

DBULLETIN

REITs – Some homework before the publication of key clauses of the Finance Bill?

HM Treasury's informal consultation exercise on changes to the Real Estate Investment Trust (REIT) regime, announced in the 2011 Budget, closed earlier this year. On 13 October, HM Treasury published a broad overview of the results of the consultation (http://www.hm-treasury.gov.uk/consult_reits_feedback.htm). The next stage is the publication of the draft Finance Bill clauses, relating to REITs, on 6 December 2011.

What are REITs

REITs or Real Estate Investment Trusts were introduced in 2007. A REIT is a corporate entity that buys, develops and sells real property. Its shares are publicly traded.

A REIT allows investors to invest in a managed property portfolio. They are tax transparent investments. The majority of income generated by the investment vehicle passes to the investors without deduction of corporation and capital gains tax, so generating dividends for investors.

There was an initial wave of entrants (mainly the publicly-listed property companies) after their introduction in 2007. There are, currently, 19 REITs. However, the government now seems to want to broaden the appeal of the REIT beyond the large listed companies that have already converted. The Treasury has also been considering REITs which own social housing. This thinking led to the consultation.

Advantages for investors

The main advantage of REITs for investors is the liquidity of the investment. Buying and selling shares in a REIT will be far quicker than buying or selling the underlying investment property. They also offer investors diversification across a portfolio of properties. That said, the shares can also trade at a discount to the value of the underlying assets.

A residual social housing REIT could offer investors, for example:

- A new residential asset class
- A long term income stream
- Experienced management

What a social housing REIT offers an RP

For Registered Providers (RPs) looking at funding, other than through grant, bank loans and bonds – a REIT launch offers the RPs the prospect of raising funds from a new source, namely equity investors.

In addition to the benefits of the proceeds of a public flotation of part of an RP group as a REIT, distributions from a retained shareholding in the REIT would also provide a tax efficient source of income for the RP.

Proposed REIT structure for an RP

This might be done by creating a new trading company which will be registered with the Tenant Services Authority (TSA) as an intending profit-making provider of social housing. It could become an operating subsidiary of an "investment holding" PLC.

The existing RP (charitable or non-charitable) could transfer social housing to a newly set up company for full value, with the associated Homes and Communities Agency (HCA) grant.

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The price for the social housing may be satisfied through a combination of (a) refinancing the RP's existing debt, through further debt and/or equity finance; (b) assuming responsibility for the existing RP's HCA grant and (c) issuing shares to the transferring RP. However, this is all fairly tentative as the regulatory regime needs to be 'fixed'.

Regulatory certainty

While there may be felt to be political "support" for RPs to create residential REIT's, banks sponsoring a REIT share issue and their advisers will want regulatory certainty. Accordingly, RPs contemplating a REIT will have a vested interest in identifying the legislative and regulatory changes essential to make a residential REIT "bankable" as far as investors are concerned. For example, what is the position regarding the transfer (or writing off) of any grant?

Pre flotation internal business issues

Any spin off or demerger of a large part of a complex business and the prospect of a flotation will involve a consideration of a raft of practical, legal and regulatory issues quite apart from getting an entity ready for listing (for example the preparation of a verified prospectus) and complying with the listing rules.

Furthermore, whether it is practicable and, for that matter, cost effective for an RP to create a REIT, will also hinge on weighing up a number of commercial issues, ideally, at an early stage. For example:

Existing borrowings – The existing financing facilities of an RP, including bonds, will need to be reviewed and the implications of moving

security to the new vehicle considered. Loan and bond terms may well be the critical factor concluding whether a spin off is viable.

Treatment of pension liabilities – This needs to be carefully handled as it may effect both the retained and 'spun off' employees.

Splitting shared services/property – Those involved in negotiating the agreements for the transfer of property assets and liabilities will need to be conscious of the differing commercial requirement for those seeking to get the best price for the shares in the REIT and the RP's need to protect its ongoing business. As a result the prospective REIT and the RP are likely to end up with different sets of advisers

The debate for many RP finance departments, looking to raise £100,000,000, or more, is whether the prospect of obtaining funding from equity investors makes a REIT a more attractive source of long term funding than the rather more familiar bond market.

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