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The evolving REITs landscape

A quarter of all UK REITs are listed on The International Stock Exchange (TISE) and here Real Estate Investment Times speaks to Fiona Le Poidevin, CEO of The International Stock Exchange Group, about why that is the case and the broader picture in the REIT sector.

We have seen an uptick in UK REITs recently, what do you see as the reasons behind this?

Real Estate Investment Trusts (REITs) were first formed in the US in 1960 and now there are more than 35 countries worldwide that have REIT or REIT-like regimes in place. They are globally recognised tax efficient structures for investment in real estate.

The UK REIT regime was launched on 1 January 2007, although there have been a series of changes in subsequent years.

REITs may be attractive to investors for a number of reasons, such as: easier entry and exit compared to purchasing a property directly; access to areas of the property sector that private investors cannot usually command; exemption from corporation tax on rental income and capital gains; and a tax rebasing of the properties used for rental business to market value on entry to the REIT regime.

Amendments in the Finance Act 2012 and Finance Act 2013 have played a part in making the regime more attractive and therefore, the number of UK REITs doubling in the last five years.

> ***“These factors have come together to drive up interest in UK real estate as an asset class and the REIT as a vehicle for that investment”***

However, these changes have also coincided with a prolonged period of low interest rates in the wake of the financial crisis and that has continued to drive demand for the higher and yet still reliable yield from alternative asset classes, such as property.

In addition, both the financial crisis and the Brexit vote led to suspensions and gating of some of the largest property funds as investors simultaneously attempted to exit these open ended structures. This has led to increased scrutiny of the suitability of using open ended vehicles for illiquid assets, for example real estate and, as a result, has driven up demand for closed ended structures, such as REITs.

Furthermore, the Brexit vote also brought about changes, such as currency fluctuations, which meant that UK property became relatively better value for investors and especially those based internationally.

All of these factors have come together to drive up interest in UK real estate as an asset class and the REIT as a vehicle for that investment.

So Brexit has had a net positive effect on UK REITs?

I think so, yes. This has been in two principal ways.

Firstly, the surprise result of the Brexit vote led to an immediate loss of confidence in the UK real estate market and in turn, this led to a significant proportion of investors seeking to redeem their shares in UK property funds.

However, many of those funds, including some of the largest in the UK, were established as open ended structures and thereby, in theory, allowing investors easy entry and exit. Yet, many managers were unable to meet the demand of the redemption requests because they were unable to realise the value of the asset, i.e. the real estate, quickly enough.

This led many of the mangers to suspend their funds or introduce gate provisions to limit withdrawals, although this did not happen with any of the open ended property funds listed on TISE at the time of the Brexit vote.

The result has been increased scrutiny from regulators, including our own market authority, of the potential systemic risk created by having open ended structures holding illiquid assets and therefore, this is driving the asset management community towards instead using closed ended vehicles, such as REITs.

"It is our experience at TISE that in the wake of the Brexit vote there has been increased international investment into UK property"

The second impact of the Brexit vote has been the relative value of the UK property market. The immediate loss of confidence in the future of the UK real estate market led to a downward revaluation of the property assets.

At the same time, sterling fell sharply against other major currencies and therefore meant that assets, such as UK property, which are valued in pounds became relatively cheaper to purchase for investors holding foreign currency. This has meant that UK property has become a better value investment for investors, and especially those based internationally.

It is our experience at TISE that in the wake of the Brexit vote there has been increased international investment into UK property, whether as noteholders to debt issuances or investors into property investment companies, such as REITs. These have some interesting consortia of investors, especially institutional investors such as pension funds and insurance companies as well as sovereign wealth funds from around the world, including the Middle East and Far East.

How has that translated into listing on TISE?

The UK regime has a number of conditions which a company needs to satisfy in order to become a REIT and retain that status. These include, among others, being listed or traded on a 'recognised stock exchange.' This condition requires that the REIT is admitted to trading on a recognised stock exchange and either: 'listed' on such an exchange; or 'traded' on such an exchange in every accounting period.

TISE is deemed a recognised stock exchange and listing venue by the UK tax authority, Her Majesty's Revenue & Customs (HMRC), under section 1005 of the Income Tax Act (2007).

TISE, which until March this year was known as the Channel Islands Securities Exchange (CISE), is home to nearly 400 investment securities, including open and closed ended property funds. In September last year our rules for investment vehicles were modernised to ensure that they were fit for purpose, not least explicitly catering for non-fund structures, such as REITs.

"This offering is proving extremely attractive so that now a quarter of all UK REITs are listed on TISE"

Our rules also specifically exempt REITs from the free-float rule requiring 25% of the issued share capital to be held in public hands. This is a similar approach to that of the UK REIT regime which itself has been amended to allow for companies with a smaller number of shareholders where they are institutions, for example pension funds, representing a wider pool of ultimate investors.

As such, our regime has proved particularly attractive for those REITs where there are a smaller number of institutional investors and especially, where they are likely to hold for the long term and therefore do not require significant levels of liquidity. Having said that, there has been a recent trend towards TISE also proving attractive to more widely held REITs and those who want the option to trade through our bespoke trading system. Other UK REITs are listed on TISE but utilise the London Stock Exchange's SETSqx trading service.

This offering is proving extremely attractive so that now a quarter of all UK REITs are listed on TISE, with the most recent being from Australian-originated shopping centre group, Westfield.

What trends are you seeing in terms of country of incorporation for UK REITs?

While HMRC approved REITs must be tax resident in the UK only, they can be incorporated in other jurisdictions. TISE-listed REITs include not just England & Wales companies but also those established in Luxembourg (particularly attractive for French investors) and the Channel Islands.

Using Guernsey or Jersey incorporated companies to avail of the UK REIT regime has some advantages compared to a UK equivalent. These include company law in Guernsey and Jersey enabling, for example, distributions to be made on a cash flow solvency basis and there being no stamp duty payable on the transfer of shares in a Guernsey or Jersey company.

What are the main opportunities for UK-REITs moving forward?

There are two potential changes to legislation on the horizon which could positively impact the REITs sector

The first is the potential reform of Solvency II by decreasing the capital risk weighting required for listed real estate. The European Public Real Estate Association (EPRA) has been exercised by the fact that under Solvency II listed real estate holds a higher risk weighting compared to direct property investments and as such, it deters EU insurers from investing into listed real estate. EPRA has stated that this risk weighting is imposed despite there being a large body of evidence that the performance of listed real estate converges with direct property over the long term. It believes that appropriately risk weighting listed real estate could help double investment into the sector and of course, there could be an associated benefit for REITs.

The second relates to the UK Government's proposed changes to the non-resident landlord regime which could increase the relative attractiveness of REITs.

What are the main obstacles facing UK REITs?

A lot of interest in UK REITs at the moment is being driven by existing real estate investment groups restructuring their portfolios and converting to REIT status due to measures which make other options less attractive or the REIT regime more attractive but clearly this is a finite set of opportunities.

Ultimately, the long term success of UK REITs is going to be driven by the wider investor appetite for UK real estate. This may become more challenging if, as seems likely, we move into a higher interest rate environment – making other asset classes more appealing – at the same time as the UK embarks on its formal withdrawal from the European Union, albeit with a transitional period and more businesses establishing/expanding their presence in the EU.

Fiona Le Poidevin
CEO, The International Stock Exchange Group

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The International Stock Exchange Group Limited

Registered Office
PO Box 623, Helvetia Court,
Block B, 3rd Floor,
Les Echelons, St Peter Port,
Guernsey, GY1 1AR
T: +44 (0) 1481 753000

Jersey
No.3 The Forum,
Grenville Street,
St Helier,
Jersey, JE4 4UF
T: +44 (0) 1534 737151

Isle of Man
Merchants House,
24 North Quay,
Douglas,
Isle of Man, IM1 4LE
T: +44 (0) 1624 675907

follow @tisegroup
follow us on LinkedIn

E: info@tisegroup.com
www.tisegroup.com

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