yields, is largely predicated on capital growth.
- Large scale, purpose built rental stock could, adopting the US multi-family housing model, generate the higher income yields, and be more suitable for REITs.
- If barriers to development are addressed, residential REITs could be a useful mechanism to engender the development of a build to let sector in the UK. This could help boost the overall level of housing supply.
- The Treasury's recent consultation paper on investment in the UK private rented sector is an encouraging step towards providing support for institutional investment and residential REITs.

### INTRODUCTION

UK REITs were first introduced in January 2007. In the first year there was a flurry of activity and sixteen property companies converted to REIT status. But, since then, the market has been more subdued with only 21 REITs listed today. These have a combined market value of £18.7bn, which accounts for 6.5% of the global REIT market.

However, despite REITs being heralded as a mechanism to *"encourage increased institutional and professional investment to support the growth of new housing"* there is no exclusively residential REIT in the UK and only two contain a residential element in their portfolio.

### WHY NO RESIDENTIAL REITs?

The lack of residential REITs is partly down to poor timing; their introduction was followed by one of the worst economic and housing market downturns in history. But, more fundamentally, REITs do not align with the current structure of the residential investment business model that is largely adopted in the UK.

Unlike commercial property, investment in residential property in the UK is largely driven by capital growth rather than income return. This partly reflects residential's lower net yields from the shorter lease structure and the cost of maintenance and management is borne by owner not tenant.

### CURRENT REITS LEGISLATION: OVERVIEW

- Shares in a REIT must be listed on a recognised stock exchange (AIM listed companies do not qualify).
- 75% of income and asset value must be attributed to property letting business ("balance of business" test).
- 90% of the profits from the property investment business must be distributed to shareholders by way of a dividend within 12 months of the end of the accounting periods in which profits arise.
- A REIT must own at least three properties; no individual property can account for more than 40% of total value.
- A REIT must have an interest cover of at least 1.25:1. The ratio compares taxable profits of the business before financing costs and capital allowances to the financing costs.
- A REIT cannot be controlled by 5 or fewer persons or must have at least 35% of its voting shares held by the general public.

Moreover, capital values and growth in residential property reflect the dominance of the owner occupation sector; there often can be a disconnect between capital values and achievable rental income. This encourages a business model largely predicated on an element of property "churn" as investors rebalance stock holdings in line with wider market movements. This type of business model is incompatible with REITs, which specify 75% of business income must be from investment assets.

The dependence on capital growth also makes the REITs gearing restriction of 1.25 interest cover difficult to satisfy. This is because "profit" refers to income only and excludes any capital gains. Redefining profit to include capital would mitigate this. However, according to REITs rules 90% of profit needs to be distributed to shareholders; this would leave just 10% to reinvest and cover debt payments.

### UNSUITABLE SUPPLY OF HOUSING

The majority of residential investment in the UK originates from buy-to-let investors (over 70% of the market), see Chart. As a result, the market is fragmented with small lot sizes; 73% of residential portfolios contain less than 10 units. Many of these property portfolios are not appropriate for a REITs type structure.

Institutions prefer large scale rental products; the target lot size criteria is generally greater than £20m, with over 100 individual rental units. These schemes provide the opportunity to leverage off economies of scale with reduced management costs, which would drive stronger net yields and therefore be more appropriate for REITs. With stronger yields and a focus on income generation, this type of product would more easily satisfy REITs rules.

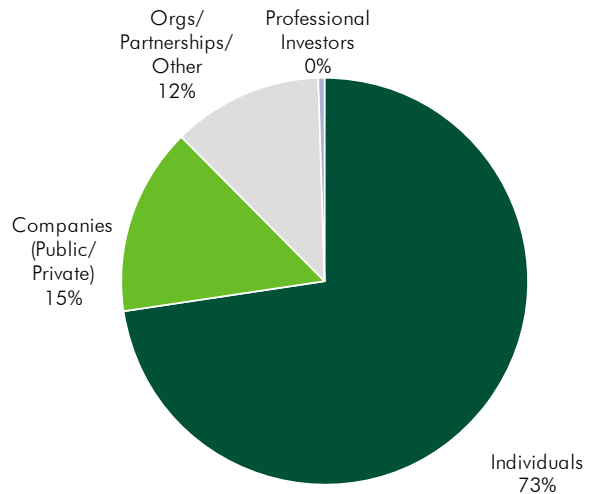
### ARE REITs NOT RIGHT?

Given the underlying market composition, the lack of appetite for residential REITs is unsurprising; UK REITs legislation is far more suited to the traditional institutional investment model, which focuses on income without a heavy reliance on capital growth. This is generally found in the UK commercial market and explains why commercial REITs have been more successful. We think the recent institutional interest in new residential investment models is key to opening up this market as suitable investment grade stock is developed.

#### US Multi-Family Housing - Archstone Boston Common



Chart: Breakdown of Residential Investment in the UK



Source: Rugg Review

### CREATE SUPPLY TO SATISFY DEMAND

Given this linkage, it follows that the residential REIT market is unlikely to fully develop without suitable large scale rental stock. This type of product would need to be purpose built as current portfolios held in the UK are too fragmented.

The wider benefits of build to let have been recognised; the HCA is committed to driving forward a build to let market with its Private Rental Sector Initiative. However, there are additional measures the government can take to support development. For example, making the liability to stamp duty and VAT and access to capital allowances more equitable for large scale investors in residential.

### DISPROPORTIONATE STAMP DUTY LAND TAX

The current Stamp Duty Land Tax (SDLT) legislation discourages bulk purchasing of property and therefore institutional investors. SDLT is payable on the total value of the purchase rather than individual units. The highest tax band of 5% will be applicable for purchases over £1 million from April 2011. The current top band is 4% payable on purchases over £500,000 and so is generally payable on bulk purchases (tax rates range from 0% below £250,000 and 3% between £250,001 to £500,000. The higher rate of 5% will not apply because bulk purchases of more than six units will be exempt).

This means the tax liable on the acquisition of stock by institutions is disproportionately high when compared with an investor buying individual lots. For example, consider a bulk buy of hundred properties with an individual value of £250,000 and a parcel value of £25 million. The stamp duty payable on the individual units would total be £250,000. However, for a REIT the comparable tax would be £1 million. This inequality between individual and bulk investors is clearly a barrier to entry for investors.

### DISPROPORTIONATE VAT BURDEN

The treatment of VAT on property acts as a huge disincentive to residential rental development. Unlike the commercial and residential sale markets there is no mechanism to enable VAT recovery by residential rental developers. While all property starts off being exempt for VAT, commercial property can be 'opted to tax' allowing developers and investors to recover VAT on their costs. This is not possible in residential property. There is a rule that alleviates the problem of irrecoverable VAT for those who build and sell residential property, but this doesn't

apply for rental property. Clearly the additional 17.5% cost of development goes some way to explain the lack of large scale purpose built rental developments in the UK. VAT also increases the cost of repairs, maintenance and property management therefore reducing net yields.

### DISPROPORTIONATE CAPITAL ALLOWANCES

Commercial property development is eligible for capital allowances, residential doesn't, making it yet more costly.

All of these factors are barriers of varying degrees to large scale residential investment by institutions.

### BETWEEN A REIT AND A HARD PLACE

To stimulate the residential REITs market the Government could consider amending the REITs legislation to align it with the UK's current residential investment business model. For example, to include capital growth in profit calculations. However this creates little "additionality"; which could come by promoting new development of residential stock suitable for institutional investment and for REITs in their current format.

REITs may not be suitable for the current underlying business model, but they could benefit a build to let sector by providing an identified exit route for new development. The additionality argument is clear; opening up this new sector would encourage new construction, provide new jobs and new housing supply.

#### US Multi-Family Housing - Archstone Boston Common



### CONVERSION CHARGE – A DOUBLE EDGED SWORD

To become a REIT, the company must pay a conversion charge equal to 2% of total portfolio value; commercially that cost is usually justified because it allows latent capital gains tax liabilities to be written off. This makes REITs an attractive option for established companies with a large CGT liability and build to let portfolios that are likely to show significant capital growth once they have stabilised income. However, for a new portfolio (without any CGT liabilities) the 2% charge is effectively just an additional entry cost. This means REITs are more likely to be part of ongoing or exit strategy rather than an entry strategy.

### AND THE ADDITIONALITY IS HOUSING...

The potential impact of institutional investment on housing supply is significant. Over the last decade institutions have, on average, invested £60 billion each year across a range of assets. Just 1% of this amount could finance the development of around 3,000 additional housing units per year. This in turn will have huge economic effects as house building is one of our biggest employers; according to the Home Builders Federation every new home built provides 1½ direct full-time jobs, plus another 6 or so further up the supply chain.

Build to let could also fill part of the void left by the decline of buy to let. The growth in buy to let engendered a huge growth in the private rental sector; according to the Survey of English Housing, the number of private rental households has increased by 1 million since 2001. However, the market downturn has led to a 80% decline in this type of investor and the availability of cheap, high LTV buy to let mortgages are unlikely to return in the foreseeable future. Build to let could reinvigorate development activity.

As well as boosting overall housing supply, build to let could reform the private rental sector. The creation of an institutional product similar to that in the US would facilitate professional management in a sector currently dominated by small landlords. This would lead to an improved offer to residents, an improved image for the sector and ultimately a new asset class for the institutions.

### CONCLUSION

Unquestionably REITs create a mechanism for a flexible and liquid route to residential investment, but could also be a driver to boost overall housing supply. The choice for the legislators is to amend REIT rules so that they can own established residential investment or leave as they are and use other fiscal tools to encourage the residential industry to build stock that suits the model, for example build to let.

If the Government is serious about promoting residential REITs, we suggest it fully supports the build to let sector. To engender purpose built rental stock, it should modify fiscal policy to make liability to stamp duty and VAT and the availability of capital allowances equitable across different types of property development.

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