

UK real estate insights

Issue 9 – July 2008

Contents

- 02 Introduction
- 04 Economic outlook: Gloom deepens
- 07 Financial services outlook: Gloom deepens further
- 08 UK hotels: Early check-out for good times
- 09 Are high streets being short-changed?
- 14 Sustainability: Are consumers buying it?
- 15 REIT rule changes
- 16 Value Added Tax: Changes to the option to tax
- 20 Property Authorised Investment Funds: Three months on
- 21 Additional tax relief on second-hand real estate acquired on or after 1 April 2008
- 22 The basics of Islamic finance
- 26 UK real estate client conference
- 27 Events and publications

Print

Quit



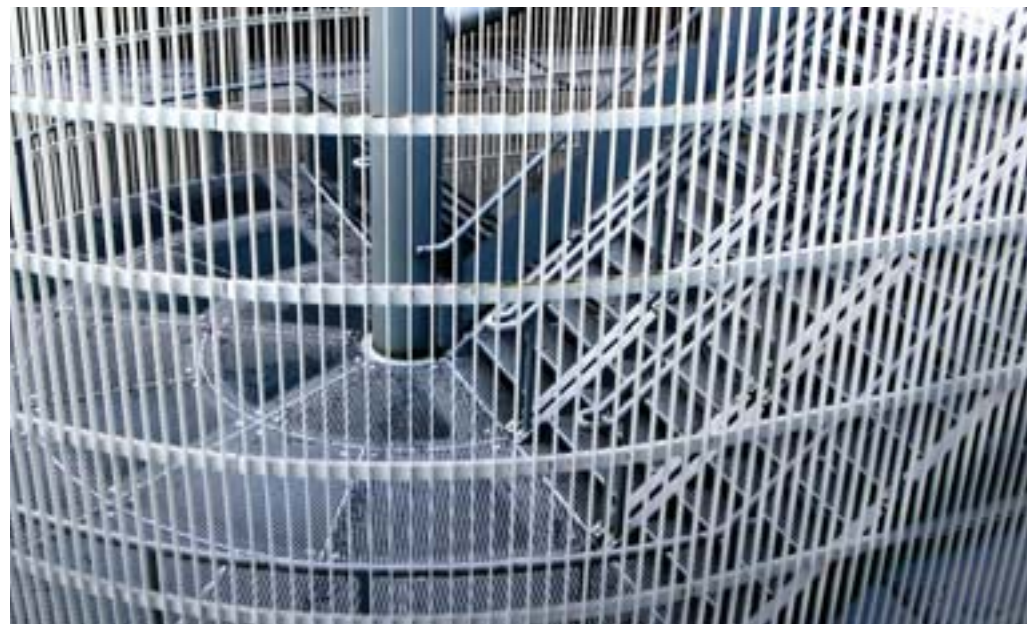
Introduction

Welcome to the latest issue of *UK real estate insights*.

On 25 June we held our annual UK real estate client conference, attended by 250 of our clients and contacts. It goes without saying that the mood was very different from the equivalent event a year ago. At the time of our 2007 conference, the IPD UK monthly index was still showing capital growth, HSBC had just agreed the £1.1 billion sale and leaseback of its headquarters in London's Docklands and securitisation was dominating the debt markets. This year the defining sentiment both in the formal panel discussion and in the informal conversations in the coffee break was one of uncertainty.

First and foremost was uncertainty over the broader economy. Since the onset of the liquidity crunch, concern has grown that the effects would spill over into the broader economy and turn a real estate capital market crisis into an occupier crisis too. In our previous issue of *UK real estate insights*, I commented that what had been a fear in December was rapidly turning into reality. It is now clear to everyone apart, perhaps, from the Treasury that we are heading into a period of economic slowdown. At our conference Ian Powell, the new Chairman and Senior Partner of PricewaterhouseCoopers¹ in the UK, provided a PricewaterhouseCoopers view of the outlook for the UK economy. This was based on research for the latest issue of our UK Economic Outlook, which was published last week. It does not make for cheerful reading, and a [summary](#) is included in this edition of *UK real estate insights*.

The second key area of uncertainty was in respect of the financial services industry. As the panelists at our conference commented, liquidity will not return to the real estate lending markets until the players recover confidence in each other. A continued climate of fear in the financial services sector is therefore



expected but unwelcome. Gloom in the sector is also bad news for occupational demand in the London office market, which is highly dependent on the financial and business services sectors. Because of this, in recent editions of this publication we have been following closely the findings of the PwC/CBI quarterly financial services survey. More detail is provided [elsewhere in this edition](#), but the key message is that the results are just about the gloomiest

since the survey was first launched in December 1989. Respondents are predicting the next quarter to be worse.

If anything the situation has deteriorated further since the financial services survey was published at the end of June and the economic outlook last week. In the United States, Fannie Mae and Freddie Mac, the Government sponsored mortgage institutions are going to need a Federal bail-out to survive. This news was followed by more gloomy data

¹ "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom).

Introduction

during the week, with the publication of statistics showing showing unexpectedly slow retail sales and a sharp increase in producer prices in June. US consumer prices also rose by 1.1 per cent in June. In the UK there is also more evidence of simultaneous stagnation and inflation. Statistics just published for June saw two indicators achieve their worst result since 1992 - the highest monthly increase in unemployment and the highest annual rate of consumer price inflation.

In order to get all the depressing news out at once, we have also included articles in this edition on the hotel and retail sectors.

Despite the gloomy background, there was some optimism at our conference. Investors who have regarded the UK as over-priced in recent years are starting to see opportunities and are looking at the market again. Investors who are not reliant on debt are beginning to make acquisitions. Although equity is not yet

coming back into the markets in significant amounts, it is accumulating out there ready for the turn in the market. A number of opportunity fund managers have announced huge fund-raising in recent weeks. Sovereign wealth funds are estimated to have grown their capital by about 18% last year, and with oil currently at over \$140 a barrel, the rate at which they are accumulating funds to invest is accelerating. In view of the increasing importance of Middle-Eastern investment capital, we include an article in this issue on the basics of Islamic Finance. We will have further articles on this and on Sovereign Wealth Funds in future issues.

As discussed in the previous issue of UK real estate insights, despite the turmoil in real estate markets over the last year, institutions have still been indicating an increase in allocation to real estate as an asset class. We will have more in the next issue on the opportunities in the market, particularly those that arise from distressed situations.

In assessing any opportunities, tax remains an important consideration. As usual this issue contains a number of articles on tax changes that affect the UK real estate industry.

As I said in my welcome to the attendees at our conference, at PricewaterhouseCoopers we remain confident in the opportunities developing in the market and continue to invest in growing our real estate practice. In that respect, I would like to conclude by congratulating the three members of our real estate team who became partners in the firm on 1 July: Sandra Dowling, who became an assurance partner at the London office, Bas Kundu, who became a tax partner, also in the London office, and Martin Fleetwood, who became a tax partner in the Belfast office.

[John Forbes](#)
PricewaterhouseCoopers
UK Real Estate Leader



Economic outlook: Gloom deepens

As mentioned in the introduction to this issue, at our UK real estate client conference on 25 June, Ian Powell, the new Chairman and Senior Partner of PricewaterhouseCoopers in the UK, provided a PricewaterhouseCoopers view of the outlook for the UK economy. This was based on research for the latest issue of our UK Economic Outlook, which was published last week. It does not make for cheerful reading.

UK GDP growth is projected in the PricewaterhouseCoopers main scenario to slow from 3.1% in 2007 to only around 1.75% in 2008 and 1.25% in 2009. This prognosis for the economy is similar to the latest average independent forecast but below the Treasury's Budget forecast, particularly for 2009.

Consumer spending growth is expected to slow more markedly to 0.5% in 2009 due to the severe squeeze on consumer spending from high debt levels, tighter credit conditions, falling housing wealth and sharply increasing household energy, petrol and food bills. Consumer spending growth has been faster and less volatile than disposable income growth since 1996. Households have both smoothed and boosted their spending growth in the face of variable income growth rates by leveraging their access to credit, notably through housing equity withdrawal. These trends have pushed savings rates (net of borrowing) down to very low levels and raised household debt to very high levels relative to incomes. However, the factors that have underpinned these developments – such as robust employment growth, low inflation and interest rates, and rising house prices – have already begun to unwind. In the

Table 1.1 – Summary of UK economic prospects

Indicator (% change on previous year)	HM Treasury forecasts (March 2008)		Independent forecasts (June 2008)		PricewaterhouseCoopers Main scenario (July 2008)	
	2008	2009	2008	2009	2008	2009
GDP	1.7 to 2.25	2.25 to 2.75	1.7	1.4	1.75	1.25
Consumer spending	1.25 to 1.75	2 to 2.5	1.7	1.0	1.75	0.5
Investment	1.75 to 2.25	2.75 to 3.25	1.5	1.2	1.5	1.5
Manufacturing output	0.75 to 1.25	1.75 to 2.25	0.6	1.2	0.5	1
CPI (Q4)	2.5	2	3.2	2.2	4	2.25

Source: HM Treasury, Survey of Independent Forecasts (average values), PwC scenarios rounded to the nearest quarter of a percent. Investment refers to total fixed investment.

coming 18 months they will provide considerably less support to household income and spending growth than in recent years, or even turn significantly negative in their effects in the case of falling house prices and higher inflation.

Business investment growth is also expected to moderate significantly in the face of uncertainties relating to the global credit crunch, while public spending growth is planned to be much more subdued than in recent years. The gloom pervading the financial services industry is covered in a separate article. A very significant point to note from that article is that the financial services industry has indicated that business volumes with industrial and commercial

companies, which had been holding up so far during the credit crunch, fell for the first time since March 2005 (a balance of -16%) and are expected to fall more heavily over the coming three months (-33%).

Slower global growth is likely to dampen exports, although this will be offset by the weaker pound. Import growth is expected to slow, so enabling net exports to make a modest positive contribution to overall GDP growth in 2008–9, but this will be far too small to offset the consumer-led slowdown in domestic demand growth.

Economic outlook: Gloom deepens

Table 1.2: Outlook for UK household income and spending growth

Variable	Average nominal growth rate (% pa)	
	2004-07	2008-09*
Employment	0.9%	▼
Average wages	4.1%	▼
Earned income	5.0%	▼
Investments	-	▼
Social security	-	◀▶
Pensions	-	◀▶
Gross household income	5.2%	▼
Direct taxes	7.2%	▼
- Taxes on income	7.6%	▼
- Employee NICs	7.2%	▼
- Council tax	5.8%	◀▶
Household disposable income	4.7%	▼
Non-discretionary household spend	5.8%	▲
- electricity and gas	13.1%	▲
- water supply	8.9%	◀▶
- food	4.7%	▲
- rental payments	7.7%	◀▶
- debt service	10.2%	◀▶
Discretionary disposable income	3.1%	▼
Total household savings	-2.6%	▲
Total household credit	11.5%	▼
- secured credit	11.8%	▼
- unsecured credit	9.8%	▼
Total household spending	4.7%	▼
Discretionary spending	4.5%	▼
<i>Memo item: RPI inflation</i>	3.1%	◀▶

* ▲ accelerating growth; ▼ decelerating growth; ◀▶ stable growth.

Source: ONS for 2004-7; PricewaterhouseCoopers' assessments for 2008-9

Risks around growth in our main scenario are significant and have become increasingly weighted to the downside in recent months. The chance of a recession has now risen to 30% in our judgement, although this is still not the most likely scenario.

Inflation is likely to rise further in the short term but then fall back towards target during 2009. However, there are still considerable uncertainties around this relating to the path of global commodity prices.

Interest rates are assumed to remain on hold for the rest of 2008, but then be cut during the first half of 2009 in our main scenario in response to slower growth and falling headline inflation next year.

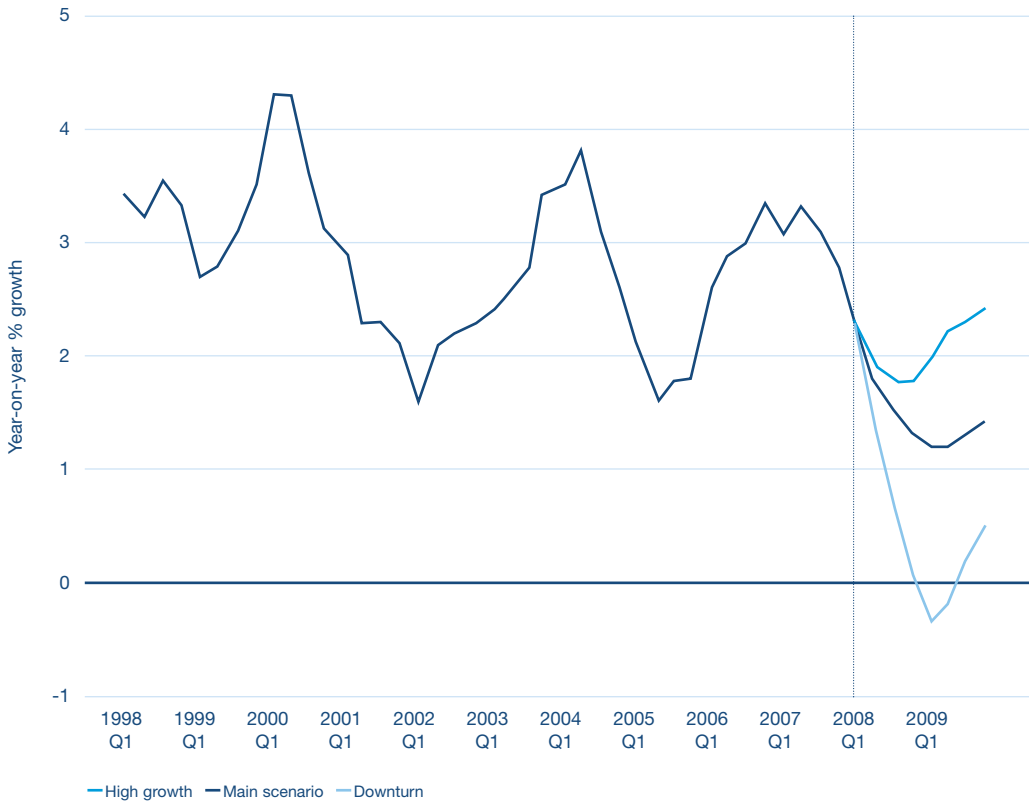
But interest rate increases cannot be ruled out if inflation accelerates further later this year, particularly if inflationary expectations rise as well. The upward pressures on consumer prices are leading to a general rise in inflation

expectations, which is potentially a major concern for the Bank of England. The latest edition of the Bank of England/Gfk NOP's Inflation Attitudes Survey, which was carried out in May, revealed a full percentage point rise in year-ahead inflation expectations from 3.3% to 4.3% since the previous survey in February.

The US economy has slowed markedly in response to the early weakening of the housing market, although it has not yet fallen into an outright recession. Euroland economic growth has also eased back recently, but the Asian economies have generally remained much stronger. Oil prices have remained very high and volatile, and food prices have also been rising rapidly. Overall, global growth is expected to be significantly slower in 2008-9 than in 2006-7 and risks are weighted to the downside given the combined impact of the credit crunch and rising commodity prices.

Economic outlook: Gloom deepens

Figure 1.2 – Alternative GDP growth scenarios



Source: ONS, PricewaterhouseCoopers scenarios

Our main scenario sees UK economic growth slowing from around 3% in 2007 to around 1.75% in 2008 and 1.25% in 2009 as the effects of falling house prices, reduced credit availability, slower global growth and higher inflation come through, particularly by dampening consumer spending growth later this year and into 2009. As indicated above, risks are weighted to the downside and there is a 30% risk of recession.

For a copy of the full UK economic outlook report, [please visit our website.](#)

Other economic research

At our European real estate client conference in Vienna last year, we presented a long-term view of the real estate world over the next 40 years,

based on various reports produced by our macro-economic team. Some of those have recently been updated:

[Which are the largest city economies in the world and how might this change by 2020?](#)

[Can rapid global growth be reconciled with moving to a low carbon economy?](#)

[Emerging markets: Balancing risk & reward, the PricewaterhouseCoopers EM20 Index](#)

For further information regarding macro-economic advice for the real estate industry, please contact [Yael Selfin](#), who is Head of Macro Consulting, Economics in our Market & Value Advisory practice.

Financial services outlook: Gloom deepens further

The latest quarterly Financial Services Survey from the CBI and PricewaterhouseCoopers covers the period to 30 June 2008. The survey, which has been running since December 1989, is a quarterly assessment of the health, perceptions and plans of the financial services industry.

As with the broader economic outlook covered in another article in this publication, the current edition does not make for cheerful reading. The impact of the credit crunch on the UK financial services industry has worsened over the past quarter, as profitability fell at a record pace and business volumes fell at the fastest rate in 17 years. Credit remains expensive and in short supply, with the gap between lending and borrowing rates widening more than at any time in the survey's history.

Job cuts have continued and business has been lost across all customer bases. Although the credit crunch has already been underway for ten months, nine out of ten firms (91%) think it will take more than six months for market conditions to return to normal.

Asked about business volume trends in the three months to early June, 20 per cent of firms said they had risen, while 55 per cent said they had decreased. The resulting balance of -35% was in line with expectations, but was the weakest result since March 1991 (-44%). The outlook for the coming three months is bleaker still, with a balance of 44 per cent expecting business volumes to fall.

Financial services firms had expected profitability in the sector to remain stable but instead it dived sharply, with a balance of 44% reporting a fall, compared with 18% in March. This is the fastest rate of decline in profitability since the survey began in late 1989, and another heavy fall is anticipated over the next quarter.

Business sentiment recorded its steepest fall since September 1990, as a balance of 57% said they are less optimistic about the overall business situation in the financial services sector than they were in March.

Most alarmingly for the broader economic outlook, business volumes with industrial and commercial companies, which had been holding up so far during the credit crunch, fell for the first time since March 2005 (a balance of -16%) and are expected to fall more heavily over the coming three months (-33%). Business volumes with financial institutions and private individuals continued to fall (-23% and -28% respectively), while a pick-up in volumes with overseas customers failed to materialise.

Jobs were again lost in the sector, and a balance of 22% reported a fall in numbers employed, but this outcome was not as bad as predicted, and slightly slower than in the March survey. A balance of 19% expects to cut jobs over the next three months.

All the major sub-sectors of financial services now display a negative outlook, and in most cases this is worsening, despite some individual spots of optimism in selected businesses.

[To obtain a copy of the report click here.](#)

UK hotels: Early check-out for good times

Our previous edition of *UK Real Estate Insights* included a summary of the findings of the PricewaterhouseCoopers forecast for the UK hotel sector for 2008 to 2009, published in March 2008.

In view of the deteriorating economic situation, an interim forecast has been produced providing a snapshot of recent trends in the UK hotel sector. This incorporates the latest macro-economic indicators and consultations with key operators and experts and supersedes the previous forecast. The update looks at UK provinces and London only with an update to analyse trends in Birmingham, Manchester and Edinburgh later in the year.

Six months into the year and hotels are performing well as room rates continue to grow. Benchmark data show that despite the economic and consumer slowdown, UK hotels continued to report positive trading results in the first half of this year. The UK saw RevPAR growth of 3.1 per cent in the five months to May compared to the same period in 2007. However, the deteriorating economic backdrop heralds a slowdown in the second half continuing into 2009. As indicated elsewhere in this issue of *UK Real Estate Insights*, [the economic outlook](#) is becoming more gloomy. Economic growth is now expected to slow to 1.25 per cent in 2009. Demand is forecast to slow sharply and the so-far resilient corporate travel sector is expected to decelerate as companies



seek to control costs and 24-hour conference business also falters. Leisure travellers too are also likely to tighten their belts. In addition, new supply will start to impact occupancy rates. Although our research found few operators concerned that oversupply is a big issue in the UK, strong trading has encouraged ambitious schemes from a variety of global and domestic brands and some cities have seen considerable room additions in recent years.

More detail is available in the current edition of [Hospitality Directions Europe](#).

[Liz Hall](#) is head of hospitality and leisure research at PricewaterhouseCoopers.

Are high streets being short-changed ?

As outlined elsewhere in this edition of *UK real estate insights*, **the economic news** for retailers is not good with discretionary spending falling and prices rising. A number of retailers have announced poor results. With the short-term issues facing the high street, it may be tempting to overlook some of the longer term pressures.

The look of your High Street is changing, and some would say “not for the better”. Traditionally, the high street has been the living centre of any village, town or city district. The changing face of the high street is being caused by changes in our shopping habits, such as increasing use of the internet, the tug of the all-embracing shopping-as-leisure shopping centres and the growth of the supermarkets. In addition, the UK has changed its social habits and we live in an increasingly ‘café’ culture. These changes have led to significant alterations in the way that developers plan, design and build shopping centres, drawing trade – and therefore drawing retailers – away from the traditional high street. This is really beginning to make it hard for local authorities, everywhere, to hold on to their high street as the vibrant hub of their community.

During 2007 and into 2008, it will have been obvious to any observer that some retailers have disappeared from our high streets and shopping centres, often leaving empty and boarded-up stores. Some are re-let, to new or different traders, but sadly some others are not, especially in those locations which are just off-pitch, or worse. There is a strange conundrum to these closures. Why should retailers be closing stores,



just when recently published statistics suggest that retail has experienced its highest percentage sales increase since records began in 1986? PricewaterhouseCoopers’ opinion is that this counter-intuitive activity probably means that although some retailers are selling more quantity, they are doing so at increasingly discounted prices, leading to a fall in profits over time. This outcome is further reflected in the number of profit warnings from quoted retailers – for example we have seen 29

profit warnings from well known retailers in the first six months of 2008 alone. In autumn 2007, after the confidential restructuring or formal administration of 8 national retailers by PricewaterhouseCoopers, we noticed that there was a common thread to the successful turnaround of each business in that a number of stores had to be closed or sold in order to survive. Between them, these eight well known retailers had something in excess of 2000 stores across the land. When we

Are high streets being short-changed ?

analysed the detail, we discovered that, on average, these retailers had to jettison 27% of their stores, bringing approximately 550 shops onto the market.

PricewaterhouseCoopers then extrapolated this research across a range of national retailers with 20+, 50+ and 100+ stores, to see what might happen over the next 12 months. This analysis suggested that, if only 10% of these national retailers were to get into financial trouble during 2008, then we could see a further 2700 stores coming onto the market during this year.

Following a spate of at least 20 insolvencies in well-known retailers in early 2008, we refreshed our analysis numbers and found that the percentage has increased from 27% to c36%. This increase is significant – a rise of about one third since last autumn. If these closures are extrapolated across the multi-site national retailers described earlier, that could be some 3,600 stores coming onto the market over the next 12 months. By any measure, more than 3,600 shops is a lot of stores to re-let, a situation further compounded by the fact that demand is already weak. At the time of the initial research, there was already about 11m square feet of retail space on

the market – the equivalent of over 150 football pitches. Some of this available space is, inevitably, also in shopping centres, as well as high streets. It takes, on average, 8 to 10 years to create a new shopping centre from scratch, so the design and layout might be considered to be “out of date” once it is opened. Whilst this may seem harsh, the world is moving so fast these days that design has to be adaptable and changeable to be really “fit for purpose”. Last autumn, in addition to the space that we predicted may become available, coupled with the space already available on the market, there was about 33m square feet in the retail development pipeline.

These statistics must have dire consequences for many town centres. It has been quoted many times in the broadsheet press, since the opening of Liverpool One – the new 1 million square feet development – in late May 2008, that there is the equivalent of seven shopping centres the size of Bluewater (which is located in Kent and said to be the third largest shopping centre in Europe) still in the UK development pipeline.

There will also be severe implications of downward pressure on retail rents, and

therefore retail yields (capital values of the buildings for property investors), with little or no rental growth potential. For lenders and funders, there must be increased prospects that retail investors may breach loan-to-value covenants, as the market continues to fall and valuers struggle to value in a downturn, causing real difficulties in the commercial property sector.

These implications are undoubtedly exacerbated by the rapid growth in internet sales, which have grown as much due to the ease and security now associated with credit card and debit card purchasing, as anything else, such as more easily navigable web-sites. Recent PricewaterhouseCoopers research showed that well over three-quarters of the under-55s will be shopping online by 2011 – and the over 55s are not far behind. Following the lead established by music and books, almost anything can now be bought online. Just one small example that illustrates what many of us already sense about this rapid growth is the pre-Christmas sales online. In the ten weeks to Christmas 2006, we spent about £7.5bn online, whilst in the same period in 2007, this amount had virtually doubled to £14.5bn. The only limiting factors for Christmas 2008 would seem

to be the credit-crunch and the spectre of unemployment, but a number exceeding £20bn might not seem unreasonable.

Bearing all of this sentiment in mind, one might be forgiven for assuming the high street as we know it is dead, but there are still some retail and non-retail businesses doing well on the high street.

Here we look at how the current market is affecting these businesses, looking at those with good prospects first and moving onto those who are struggling.

Restaurants, Cafés and Take-aways

Restaurants, bars and coffee shop space has doubled and will form nearly 20% of the High Street of the future. Spending on leisure activities has increased, and eating-out has increased in popularity significantly during the last fifteen years of stable economic growth. We question how far this trend will continue as the economy goes through a downturn in the medium term and disposable income becomes less available. However, the recent announcement by Starbucks of massive store closures in their home markets may indicate that the

Are high streets being short-changed ?



burgeoning coffee shop bubble may have burst, or at least has a leaky valve in the bubble.

Hairdressers, Beauty Salons and Tanning Salons

Haircuts, manicures and a tan cannot be bought on the internet, so will always have a place on the high street and in shopping centres. The current culture of going to the hairdressers shows most

people would rather pop to their local high street hairdresser, than venture to a shopping centre or into the city – convenience is key. Recent statistics show an eight-fold increase in these businesses – a volume which could represent 10% of the high street going forward. There is an argument that this 'luxury spend' may dwindle as purse strings tighten in the coming months, but there is also a counter argument that shows the 'lipstick' effect comes into

play in a downturn... people will spend money on these little luxuries to cheer themselves up.

Service, professional and financial outlets

The presence of these non-retail outlets has more than doubled in the last 15 years. Estate agencies and other professional services, which historically have not been able to afford the prime shopping space occupied by the traditional retailers, have crept onto the High Street. The significant statistical change is a 160% increase in estate agents over the past 15 years (although with between 40 and 150 branches closing each week currently this trend may be reversed), The other notable increase is in service-based businesses such as employment agencies, insurance agencies and professional offices such as local solicitors. These services cannot easily be substituted by the internet and therefore we predict that these service-led outlets will continue to grow in percentage of high street space.

Pharmacies and Chemists/ Health and Beauty

The health and beauty market struggles to compete with the supermarket offer in terms of price and convenience. This trend has seen retailers such as Boots and Superdrug move to out-of-town locations to try to compete on choice and size (if not on price). Boots once had several stores in most major high streets. Not so many any more.

Charity shops

A rapid growth in Charity shops, which traditionally filled empty shops on short-term lets, now take full leases and trade well on most high streets, although not in many shopping centres, where their product and image is not perceived to be of sufficient quality or with sufficient resources to pay really high turnover-based rents. In addition, the recent withdrawal of the empty rates waiver does not apply to charity shops – they are exempt, which will cause a further likely rise in their place on the high street.

Are high streets being short-changed ?

Travel agencies

Travel agencies also doubled in the same 15 year timeframe, which is surprising, but the peak was perhaps two or three years ago before buying travel on the internet became the norm for almost everyone, businesses included. Further growth is unlikely given the recent amalgamation of the First Choice and Thomson (TUI) brand in 2007, and Thomas Cook's continuing strategy of down-sizing, coupled with the knowledge that most travel and holidays are booked online.

Banks and Building Societies

The representation of banks and building societies has remained reasonably static in the last couple of years, despite massive branch closure programmes 5 – 10 years ago. Clearly needing to create trust with their customer base, face-to-face interaction seems critical, although the Woolwich has recently announced a new and very large branch closure initiative. This move by the Woolwich leads to the question of how much longer the importance of F-2-F will outweigh the costs of maintaining a branch network, with declining footfall of customers going through the front door.

The strong shift towards the convenience of internet banking, which is open for business 24 hours a day, and with the younger generation apparently needing far less reassurance about the use of the internet than their elders, will make a significant difference to the changing face of the high street. Local authority planners, and their Planning Committees, will have an impact and influence, too, as changing the use of financial premises to ordinary retail premises requires a formal planning consent.

Mobile Phone Shops

We have all seen the rapid growth of phone shops mopping up vacant space in most high streets and now going straight into existing and new shopping centres. They pay good rents and are attractive to landlords because of those rents, and the footfall that their product generates. It is hard to see, though, why these shops should continue to grow – just how many mobile phones do we need as a nation... a recent estimate suggested that there were already more than three working mobile phones for every adult in the country. So, unless a new and somehow differentiated retailer emerges on the market, these shops may have reached a saturation point and

their visually repetitive dominance may have peaked.

Household, Furniture and DIY retailers

Businesses who thrive on house sales, such as removals, furniture, carpets, home accessories, kitchens, bathrooms and the like, will struggle to survive. Traditionally, in a downturn, some of these retailers do well, along with DIY stores, as home owners refurbish their properties in preference to moving. However, in this downturn, the remortgage market (which is also shrinking) is focused on the renewal of expired fixed-term mortgages, a phenomenon not seen before... as opposed to equity release for home improvements.

Clothing and Footwear

The big losers on the High Street over the previous 15 years are the mid-market clothing and footwear companies. PricewaterhouseCoopers research, based on two typical market High Streets, shows a reduction of nearly 50% of these stores in that time. Footwear, in particular, has recently lost presence at a rapid pace on the

High Street, due to the loss in 2008 of brands like Stead and Simpson, Dolcis and Ravel.

Whilst many people would probably not buy shoes on the internet – wanting to try on the shoes before purchase – the supermarkets have also played their part in the demise of high street retailers by introducing own-branded low price clothes and shoes, which have undercut the traditional brands on the High Street, on price and volume, together with department stores that have increased their ranges through branded franchise offers.

Electrical

In the late 80s/early 90s, the electrical retailers became ferociously competitive in order to win customers and it was quite normal to see them all represented on your local high street. There were even some suggestions that they were taking property specifically in order to prevent their competitors from moving into the neighbourhood. As the years moved along, these retailers started to move to out of town retail parks and, now, their offering has almost entirely been taken over by the internet. DSG group recently announced that it

Are high streets being short-changed ?

would be withdrawing from 100 units around the UK by non-renewal of leases as it tries to restructure and downsize its business.

Music, Books and Toys

The internet, particularly, has had a huge impact on the music and the book business as those retailers have realised that they no longer require a portfolio of expensive properties from which to sell their products. Older generations have taken to the new medium, but the younger generation particularly continue to be early adopters of purchasing music through the internet and now, of course, downloading music, podcasts and even TV programmes direct to their computers and MP3/MP4 players.

We have seen the demise of Our Price, Music Zone, Fopp, Just Tapes and MVC, amongst others, whilst the music section of Woolworths and WHSmith has been seriously down-sized or removed altogether. According to PwC consumer research, 90% of shoppers will be buying CDs and DVDs online in the next 5 years – always assuming that CDs and DVDs are still the preferred method of delivery of music and video-based entertainment in five years time, and that

direct down-loading has not replaced all previous methods of purchase.

The supermarkets have also undercut the traditional music retailers on price, and forced out many smaller and national retailers with their sheer buying power. In fact, HMV and Zavvi are the only national retailers which still have a high street presence. The book market has seen similar trading conditions, and consolidation has led to the main shop-based retailer with a national store portfolio being Waterstones. Just like Borders in the US (currently struggling according to media reports) one could consider whether it is the Waterstones internet offering supporting their stores, or the other way around.

To summarise, if trends continue, we will see a marked decrease in fashion, clothing and footwear which could dramatically reduce in the number of outlets in the average high street, unless they can offer another dimension, like a bar or nail salon incorporated in their shop – with the successful retailers continuing a rationalisation of their store portfolios and maintaining prime locations in prime towns as opposed to secondary high street locations. Consequently, a far sharper focus on location and the retail strength of

individual towns will become the subject of debate for all involved in retailing, probably creating further polarisation in retail locations generally.

Chemists, banks, books, toys and music could all but disappear, along with travel agents. This polarisation could create the most worrying trend, and it is our belief that voids could continue to rise from 10% to 12% currently, to as much as 18% to 22% - therefore a fifth of the High Street could be vacant. A very unhappy story for many town centres.

Quite what might happen to this vacant retail space in the medium/longer term is almost impossible to tell. However, in our next article, we will be looking at the way the high street was 15 years ago, compared to today and what we think will be taking the place of these retailers in the high street of 2012. Whilst we not possess a crystal ball, we do think that there are serious warning signs for developers, investors, retailers, funders and the general public – which we will explore in the third article.

[Barry Gilbertson](#) is a partner who leads our real estate Business Recovery team. [Deborah Parker](#) is a Senior Manager in the same team.

Sustainability: Are consumers buying it?



PricewaterhouseCoopers has just launched the results of a major piece of research into the attitudes and habits of 4,000 UK consumers which demonstrates the existence of mainstream public awareness and concern about sustainability issues. The implications for retail & consumer (R&C) businesses, and their real estate, are likely to be far reaching.

The research shows that:

- Whilst a significant majority of consumers are motivated to act and change behaviour, they are currently prevented from acting on their desire to buy more sustainable products by premium prices, confusion about the implications of their choices and the lack of available alternative products.
- Given that 60% of consumers believe that sustainability issues are the most important facing the world and that 80% stated that they are worried about climate change in particular, they are unlikely to tolerate companies that make platitudes to sustainability.
- It seems clear that companies wanting to succeed commercially must approach sustainability strategically and with transparency.

The impact on R&C businesses is tangible across every point of the business model. With governments also increasingly taking action to regulate and encourage changes in consumer and corporate behaviours on waste and carbon, the forces converging on R&C businesses are very powerful and the commercial logic for assessing and minimising energy, carbon, water and commodity usage is clear. Regardless of market position or scepticism of the science, consumer awareness, competitor action, resource scarcity and regulation changes mean that all R&C businesses need to develop a strategic response to sustainability issues.

The best organisations are investigating how they can reduce both their cost and their regulatory exposure. For example:

1. Most major UK grocers are investing in technology to make their operations more energy efficient and reduce hazardous – and potentially taxable – emissions.
2. Companies are also adopting innovative supply chain solutions to secure the quantity and quality of materials they need to manufacture and operate.

These topics were the subject of the debate at the Operational Efficiency & Sustainability breakout session at the PricewaterhouseCoopers UK Real Estate Conference on 25 June 2008. Broadly, we concluded:

- Given that responsibility for the overwhelming majority of businesses' emissions rests with buildings and associated transport activities, the potential impact on current fuel-intensive logistics models and exposure to ageing and inefficient stores were seen to be major challenges for R&C occupiers.
- With no immediate technological solutions available to combat the effect on climate change from existing building stock, the implications for the real estate sector holding such illiquid assets are equally pressing.

Please [click here](#) to download the survey discussion paper.

REIT rule changes

HMRC have decided to rewrite the REIT legislation with a view to offering more clarity and to make some specific changes in the law.

The legislation will now be focused on REIT groups, whereas previously the starting point was a single company REIT with amendments to bring in group issues. The document is lengthy and HMRC is also seeking views through more than 70 questions. We are currently reviewing these proposed changes and will be discussing points with a number of clients and then responding before the deadline of 23 July 2008.

In a separate development HMRC has confirmed that the REIT regime can include property-rich businesses such as pubs, hotels, leisure, nursing homes and retail. Some restructuring of those businesses will be required to separate the operating business from the property rental business – an Opco/Propco split.

Certain requirements have to be met by the property rental business, including for example, 75% of its profits have to be rent and 75% of its assets must be used to generate rent. Furthermore, the parent company cannot be closed, has to be listed on a recognised stock exchange and has to be UK tax resident. There is an entry charge of 2% of the market value assets used in the property rental business and 90% of the net rental profits (being rents less management and maintenance costs, interest and



capital allowances) have to be distributed to shareholders.

This initiative provides an opportunity for a group to obtain potentially substantial tax benefits, given that the operating business can claim tax relief on the rentals paid to the property rental business while the property rental business is exempt from tax on its rental profits and gains made on the disposal of its rental assets.

Rosalind Rowe is a partner in the real estate tax team, with a particular focus on UK REITs.

Value Added Tax: Changes to the option to tax

The long-awaited changes to the VAT treatment of supplies of land and property came into effect on 1 June 2008. The changes made to Schedule 10 of the VAT Act 1994 concerning the option to tax are designed to improve clarity and enact the revised rules announced in the 2008 Budget.

Background to the changes

The option to tax rules have evolved over a number of years, primarily as a result of the introduction of various provisions intended to block perceived 'VAT avoidance', and the structure had become difficult to follow. The revision has made locating the relevant parts of the legislation and interpreting their meaning far more straightforward by dividing the schedule into three parts: the option to tax land; residential and charitable buildings, change of use etc.; and general.

Each part is divided into paragraphs, which bear a heading summarising their content. The language is also simplified to some extent, with phrases such as 'option to tax' and 'opter' replacing 'election to waive exemption' and 'the person who has made the election'.

In addition, because the existing 'option to tax' rules were introduced in August 1989 and options can be revoked after 20 years, measures have been introduced to enable revocations to be managed before the first opportunities to revoke arise in August 2009.



Changes and how they might affect your business

Real Estate Election

A new type of option to tax, known as a Real Estate Election ('REE'), is an optional facility for businesses which, once exercised, removes the requirement to notify an option to tax in respect of each subsequent acquisition. This administrative easement should enable

businesses which are involved in frequent land and property acquisitions, lettings and disposals to avoid potential issues which might arise from a failure to make or notify an option to tax at the correct time.

Although the REE might initially appear to be an ideal solution for certain businesses (i.e. those that will generally opt to tax), there are some potential pitfalls. These include how to treat interests in land already held before the

Value Added Tax: Changes to the option to tax

REE is made; the treatment of property where exempt supplies have already been made and HMRC's prior permission to opt to tax would be required; and options previously made where there is no interest in the land at the time of the REE. These issues should be considered in detail before making a REE.

Whilst a REE should alleviate some of the administrative burden of making options to tax on an ongoing basis;

HMRC can, at any time, request the provision of information concerning the opter's property interests, including addresses and land registry title numbers of the properties and dates of acquisition and disposal of properties covered by the REE.

The new REE provisions, as a whole, are complex and should be considered carefully, especially where businesses have already exercised significant numbers of options to tax and,

particularly, in relation to the existing options to tax of members of VAT group registrations.

Revocation of the option to tax

The cooling-off period in which an option to tax can now be revoked has been extended to within six months of it being effected. The changes also allow revocation even if VAT has been recovered, subject to there being a provision in the legislation under which it can be repaid. However, revocation will not be allowed without HMRC's permission if the property has: been put to use; had VAT charged on any supply of it; or was acquired by way of a transfer of a going concern.

This change is welcome as the revocation of the option to tax will now be feasible in more cases. Revocation should always be considered if a transaction does not proceed or the option to tax has been made on land that is not ultimately acquired and little or no VAT has been incurred.

In addition, an option to tax exercised by any person in relation to a property where no interest has been held for over six years is automatically revoked. This is in line with the record-keeping

requirements for VAT records so makes practical sense as there is no longer a requirement to keep all option to tax records indefinitely (or for 10 years as previously envisaged).

An option to tax can be revoked when 20 years have expired from the date of the original option, provided that certain conditions are met and due notification is given to HMRC. If the conditions are not met, you can still revoke an option to tax, in certain cases, as long as prior permission is granted by HMRC.

Revocation of the option to tax may be advantageous where an interest in property is to be granted to businesses which are unable to recover VAT. However, the opter must take into consideration the VAT which will become irrecoverable once the option has been revoked, particularly where the property may subsequently require substantial refurbishment or renovation. Revocation will be attractive, for example, if there is a tenant repair and maintenance lease.

Changes to the scope of the option to tax

The new Schedule 10 makes it clear that an option to tax land will also apply to any building on opted land or any



Value Added Tax: Changes to the option to tax

building subsequently constructed on opted land. However, under the transitional provisions in place, where existing options to tax have been made and it is clear from the notification that the option was to apply only to the building, transitional provisions will allow businesses to treat the option to tax as revoked if the building is demolished at any time in the future.

In addition, to provide more flexibility, if a new building is constructed outside the curtilage of an existing building, the new building and its curtilage can be excluded from the effect of the option to tax.

Permission to opt to tax

Permission to opt to tax needs to be sought where, in the period of 10 years prior to the date on which the taxpayer wishes to opt to tax, exempt supplies have been made in relation to land or buildings which are to be opted unless the conditions for 'automatic permission' are met. Previously, the option to tax took effect after the date that permission was granted and separate notification was required subsequent to approval. This resulted in problems in several circumstances where the option to tax needed to be effected quickly but HMRC

took some time to give approval. The new rules allow the option to be effective from the date permission was requested or any subsequent date as agreed, and a refusal of permission can now be appealed to the VAT and Duties Tribunal.

Buildings to be converted for residential use

Historically, there have been a number of exclusions from the effect of the option to tax in relation to residential buildings. These exclusions have led to many instances of last-minute contract wrangling where the purchaser and vendor do battle over where VAT is charged. In a move that will be welcome to sellers of such property, HMRC has introduced the need for certificates to be issued by the person who will carry out any conversions to such properties and by intermediaries involved.

The key aspect of this form is a declaration by the purchaser and a clear unequivocal statement in relation to which part of the building (if the entire building is not to be converted) will be converted. All certificates should be issued before the price for the grant is legally fixed (usually on exchange of contract), with any relevant

intermediaries holding a certificate from their customer before issuing their own certificate. Sellers can, however, at their discretion, accept certificates that have been issued after the price has been fixed, but only for amounts payable after the receipt of the certificate.

Similarly, the revisions also introduce certificates for Housing Associations to issue in respect of opted land which is to be used for constructing residential buildings.

Extent of the option to tax – VAT groups

Historically, for larger corporate groups, it has been extremely difficult to decide in some instances whether a company is tainted by an option where it does not hold an interest in a property but it has, at some time in the past, been VAT grouped with the opter.

The revised Schedule 10 aims to clarify the position by confirming who is affected by an option and, as such, is a 'relevant associate'. The new provisions provide greater clarity but, in some circumstances, it may be necessary to make a request to HMRC to cease to be a relevant associate; it may not be automatic.

Disapplication of the option to tax – definition of 'occupation'

In recent years, the wide-ranging anti-avoidance provisions have led to numerous problems in respect of transfers of a going concern ("TOGC") where there is no intention of avoidance. One such circumstance has been addressed, i.e. disapplications of the option to tax taking place in respect of ATMs owned by a bank financing the acquisition sited either within buildings or on the wall of a building. With effect from 1 June 2008, the anti-avoidance rules have been revised so that ATMs are excluded from definition of occupation and thus do not need to be considered when applying the disapplication rules.

HMRC has also taken the opportunity to properly define the level of VAT recovery below which a tenant can be considered to be in exempt occupation. For the purposes of the disapplication tests, recovery below 80% has been enshrined in tertiary legislation in the Public Notice.

Unfortunately, the changes do not go far enough to help others who may be unwittingly caught. For example, a business purchasing a shopping centre containing a branch of the bank financing the acquisition will be unable

Value Added Tax: Changes to the option to tax

to provide the required notification to enable the transaction to be a VAT-free TOGC. Consequently, if the vendor has opted to tax, VAT will be due on the full value of the acquisition, and although most of this VAT (excluding the area occupied by the bank), will normally be recoverable it will increase initial borrowing requirements and the Stamp Duty Land Tax payable.

There may be two possible solutions to this:

1. use a de minimis limit so that the area occupied by the financier can be ignored if it is less than, say, 10% of the whole building; or
2. treat the transaction as two, with the area occupied by the financier being treated as standard rated or exempt and the remainder as a TOGC.

Unfortunately, HMRC is yet to be persuaded of the merits of these solutions so the provisions are still likely to catch 'innocent' transactions.

Summary

In general, the revised rules on opting to tax should be of some benefit to businesses trading in land and property and HMRC has taken time to engage with the property sector on these issues. The timely introduction of measures concerning the revocation of the option to tax is welcome, as businesses involved in property transactions can now begin the process of considering, both strategically and with regard to individual properties, how they should approach the opportunity to revoke existing options. However, the new rules can be complex and, as they may significantly affect current and future supplies of property, they will require very careful consideration and in some aspects have done little to address the real practical difficulties encountered by businesses.

HMRC has published a revised Public Notice 742a, which provides helpful guidance on the effect of all the changes set out above. A number of new forms have also been produced and these are required to be used for many of the certifications and notifications required under the revised rules.

[Andrea Clarkson](#) is a director and leads our real estate VAT team. [Helen Whitfield](#) is a manager in the same team.

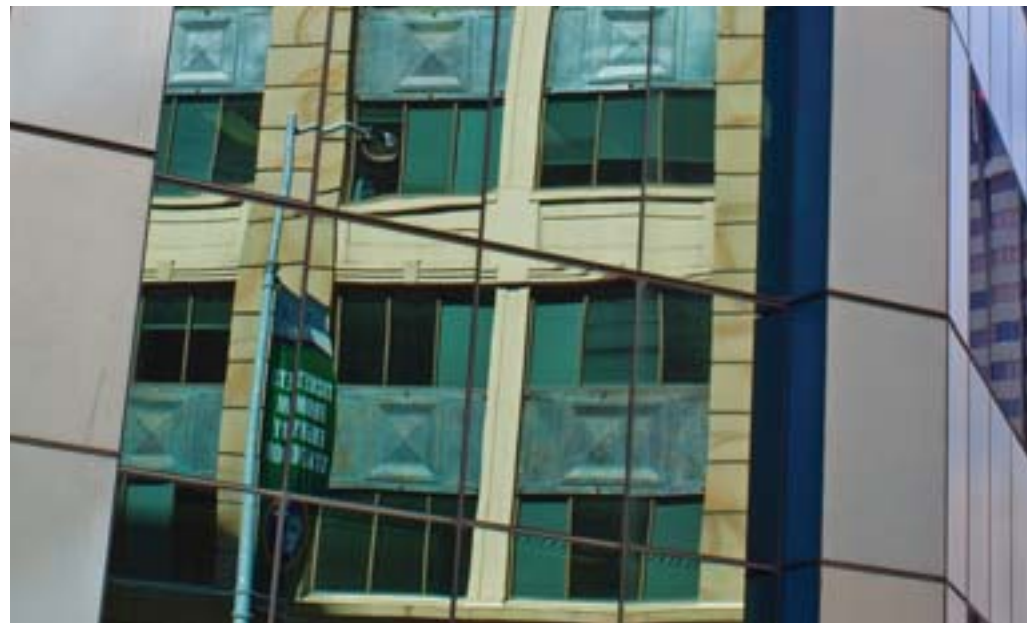


Property Authorised Investment Funds: Three months on

The “Property Authorised Investment Funds” (PAIF) regime was introduced from 1 April 2008.

The PAIF regime is largely modelled on the UK REIT regime with a relaxation of certain limits to reflect the open-ended nature of PAIFs, which must be constituted as UK OEICs before electing for PAIF status (requiring existing AUTs to convert to OEICs before electing in to the regime). The PAIF regime offers an opportunity for asset managers to launch an open-ended property fund with an effective tax exemption at fund level. PAIFs can invest in a wide range of property related assets with investors being taxed as if they had held the underlying assets directly, via a withholding regime.

The Final Regulations have now been laid and the guidance has been finalised and published under Property Authorised Investment Funds within the Company Taxation manual. As this is a new regime and the conversion process involves a number of complex issues to manage, not least the requirement for systems amendments, asset managers should take time to consider carefully the potential benefits to launching, or converting to, a PAIF. We are part of an industry wide team which has been working with HMRC to resolve some of the issues arising from this new regime.



Therefore if you have comments or suggestions for us to make to HMRC or would like to know more about PAIFs then please contact [Suzanne Ashwell](#) on 020 7804 4257 or [Rosalind Rowe](#) on 020 7213 5455.

Additional tax relief on second-hand real estate acquired on or after 1 April 2008

If your business has acquired real estate property on or after 1 April 2008 (or 6 April for individuals and non-resident landlords) in a third-party asset transaction, it will more than likely be entitled to claim additional tax depreciation, over and above the capital allowances the seller was entitled to claim.

What has given rise to this opportunity?

The availability of this additional tax relief has come about through reforms to the capital allowances regime, which have extended the definition of what is plant and machinery. This has meant that acquirers of property from third parties on or after the April effective date will be entitled to claim plant and machinery allowances (annually, at a 10% reducing balance) on certain assets that were previously ineligible for tax relief.

This additional relief should still be available even where the buyer and seller have elected to transfer historic capital allowances at a set figure. Sellers suffer no negative impact as a consequence of the buyer's claim, since they were never entitled to capital allowances for their expenditure on these assets under the prevailing regime.

Whilst detailed claims will need to be constructed to identify and quantify the additional qualifying assets, because entitlement results from a simple extension to the parameters of what qualifies, no tax planning will be needed to access this extra relief.

The situation may be different in acquisitions that are not the first transaction of properties on or after the effective date.

What could the additional tax relief be worth?

To indicate the potential benefits, the additional capital allowances available on the acquisition of an office building could be in the region of 5% of the value of the property. This would mean that for a £100m office property, or portfolio of office properties, the net-present cash value of these allowances could be close to £1m.

How must the claims be prepared?

Claims need to be made in tax returns and prepared on the basis of a just and reasonable apportionment of purchase price. Established formulae and guidelines are used to determine how much of the purchase price can be attributed to the newly eligible assets, which the seller did not/could not claim under the old regime. It would be helpful to be able to demonstrate that the seller

had never made claims on the relevant assets and, where possible, we recommend obtaining copies of sellers' historic claim reports and pursuing cooperation clauses in sale and purchase contracts. However, even in the absence of these, it should still be possible to evidence entitlement and prepare robust claims.

What else should buyers consider?

The opportunity mentioned above deals specifically with claiming capital allowances on additional qualifying assets. However, where elections are being proposed to transfer allowances between seller and buyer on assets the seller has previously claimed, it is possible to undertake some straightforward tax planning to structure the elections in such a manner as to maximise the buyer's cash-flow benefit of the allowances it is acquiring.

Stephen Perry is a senior manager and leads our Capital Allowances team.

The basics of Islamic finance

In recent years, Islamic finance has grown rapidly across the world, with the sector now estimated to have assets under management of US\$500 billion.² Growth is conservatively estimated at over 10% per year,³ and with oil currently trading at over \$140 a barrel, the Middle East is likely to generate increasing capital for investment. This makes the Islamic financial world an economic force not to be ignored.

London's existing strength in financial services and its position as a global financial hub have facilitated rapid growth as a key centre for Islamic finance. The UK government has supported Islamic finance with the Treasury adjusting fiscal policies to facilitate sukuk (Islamic bonds) and home-financing products. The UK has also been attracting a substantial amount of Middle Eastern investment in real estate. 'Current Trends in Shariah Property Investment', published by The Royal Institution of Chartered Surveyors in October, 2006 estimated that Shariah-compliant monies accounted for around 11% of foreign investment in the UK commercial real estate market – an increase from 4% in 2004. According to the study, the consensus at the time was that the amounts invested through Shariah-compliant funds would increase dramatically and the current position of global capital supports these views more than before.

The government is currently looking into ways to issue Shariah-complaint sukuk. This was announced by Economic Secretary and City Minister Kitty Ussher MP on 2 June 2008: "Today's discussion has emphasised both the importance of the Islamic finance sector to the City and the government's commitment to



ensuring the continued growth of this important sector in the future. The government is determined to maintain its momentum on work on Islamic finance and to make clear to stakeholders its commitment to this industry. As such, we want to reiterate our aim to publish a paper detailing the UK strategy on Islamic finance by the end of 2008. This paper would clarify the role of the government in the development of this sector and

importantly, the steps that industry will need to take to ensure that Islamic finance becomes one of the UK's success stories". This statement clearly demonstrates that the government recognises the importance of Islamic finance and is committed to looking into ways to develop this important alternative area of finance to ensure that London establishes itself as the leading Islamic finance centre.

² 'Islamic Finance 2008' published by Islamic Financial Services London, January 2008.

³ Ibid.

The basics of Islamic finance

Shariah and sources of Islamic law

The primary source of Islamic law is the Quran (text of God), which in any case is the first source to find answers. The secondary source is the Sunnah (the words or acts of prophet Mohammad). Other sources include ijma (consensus on a matter by independent jurists), ijthad (interpretation) and qiyas (legal analogy).

Shariah scholars play an important role in Islamic finance as they are qualified to issue fatwas (legal pronouncements) on financing structures to confirm their compliance with the Islamic principles. In practice, views may differ amongst Shariah scholars, and typically Islamic banks, investment and asset managers (in the conventional sense) will have their own Shariah board which will issue fatwas for products launched and offered to their clients or investors.

From a business perspective, the major prohibitions in Islam are:

- riba (interest)
- gharar (deception, cheat, enticement and overall uncertainty)
- maysir (speculation)

In order for investments to be fully Shariah compliant, in addition to meeting the above key principles, the underlying assets should be involved in legitimate (halal) activities. Any investment where the underlying activity is not halal must be avoided. Prohibited investment activities will, amongst others, cover the following:

- Conventional banking transactions involving payment and receipt of interest on deposits and loans.
- Conventional insurance and re-insurance activities.
- Distilling, producing, selling and marketing of alcoholic drinks.
- Defence industry.
- Gambling, including renting buildings for that purpose to a bookmaker.
- Processing and selling pork and meat not processed according to Shariah.
- Businesses involved in sexually explicit entertainment, night clubs and related activities.
- Transactions involving lack of knowledge, excessive risk and interest.

Some investments pose difficult but not insurmountable challenges to structure the investment so that it is Shariah compliant. For example, in the case of an investment in a retail shopping mall, it is likely that a substantial proportion of the shops would be engaged in impermissible activities. This would require some form of re-structuring to either segregate the non-permissible activities in a separate structure or for the fund/asset manager to report the income from 'impure' sources to investors. The investors can then donate this 'impure' income to charity to 'purify' the underlying forbidden activities. In this way, each investor can deal with the income in the manner that the investor considers appropriate.

Methods of Islamic financing

The most common forms of Islamic financing methods used within the Islamic finance industry are:

Murabaha

Murabaha is a financing technique which is typically used to provide acquisition finance. The provider of finance, which is typically an Islamic bank, buys an asset from a supplier and sells it on to its

customer at a premium. The customer pays the bank in instalments over the agreed period of time. The premium is generally based on LIBOR plus a margin. A murabaha financing can be arranged for acquisition of a variety of assets, including real estate.

Mudharabah

Mudharabah is a partnership contract between two parties where one party, i.e. provider of finance (rab al mal), provides capital and the other party, which is typically an Islamic bank (mudharib), provides expertise and knowledge and manages the partnership. The profits are shared as per the agreed profit-sharing ratio and in the event of a loss, the rab al mal fully absorbs the loss. This form of arrangement is very common in Islamic banking as Islamic banks usually use mudharabah contracts with clients who deposit their money in the bank in the expectation of a return. The bank may utilise the funds at its disposal and enter into a mudharabah contract with its other clients and provide the required capital (acting itself as a rab al mal) for a project in the expectation of a return (a two-tier mudharabah).

Although mudharabah is most commonly used in the Islamic banking sector, its

The basics of Islamic finance



use is not limited merely to banks. In practice, it can be used for types of investment involving management of assets by an asset manager and provision of expertise to a venture by a person in return for a fee and a profit share.

Musharaka

This is similar to a conventional partnership or joint venture. Under a musharaka contract, both parties provide capital, and profits are shared according to a pre-agreed profit share ratio whereas any losses are shared according to the amount of capital contributed by each partner. Musharaka contracts are often used in long-term investment projects and the partnership continues until the project is finished. Each partner retains its share in the capital until the end of the project.

Diminishing musharaka

Diminishing musharaka is a popular tool for banks with particular success in the property sector. This method involves a slight variation of the musharaka method in that the joint ownership of an asset or project is divided into units to be transferred periodically for a fixed price from the bank to the ultimate owner. This

type of arrangement is most commonly used in the UK for Shariah-compliant mortgages for residential properties.

Ijara

Ijara is a form of leasing. In practice, ijara is similar to a conventional lease where a lessor (typically an Islamic bank) purchases an asset and then leases it to a lessee for a specific rental income. The bank retains the legal title to the asset during the term of the ijara contract, whereas the lessee holds the asset in trust during the duration of the ijara contract. In the case of a simple ijara contract, the lessee returns the asset to the bank or the financier at the end of the ijara contract.

In practice, most ijara contracts provide for a formal redemption feature whereby the lessee promises to buy the asset at the end of the ijara contract period at a pre-agreed price. Often, the final purchase price is a token sum. This type of ijara contract is called as ijara-wa-iktana. Ijara contracts are a familiar feature of Shariah-compliant real estate transactions.

The basics of Islamic finance

Istisna

Istisna is a form of project or contract finance which takes the form of a sale of an asset before it comes into existence. This type of financing arrangement is permitted under Shariah irrespective of the fact that at the time the parties enter into the agreement, the contract lacks one of the three main elements (contracting parties, subject matter and offer and acceptance) of a valid contract from a Shariah perspective, i.e. non-existence of the subject matter. The use of istisna is most prevalent in the manufacturing, processing and construction sectors. In practice, on delivery of the finished asset, an Islamic bank may sell the asset back to its client under a murabaha or ijara contract, or enter into a parallel istisna and sell the asset to a third party purchaser at a premium, which could in fact be under a murabaha or an ijara contract.

Under an istisna contract, payments may be made in a lump sum in advance or progressively in accordance with the development phase. The delivery date and price is agreed from the outset and the final settlement takes place on delivery of the completed product.

Salam

A salam contract is typically used for commodity finance rather than for real estate.

Sukuk

Islamic bonds are known as 'sukuk' (the plural term of sakk). Sukuk are investment instruments which are registered in the name of their holders. Sukuk are linked to underlying assets and represent an undivided ownership of assets by their holders. The investment returns on sukuk are based on the performance of the underlying assets and each holder is entitled to a proportionate share of the profit or loss generated by the underlying asset.

In practice, sukuk may take different forms depending on the nature of the underlying asset or project, for example, mudharabah sukuk, musharaka sukuk, ijara sukuk, istisna sukuk and salam sukuk. Whatever the underlying asset or project, sukuk will be issued by a special purpose vehicle ("SPV"). The SPV is typically established by the originator (i.e. the entity looking to raise funds).

Depending on the nature of the underlying asset or project, the originator will sell the asset or enter into a mudharabah or musharaka arrangement with the issuer (the SPV). The SPV will hold the underlying asset in trust for the benefit of the sukuk holders. The SPV is typically bankruptcy remote, which means that in the event of the bankruptcy of the originator, the creditors of the issuer cannot claim the assets held in the SPV.

Irfan Butt is a senior manager in tax specialising in real estate funds. He is also an Islamic Finance Practitioner, having undertaken the Islamic Finance Qualification offered by the Securities and Investment Institute (UK) in collaboration with Ecole Supérieure des Affaires, Beirut, Lebanon.

UK real estate client conference



We held our annual real estate conference on 25 June.

Nearly 250 clients and contacts in the real estate industry attended the plenary session.

Ian Powell, our UK senior partner elect provided a PricewaterhouseCoopers view on the economic outlook for the UK, after which a panel of leading figures from the real estate industry discussed the consequences. The panelists were:

Peter Reilly

Managing Director, Chief Investment Officer, European Real Estate Group, JPMorgan Asset Management

Mike McNamara

Managing Director, Head of Real Estate Finance RBS Global Banking & Markets

Christopher Nicolle

Executive Director, Head of Corporate Advisory, DTZ Corporate Finance Limited

Liz Peace

Chief Executive, British Property Federation

The plenary session was followed by breakout sessions on:

- Fund structuring
- Distressed assets
- UK companies
- Sustainability and the environment
- Property derivatives
- Investing in Emerging Markets
- Managing complex fund structures
- Eco-towns

To obtain copies of the slides, please contact the [PricewaterhouseCoopers real estate team](#).

Events

Save the date

European Real Estate client conference

Our annual European Real Estate client conference takes place on 2 and 3 October in Lisbon.

For further details, please contact the [PricewaterhouseCoopers real estate team](#).



Opportunities for the property-occupying company – 14 October 2008

This seminar concentrates on how occupiers of business property can optimise the value of their real estate and minimise the associated tax liabilities, and is recommended for executives of companies that have significant property interests. Companies can generate significant benefits by having a well-considered commercial and tax strategy for the property they occupy.

Although the seminar is not aimed at our real estate industry clients, they might find it of general interest.

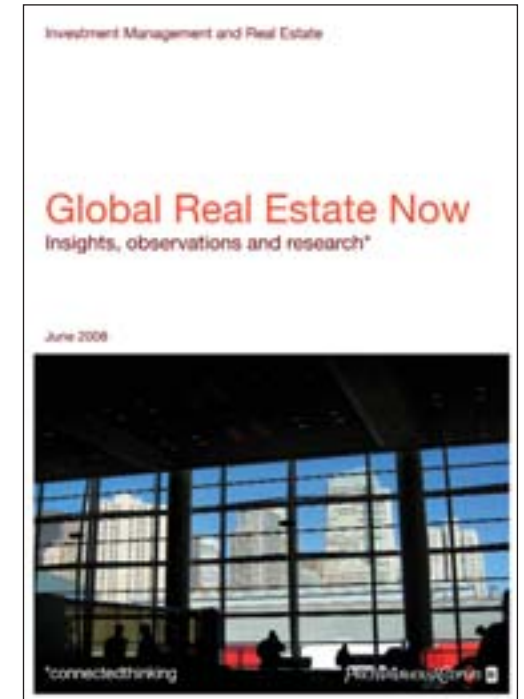
To find out more, and to register for this event, [please visit our event website](#).

Publications

The latest issue of Global Real Estate Now has recently been published. It includes articles on:

- **Emerging trends in real estate® 2008:** Overview: a combined look at the Asia/Pacific, North American and European markets
- **Global real estate and the credit crunch:** Lessons we should have learned long ago
- **Eye on Asia:** Foreign investments in India's real estate sector: Tax and regulatory overview
- **Eye on Australia:** Back to the future: Restoring confidence in the Australian listed property trusts sector
- **Eye on Europe:** Thin capitalisation rules in selected Central and Eastern European countries
- **Eye on the Americas:** How the South is won: European investors enter the Latin American real estate market
- **Eye on the Middle East:** Leisure-driven real estate development in the Middle East: Firm foundations or just sandcastles in the sky?
- **Tech corner:** Are you ready for XBRL?

To obtain a copy, please contact the [PricewaterhouseCoopers real estate team](#).



The member firms of the PricewaterhouseCoopers network provide industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

This report is produced by experts in their particular field at PricewaterhouseCoopers, to review important issues affecting the financial services industry. It has been prepared for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. If specific advice is required, or if you wish to receive further information on any matters referred to in this paper, please speak with your usual contact at PricewaterhouseCoopers or those listed in this publication.

© 2008 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.