UK real estate insights

Issue 1 – May 2006

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Introduction

Welcome to our new quarterly *UK real estate insights*, where we aim to provide industry developments, insights and thought leadership on issues that will affect you. This first issue focuses primarily on tax, and in particular the landmark changes announced in last December's Pre-Budget Report and refined further in April's Budget and the Finance Bill.

The introduction of UK-REITs represents a defining moment for the real estate industry in this country. This will affect real estate companies that are able to convert, those that are not, and the real estate funds industry. It also provides a challenge and an opportunity for operating businesses with major real estate assets. At the same time as the introduction of a tax free property holding vehicle, the Government has also greatly restricted the ability to take out other forms of tax planning. Specific measures include blocking perceived abuses, such as the use of Jersey Property Unit Trusts to avoid stamp duty land tax (SDLT) and the buying of capital losses, as well as the extension of the tax avoidance disclosure (TAD) rules.

In this issue we also look at the findings of *Emerging Trends in Real Estate Europe 2006*, a joint report by PricewaterhouseCoopers LLP (PwC) and the Urban Land Institute (ULI), published in February 2006. We look at the key findings of the report and developments since it was published.

The annual PricewaterhouseCoopers UK real estate Seminar, to be held on Thursday 25 May 2006 at the Institute of Directors on Pall Mall, will present an opportunity for you to hear the current thinking on these issues and a number of others, as well as network with your peers. Further details of the seminar can be found in the newsletter, click here to find out more.

There are more links throughout the newsletter which will put you directly in touch with our real estate network. If you have any general queries or feedback on our first issue, or would like to subscribe to future issues or link to this newsletter from your website, then please email the UK real estate insights team.

John Forbes
PricewaterhouseCoopers real estate leader

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Approaching the UK-REIT environment

Looking at the considerations for companies

Nobody can have failed to notice that UK-real estate investment trusts (UK-REITs) legislation is on the way. Operating a property business in a corporation tax free environment is clearly attractive, particularly with relaxation of the proposed gearing restrictions and other improvements since the UK-REIT legislation was first published in December 2005. Companies with large real estate holdings are being encouraged to become UK-REITs in order to attract new investment and realise greater value from existing real estate holdings.

This is not only within the real estate industry. Operating businesses with major real estate holdings such as retailers, hotel owners, leisure operators and utilities are the subject of fevered speculation.

There are lots of questions for potential UK-REITs to consider, but how realistic is conversion for real estate companies?

The obvious candidates and investors

The most obvious candidates to become UK-REITs are the existing listed real estate companies quoted on the main market. But how will their investors fare under the new regime?

The Government has announced that pension funds and other similar institutions will be entitled to receive distributions from the gross of UK-REITs, although the regulations to implement this have yet to be published. For these investors, the UK-REIT is clearly a major step forward. For other investors, the position is less clear.

Suppose an existing company makes £100 of net income, pays tax of 30% and distributes the after tax amount: what is the effective rate of tax for the shareholder on the £100 earned?

For shareholders that are UK individuals, the effective rate on the £100 is up to 47.5%. If that company becomes a UK-REIT, the effective rate of tax will fall to 40%. But is this a sufficiently large incentive to convert? Supposing the shares are to be held in an ISA. HM Revenue & Customs (HMRC) has indicated this will be allowed but confirmation that UK-REITs distributions can be received gross by ISAs remains outstanding. For non-resident investors, the withholding tax rate on distributions exceeds the effective tax rate paid by many current fund structures, even though the UK-REIT itself is not subject to tax. Therefore, for non-resident investors, the attractiveness of UK-REITs is still open to debate.

Other than for the very largest quoted companies, limits on single shareholdings are likely to be a major issue. UK-REITs must restrict distributions to people benefiting from 10% or more of the ordinary share capital. If they do not, the UK-REIT will suffer a tax charge on a proportion of the distributed profits. The rules will allow the company to avoid this predicament if it places restrictions on substantial shareholdings. But how will that affect the value of that shareholding? Will the UK-REIT regime allow this to continue if others abuse it? It may be possible to restructure shareholdings to overcome this difficulty but an upfront tax cost may arise.

For even the most obvious conversion candidates, whether or not to become a REIT is not immediately obvious without first considering the potential questions and carrying out modelling to determine the best option.

Property rich businesses

Well before the announcement of the UK-REIT regime, property rich operating businesses were highly attractive targets for takeover. Private equity funds, in particular, have been excited about anything that could be split into business [trading] operations (Opco) and the property holding elements (Propco). The arrival of the UK-REIT adds to their options, but also potentially offers a bid defence for their targets.

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Approaching the UK-REIT environment

However, companies holding real estate for use in the business (e.g. hoteliers) may face further obstacles to get assets into a UK-REIT. It will be necessary to demerge the real estate and operating business into separate entities (the properties in a UK-REIT cannot be used for the business' own use), listing the property company separately and leasing back the premises. The tax and commercial hurdles can be overcome, but it takes time and forethought. In particular, due to anti-avoidance legislation, the process of demerger is quite challenging.

Companies will have to ask themselves many questions before embarking on conversion to UK-REIT status. What will be the effect of demerging? Investors may benefit through higher share prices in the demerged UK-REIT and operating companies, but how will the operating business fare once exposed to market rents?

As regards corporate governance, is it appropriate for the same directors to serve on the boards of both the UK-REIT and the operating business? How will conflicts be handled and what impact will it have on operations?

Companies leasing back key sites may wish to have the security of very long leases to protect commercial positions. Under International Financial Reporting Standards (IFRS), the UK-REIT may have to account for these as finance leases. How does this impact on valuations?

The business model

Does a company churn its investments? This must be considered on a case by case basis, but too many sales may breach the income or assets value tests under the regime. Working through the numbers, carrying out financial modelling and testing the sensitivities may be the key. Crystal ball gazing this may be, but it will focus the mind on the possible outcomes.

What about real estate development? Property investment companies regularly develop assets which they intend to hold. Indeed, property managers who sweat the assets of their business are applauded in the market place. Development is just one of the tools used to increase value. However, under the UK-REIT regime, if a company spends more than 30% of the fair value of a property (measured at the earlier of acquisition or entry into the regime) on

developing an asset which will be sold within three years of completion, then the gain will be taxable. So, if a company receives a high offer on a property after two years of ownership or completion does it sell and pay the tax (no deferred tax having been provided earlier on the basis that the gain would normally be tax exempt) or hope the value holds up for another year?

Some investment companies carry on more mixed businesses. They use the talent within the in-house development team to develop real estate for third parties, selling on or taking a developer's profit share on completion or final letting. This has become more common in recent rising markets. But will this be permitted to continue on the same scale if the group must remain within the confines of the UK-REIT rules?

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Approaching the UK-REIT environment

Being listed – good or bad for REITs?

What about real estate investment companies that are not quoted on a recognised stock market (AIM is not a recognised market for UK-REIT purposes)? Does the company go for a full UK listing? How will senior management and the operation of the business adapt to different regulation? The listing regulations for real estate companies are in the process of change, and therefore for those companies considering listing to benefit from the UK-REIT regime. At the moment it is not clear exactly what the requirements will be.

What about listing elsewhere? Jersey and other offshore territories are already promoting their attractions. Or with the advent of the UK-REIT regime is it time to sell up and reinvest elsewhere or through another structure?

If the decision is to remain outside the UK-REIT regime, how do companies remain competitive? Based on the experience of other countries, REITs raising equity to further finance expansion has proved relatively easy. Will this be the case for the UK as well?

Creating new investment vehicles

How important is the UK-REIT for fund managers looking to create attractive investment vehicles? The tax treatment depends crucially upon the nature of the investors. In particular, where significant investment from overseas is anticipated, a UK-REIT may not be the best vehicle. The tax inefficiency of the UK company as a way of holding property has led fund managers to create a variety of tax efficient offshore fund vehicles for investment in the UK. The most recent developments in this area have led to the refinement of virtual REIT structures that are potentially more tax efficient than the UK-REIT itself. Some sophisticated modelling is required to test the sensitivity of actual and virtual REIT structures to different investor mixes.

Although the press coverage of the introduction of UK-REITs has provoked considerable interest from overseas investors (and overseas fund of funds), of all the different investors, the non-resident is probably the one for whom the UK-REIT is the least appealing.

Breaching the rules

The Government wishes to adopt a pragmatic approach when it comes to inadvertent breaches of the rules. However, where commercial circumstance causes a breach, the UK-REIT may be taxed.

For example, a major refinancing may result in significant finance costs being taken to the income statement. Conceivably, this could breach the profit to interest cover ratio. A tax charge would arise on the finance costs paid in excess of the amount allowed by the ratio.

Placing too many properties in the UK-REIT into a refurbishment or redevelopment phase at one time – so that rents temporarily fall – could damage the financial ratios needed to stay within the regime.

Where to now?

The Government, with encouragement from the real estate industry, has produced a workable framework for UK-REITs. This has been widely welcomed.

However, even quoted companies should not assume that the UK-REIT is the only way forward or the most appropriate for all commercial circumstances. For others, such as unquoted companies, fund managers or operating businesses long in real estate, the answers are even less obvious.

All the impacts – not just the tax – must be carefully considered before taking the plunge. There are still alternative tax efficient structures to be considered, the return on investment must be modelled and the accounting and corporate governance effects thought through.

Should a company set up or become a UK-REIT? There are a lot of questions to be considered before companies find the right answer for their business.

For more help on how to evaluate REITs options please contact Ros Rowe or Victor Clarendon.

A sledgehammer to crack a nut?

Stamp duty land tax after the Budget 2006

The dust has yet to settle fully, but it is clear from the current text of the Finance Bill that there will be winners and losers following the recently announced changes to the stamp duty land tax (SDLT) regime.

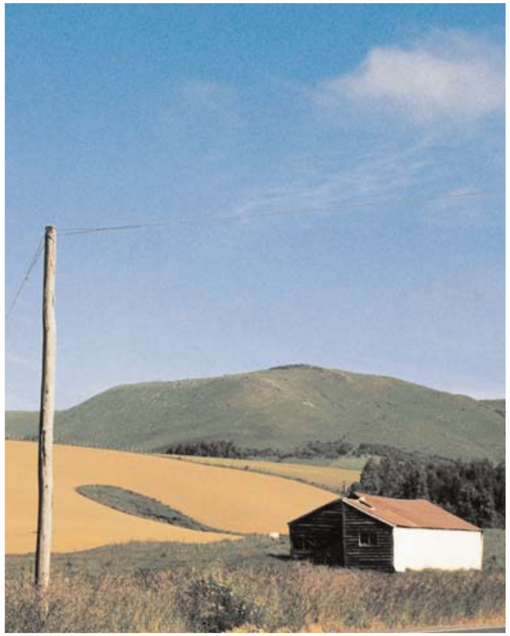
Most partnerships should benefit from clarifications and simplifications to the complex partnership-specific SDLT rules (Schedule 15 to Finance Act 2003). Certain trading partnerships will be pleased with a new exemption for transfers of interests in those partnerships. Partnerships will also welcome amendments to prevent potential double charging of SDLT on certain transactions that will bring the actual statutory provisions in line with the outcome intended.

Putting the winners to one side, this year it is those who are less well off who take centre stage. Step forward, but no bows please, property unit trusts.

In one sense, the abolition of seeding relief for unit trusts (s.64A Finance Act 2003) is not unexpected. Indeed, companies might wonder why the relief survived last year's Finance Act given that for some time HMRC has been open about its concerns that seeding relief was being abused. HMRC felt that an increasing volume of high-value, single-asset sales being structured by means of a contribution to an offshore unit trust (relieved from SDLT by s.64A) followed by a sale of the units in that unit trust (outside the scope of SDLT and, ordinarily, stamp duty reserve tax) had stripped away the commercial credibility of the relief.

However, some may feel that the abolition of seeding relief is using a sledgehammer to crack a nut. Flowing from the Government's high-level policy of encouraging greater collective investment in real estate (in the interests of promoting market liquidity and development financing), the original purpose of the relief was to permit the SDLT-free creation of commercially-managed property unit trusts. Many institutional investors with large property portfolios saw the potential to attract desirable third-party investment into those portfolios without an upfront 4% SDLT charge.

The new REITs regime could be the way forward. REITs may not be suitable for all companies though, as the 2% conversion charge will be on top of any SDLT arising from restructuring a corporate group in circumstances where only a portion of that group will be converted into a REIT.



It remains to be seen how the new SDLT changes, and REITs options, will affect the real estate industry.

For more information on SDLT considerations please contact Craig Leslie.

Other real estate matters in the Budget

Apart from the major announcements regarding REITs and stamp duty land tax (SDLT), what else changed for real estate in the Budget? Although there were no headline-grabbing changes, there were a number of other corrections, clarifications and simplifications in the Budget and subsequent Finance Bill, that have a potentially wider impact on the real estate sector.

Planning-gain supplement

Last December, the Government issued a consultation document on the proposed introduction of the planning-gain supplement (PGS).

PGS will be a levy on the increase in value of land when full planning permission is granted, payable by the developer when development of the land commences. The rate of PGS has not yet been announced, nor has the start date, although this is unlikely to be before 2008.

Representations have been made to HMRC from various groups, detailing the potential difficulties and complexities arising from such a levy. Overall, there seems little appetite for PGS.

The 2006 Budget contained no further announcements, and HMRC has not yet responded to the representations. We are monitoring developments on PGS but taxpayers should consider the potential impact this on their real estate.

A detailed commentary on PSG will be included in the next issue of this newsletter. For more information on the potential issues around PSG, please contact Kevin Leaver.

Tax avoidance disclosure

Changes to the tax avoidance disclosure (TAD) regime have been announced. In particular the regime will now cover the whole of income tax, corporation tax (CT) and capital gains tax (CGT), extending the range of tax planning it will deal with.

This is a further extension of the policy of shortening the shelf-life of new tax planning ideas, which is now likely to have a greater impact on real estate planning.

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Other real estate matters in the Budget

Anti-avoidance measures dealing with capital losses

In December 2005 various provisions were announced, with immediate effect, targeting anti-avoidance by companies in relation to the buying of capital gains and losses, the contrived creation of capital losses, and the conversion of income streams into capital gains and the creation of a capital gains matched by an income deduction. Minor changes have been made to deal with some, but not all, of the anomalies identified. There is some further guidance available, but the rules themselves remain substantively unchanged.

Although the amendments in April were technical in nature, the earlier provisions announced in December had a significant impact as companies in the real estate sector had been active buyers of capital losses.

Anti-avoidance measures dealing with sale of lessor companies

Measures introduced in December 2005, aimed at deterring the tax motivated sale of lessor companies to loss-making group companies, would have applied to the sale of many property investment holding companies. Amendments included in the Finance Bill make it clear that these provisions will not apply where the plant or machinery is incidental to the property leased.

Leased plant and machinery (leasing reform)

Property such as offices and retail premises include items of plant or machinery such as central heating, air conditioning and lighting. The Government has accepted that in general it will not be appropriate to bring leases of these kinds of plant or machinery within the scope of the new regime (under which capital allowances are claimed by the lessee, not the lessor) where plant or machinery is leased as an incidental part of a typical property lease. This is expected to be supported by a published list of plant and machinery.

VAT

A consultation on proposed changes in the area of partial exemption has been announced, with potentially greater powers to adjust methods retrospectively if they are not considered to be 'fair and reasonable'.

New legislation will also make provision for a wholesale rewrite of the existing law in schedule 10 VAT Act 1994 (buildings and land), together with incidental, consequential, supplemental or transitional provisions and amendments.

For more information on the Budget developments relating to the real estate industry please contact Tim Jones.

London emerges as top investment location

Emerging Trends in Real Estate Europe 2006 **is a joint report by PricewaterhouseCoopers LLP (PwC) and the Urban Land Institute. The report has been compiled by a survey of approximately 200 investors, as well as more than 100 in-depth interviews with senior real estate executives across Europe. Here Andrea Carpenter, managing director, ULI Centre for Regeneration and Sustainability, looks at the key findings of the report and recent developments in these areas.**

The size and popularity of the London market has determined its place as front and centre in many of the major European real estate trends, both as a target market for investment and as a source of capital. In terms of risk adjusted return, the report ranked London as the second best real estate investment market in Europe, closely following Paris which topped the index for the second year running. London's strong position on investors' radar screens makes London no stranger to the large amounts of money being aimed at the real estate sector, the impact of which underscores all the trends outlined in the report. This high level of capital is having a direct impact on pricing with interviewees reporting that the market has gone 'white-hot', particularly in major locations such as London. One participant commented, "People are prepared to pay what would have been considered crazy yields only a year ago."

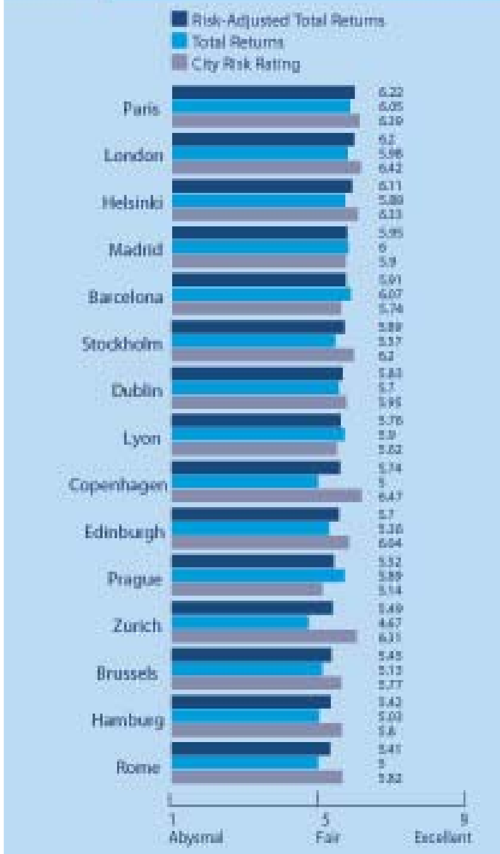
There is little surprise that London ranks alongside Paris as respondents talk in similar terms about the two cities. They lead the pack with their solid total return, rent growth prospects and favourable risk ratings. As one interviewee observed, the depth and size of the London market, just like Paris, continue to give London merit for both buyers and sellers. The diversity of both markets is enabling investors to continue to fund opportunities when the weight of capital is making the market extremely competitive.

London holds a rare position among the 27 markets covered by the report – it is one of just a handful whose prospects are gaining momentum on the back of recovery throughout 2006 and into 2007. "The cyclical upturn is underway," said one interviewee, and the city is already able to rely on "good core tenant demand," said another.

In the office market, respondents generally believe the office sector has two to three good years of performance ahead of it. The West End still outranks the City, where recovery is slower. With a vacancy rate of 5%, the West End has its lowest vacancy rate in four years and the CB Richard Ellis (CBRE) rental index for the area is up 3.6% year on year. In addition, new supply is 40% lower than its peak in 2003 and many interviewees see the West End as a healthy development option.

The City lags in its recovery, but it is starting to see positive demand figures that have reduced ready-to-occupy space to 10% but tenant incentives need to be worked out of the market before any significant rental growth is seen.

Exhibit 3-1 City Return/Risk Prospects



Source: Emerging Trends in Real Estate Europe 2006 survey.

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London emerges as top investment location

London's recovery also means investors are starting to put development back on the agenda. This is a growing trend in Europe with investors looking at two options. Istanbul and Moscow's positions at the top of the development prospects rankings illustrate that, for the more adventurous investor, there are emerging markets in which to find opportunities. However, just behind those riskier cities are London, Paris and Barcelona, all top ranked markets with a similar recovery play, allowing investors to consider development in selected parts of the markets. Investors have, however, sounded a note of caution. According to one respondent to the survey, "The new pipeline could come in too early and choke off the rent recovery before it gets going".

The UK is unusual compared to other European markets in the extent to which investor interest focuses on the capital city. For office investments, investors looking for value will continue to search cities outside the capitals in 2006. A typical response has been to focus on locations where rental prospects are strong and pricing has not yet adapted to reflect this. For France, this means Marseilles and Lyons, and in Spain, Alicante, Valencia and Seville. The trend is also spreading to Italy, where, according to the survey, "there will be a reduction in the demand for offices in the main cities and growth in the middle-size cities, both for development and investment." In most cases, this investor strategy is occurring where the capital city market is favoured, but has become too hot for investors who still want to benefit from the country's economic prospects. The UK is an exception to this, where there is more caution with regard to the regional markets, which tend to be more mature relative to continental second-tier cities. "It is very important to look at local supply in UK regional office markets," says one interviewee, with others seeing office rental growth in London but "less evidence in the UK regions."

Outside the office market, the UK again has exceptions to the European trend. The UK was not as attractive for investors in retail property, with respondents commenting that retail in the UK has peaked. This also had a knock-on effect on industrial property with weakening retail performance having an impact on distribution and logistics assets. Investor focus, where it remains, is on the south, which benefits from a stronger regional economy.

Latest developments

It is important to note that the interviews that provide the data for the report were conducted before the UK Pre-Budget Report (PBR) announced the introduction of UK-REITs in December 2005. When the interviews were conducted, the two key imponderables identified by investors were the effects of the possible introduction of REITs, and the introduction of a tax on the development value of land. Both of these were announced in the PBR. The REITs legislation is considered in more detail on page 2 and planning-gain supplement will be covered in more depth in the next issue. Even before the publication of the detailed legislation, the UK had been subject to the REIT-fever that has hit Europe as the UK and Germany continue to petition their governments for a tax-transparent vehicle alongside continental schemes such as those in France, the Netherlands and Belgium. One interviewee concluded, "The previous

trend was public to private. The new trend will be private to public." The European Public Real Estate Association (EPRA) listed sector index outpaced the general equities index in 2005 with a 26.1% rise, benefiting from the anticipation that REITs legislation will be approved in the UK and Germany.

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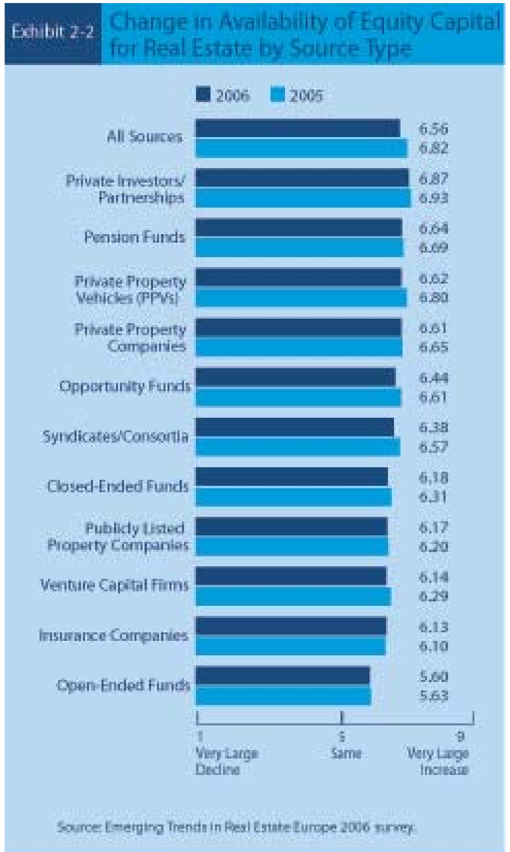
London emerges as top investment location

Other investment locations

While London is benefiting with high levels of investment due to its liquidity and transparency of its markets, a large amount of capital is also heading east. Spurred on by the belief that higher yields and less competition is to be found in eastern locations, investors are looking to the traditional central European markets of Hungary, Czech Republic and Poland, as well as looking at new locations such as Romania, Croatia and Ukraine.

However, not to miss out, UK investors are joining the charge and many previously UK-only investors are now bypassing western Europe to make their first international investments in eastern Europe. The *Emerging Trends* report looks at sources of capital as well as targets for investment, with London featuring as a key player.

The one resource Europe's real estate investment markets are not short of is capital. One interviewee commented, "If you have an asset with an income stream



to sell, there are 50 people queuing up to take it off you." In most markets, the ample funding of a few years ago has given way to a surfeit. Indeed, the excess of capital, given the shortage of investment stock, is seen as one of the most serious problems facing investors over the coming year. Nearly 56% of those surveyed think that capital will be either moderately or substantially oversupplied in 2006, and the availability of both debt and equity capital will continue to increase relative to 2005.

"There is thwarted capital hunting everywhere," said one respondent, and it is coming from every conceivable corner of the world. More capital came into the markets last year than anyone anticipated and there is no slowdown in sight. Increasing investment flows are expected from all over Europe, but they will be met with stiff competition from Middle Eastern, North American, Asian and Australian money. Comments from the survey include: "An Australian pension fund would not have thought of investing in the EU ten years ago. Now they're everywhere." "The full force of Asian money has not been seen yet and the impact will be big," and, "There are rivers of capital pouring in from the US – investment banks and all kinds of funds with massive institutional backers."

The survey results show that London has established itself as a key location for the management of those global capital flows.

A full copy of the report can be downloaded from PwC's website www.pwc.com/uk/emergingtrends. The findings of the *Emerging Trends* report, and the impact of the introduction of UK-REITs, will be debated further by a panel of experts at the PwC UK real estate seminar on 25 May. Click here for further details on the conference.

Andrea Carpenter is managing director of the ULI Centre for Regeneration and Sustainability www.uli.org

For more information on the *Emerging Trends* study please contact John Forbes.

Events

PricewaterhouseCoopers (PwC) real estate seminar: The UK real estate industry: ready for REITs?

On the afternoon of Thursday, **25 May 2006** PwC will be holding the annual real estate seminar at the Institute of Directors in London. Registration will be from 1:15pm and the seminar will finish at 6:00pm, followed by a drinks reception.

The seminar agenda offers a unique insight into developments in the real estate industry and will include an economic overview from Dr Bill Robinson, director of business economics at PwC. This will be followed by a panel discussion on **Emerging Trends in Real Estate: Ready for REITs?** A panel of specialists from the real estate industry will discuss where the UK real estate industry is now, the findings from the emerging trends report, the impact of REITs and other key issues for the year ahead.

Panel chair:
Andrea Carpenter, managing director, Urban Land Institute

Panellists:

- Peter Reilly, managing director and chief investment officer, JP Morgan Asset Management
- Nick Jacobson, head of European real estate and lodging, Citigroup
- Peter Damesick, head of UK research, CB Richard Ellis Ltd
- Aidan Smith, finance director, Liberty PLC

Delegates will also be able to join workshops looking at:

Europe's emerging markets

- Emerging trends for emerging markets – findings from the emerging trends report.
- Structuring outbound investment from the UK.
- Particular issues for funds.
- Local tax issues in the target markets.

Executive compensation

- Carried interest and co-investment planning for funds.
- Share schemes and cash bonus planning for real estate companies.
- The impact of REITs.
- The impact of personal pension reform.

REITs I

- Converting to a REIT.
- Listing rules.
- The virtual REIT for non-resident investors.
- How to compete if you are not a REIT.
- Modelling the options.

Closing the deal

- SPAs and completion accounts.
- Financial assistance and whitewash procedures.
- Tax.
- Particular issues on JPUTS and non-UK SPVs.

Infrastructure

- Latest developments in PFI.
- Secondary transactions.
- Infrastructure funds.
- The cross border dimension.
- Olympics 2012.

REITs II

- Issues for mid cap and smaller quoted companies.
- Strategies for unquoted and AIM listed companies.
- Selling to a REIT.
- REITs and SDLT.

For more information or to register contact Kathryn Piper.

INREV Reporting Workshop 31 May 2006

IPE real estate investor forum 1 June 2006

Sandra Dowling from PricewaterhouseCoopers will be presenting at the INREV Reporting Workshop to be held on 31 May 2006 in Amsterdam. The workshop will be linked to the IPE Real Estate Investor Forum and awards event taking place on 1 June. The objective of the session will be to present and discuss the INREV initiative for the establishment and implementation of best practice reporting for non-listed real estate funds across Europe. Sandra Dowling will be presenting the updated straw man set of accounts, which will be discussed during the workshop.

John Forbes will be a keynote speaker at the IPE real estate investor forum presenting 'Maximising Alpha – where does tax fit into the equation?'. For more information on both events, please contact John Forbes.

If you have any general queries or feedback on our first issue, or would like to subscribe to future issues or link to this newsletter from your website, then please email the UK real estate insights team.