



SWIP Guide to REITs

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European real estate securities portfolios for retail and institutional clients. Prior to this position, Ian was Head of Property Research at SWIP, responsible for pan European research and strategy in the direct property market.

Prior to joining the company in January 2001, Ian worked as an Investment Analyst for Foreign & Colonial and Property Market Analysis, a European property research house.

Foreword by Ian Hally and Nigel Bolton

The case for investing in commercial property is compelling; it offers the potential for a competitive total return with a relatively low volatility and a steady income with the prospect of reasonable capital gains. Property is also an essential tool for achieving portfolio diversification as it tends to outperform at opposite times to other asset classes and therefore helps to smooth out returns at a portfolio level.

However, commercial property has not traditionally been accessible to all investors. Gordon Brown gave the go-ahead for the creation of real estate investment trusts (REITs) in his pre-Budget report in December 2005 to address the concerns previously associated with property investment, namely a lack of liquidity, inefficient tax structures and inaccessibility to small-scale investors.

With the introduction of UK REITs, investors have access to a tax transparent, listed, real estate investment vehicle.

REITs focus on property assets, have limits on borrowing and do not pay capital gains or income tax and provide a more tax-efficient vehicle to invest in commercial property. To qualify for this tax structure, the bulk of income generated has to be paid to shareholders, who then pay tax on their dividends.

The introduction of REITs in January 2007 won't result in an overnight revolution in the property investment market but, over the next few years, we expect REITs to transform the way in which investors can access property and we are likely to see strong investor demand for this vehicle. We expect investors to be drawn to the benefits of a relatively high dividend yield, steady capital value growth prospects, professional management, better liquidity and good diversification characteristics.

One of the most significant changes is likely to be the positive impact on ISA sales. Although investors can currently invest in property through their ISA via listed property companies and commercial property funds, REITs will offer a tax-efficient alternative.

Given the impact that REITs will have on the commercial property market, SWIP has produced a guide to answer the key questions surrounding their introduction next year. We hope you find this useful.

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Nigel Bolton, Head of European Equities
and Manager of the European Real
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SWIP Guide to REITs

• What is a REIT?

A REIT, or Real Estate Investment Trust, is a publicly listed company, which purchases and manages property in order to deliver income and capital growth for investors.

• When were REITs introduced in the UK?

REITs were launched in the UK in January 2007.

• How does a company qualify as a REIT in the UK?

To qualify for REIT status, property companies have to meet the requirements which have been established by the UK Government. The key points are as follows:

1. The UK REIT structure is open to companies resident in the UK and publicly listed on a recognised stock exchange (excluding AIM).
2. A UK REIT has to divide itself into a ring-fenced REIT business and a non ring-fenced business. To maintain REIT status the ring-fenced business must account for at least 75% of the company's assets and income.
3. A REIT must have 75% of its income and assets held within a property letting business. These 'ring-fenced' assets receive tax benefits as outlined on page three.
4. The ring-fenced assets must consist of at least three properties and each property must account for no more than 40% of the portfolio.
5. REITs are limited in the extent to which they can borrow. The Government has set an interest cover rate test of 1.25 on a pre-capital allowances basis. On this basis, most listed UK property companies qualify for REIT status.
6. A shareholder must not hold more than 10% of a REIT.



- **What are the benefits of REITs?**

Compared with property shares, REITs offer significant advantages in terms of tax treatment. Shareholders in a listed UK property company face a double tax: the company pays corporation tax on its business activities, while the investor pays tax on dividends and capital gains. In comparison, REITs are more tax-efficient and the REIT does not pay corporation tax on its ring-fenced assets on the condition that 90% of net taxable profits received is distributed to shareholders as dividends. The caveat is that, to ensure a 'tax neutral' transition for the Inland Revenue, a conversion charge of 2% of the gross market value of these ring-fenced assets will apply.

- **How are non ring-fenced assets treated?**

A REIT with an income producing non ring-fenced business pays two separate dividends, with different tax treatment for each distribution. The non ring-fenced assets, which could include property developments, are subject to the current tax requirements faced by listed property companies and are not exempt from corporation tax. Investors also receive dividends in the same way as they do through listed property companies.

- **What are the advantages of REITs compared with other forms of commercial property investment?**

Barriers often associated with commercial property investment include a lack of liquidity and inaccessibility to small-scale investors. By investing in REITs rather than direct property

it affords the investor greater flexibility to move in and out of the asset class on a tactical basis due to the higher liquidity.

Although retail investors can invest in property through their ISA via listed property companies and commercial property funds, REITs will offer a tax-efficient alternative. As a result, we're likely to see strong growth in REITs, with investors drawn to the benefits of a relatively high dividend yield, steady capital value growth prospects, professional management, better liquidity and good diversification characteristics.

- **Will REITs replace other forms of property investment?**

REITs have been successful in the countries where they are currently available but they have not replaced other forms of property investment. Direct property continues to offer distinct benefits to retail and institutional investors and, with the changes to ISA rules in December 2005, direct property funds such as the SWIP Property Trust can be held in an ISA, making direct commercial property more accessible to the retail investment market.

- **What are the benefits of direct property as opposed to property securities or REITs?**

The key benefit of direct property funds is diversification from traditional asset classes. Returns are not correlated with equities and bonds and, within a balanced portfolio, can help to reduce overall risk.

By investing in real estate securities rather than direct property, investors have greater flexibility to move in and out of the asset class on a tactical basis due to higher liquidity and lower trading costs. However, while real estate securities provide liquidity, they are also more influenced by short term movements in the stock market than direct property funds and therefore see higher volatility.

In markets where REITs are well established, like the US and Australia they have become a separate asset class with good portfolio diversification benefits. Investors in these markets view REITs as being complementary to their direct property market activities. There are however some retail and private investors in these countries who view REITs as their only way to gain exposure to the property market.

SWIP recommends that an investor's property holdings are around the ratio of 75% direct property funds and 25% indirect property funds, in order to take advantage of the diversification benefits and relatively low volatility of direct property with the added benefits of increased liquidity provided by indirect property shares such as REITs.

- **What can REITs invest in?**

REITs can invest in both commercial and residential property. We expect there to be a variety of REITs in the UK, focusing on different areas of investment. We have seen in the US that a wide variety of REITs have developed, from a combination of residential and commercial REITs to REITs focusing on very niche markets.

The legislation stipulates that a REIT must have more than three properties in its portfolio, each accounting for no more than 40% of the ring-fenced assets. Properties within a REIT must not be owner-occupied.

- **How can an individual invest in a REIT?**

Individuals can invest in a REIT by purchasing shares directly in the REIT through a stockbroker. Alternatively, they can invest in a fund that specialises in real estate investment such as the SWIP European Real Estate Fund, SWIP UK Real Estate Fund and SWIP Global Multi Manager Real Estate Fund. These funds provide access to the listed property market and will also provide exposure to UK REITs when they become available.

- **Where are they currently available?**

REITs are currently available in many countries including the US, Canada, Australia, Hong Kong, Japan, Singapore, the Netherlands, Belgium and France. REITs have been successful in the US for over 45 years and have for some investors become the de facto means of investing in property. The Netherlands introduced REITs in 1969, creating the second largest quoted real estate market in Europe, behind the UK. France introduced their equivalent of the REIT, the SIIC (Société d'investissement Immobilier Cotée), in 2003.

- **Which other countries are planning to launch REITs?**

Germany is currently finalising its plans to launch a REITs structure and is expected to introduce REITs in 2007/8. The launch of REITs in Germany will have a particularly dramatic effect on property investment. Germany is Europe's largest property market but currently has only a very small quoted sector. At present, 65% of companies own their own property. For example, Siemens is the second largest property owner after the government. This is set to change significantly and we could see as much as €80bn in German REITs in the next five years as owner-occupiers take the opportunity to realise their real estate assets by moving their property into a REITs structure.

Other countries, such as Sweden and Italy, are also following the development of REITs closely and are expected to develop their own REITs structure at some point in the future.

- **Do most property companies qualify for REIT status under UK legislation?**

SWIP believes that most UK-listed property companies will qualify for REIT status under current rules and we expect most property companies to convert to REIT status as a result of the legislation.

The cost of conversion and borrowing levels are fair and straightforward and the distribution rate of 90% of net profits puts the UK in line with the US, where REITs have become a successful way for investors to access property.

- **Will most REITs be conversions from existing property companies or new trusts?**

SWIP expects many of the existing listed property companies to convert to REIT status but we also expect new trusts to be launched in the market.

- **What impact will the introduction of REITs have on the UK commercial property market?**

SWIP expects the introduction of REITs to have a positive impact on sentiment towards the UK commercial property market. Given that REITs will offer significant advantages in terms of tax treatment it is likely that investment interest will increase following their launch and they will broaden the investment routes for investors to get access to property as an asset class. The introduction of REITs won't transform the industry overnight but, in the long-term, SWIP believes that REITs will become a popular means for investors to gain exposure to property.

Evidence from France, Japan and Singapore reveals that prime office yields fell around 25 basis points in the year in which REITs were introduced. However, given the low yields already forecast for the property market this year, SWIP believes it is debatable whether the introduction of REITs will drive yields down much further.

About SWIP

SWIP's Credentials

SWIP is one of the largest asset management companies in the UK. In total, we have funds under management of over £101.7 billion**, which we invest across all major asset classes, including property, domestic and overseas equities, bonds and cash.

We are one of the largest and most successful managers of property in Europe and offer a range of direct and indirect property funds investing in the UK and overseas.

****Source:** SWIP, 31 December 2006

Investment Philosophy

We believe that the key to achieving competitive returns is fundamental in-house research that identifies the true worth of real estate equities. Short-term factors often drive prices, with markets failing to account for long-term influences. Therefore, by conducting our own thorough research and focusing on the long term, we can take full advantage of any undervaluing of equities by the market. To manage a portfolio of real estate equities effectively, we need to fully understand both the direct real estate and equity markets. To this end, we carry out top-down research on economies, real estate markets and sectors, and combine this with our bottom-up views of the individual real estate companies. This allows us to identify the long-term value of real estate equities and take advantage of any market anomalies.

The Team

SWIP has established a pan-European property securities team, which brings together SWIP's in-house property expertise with in-depth, bottom-up stock analysis, company valuation and stock picking skills from SWIP's UK and European equity teams. The team is led by Nigel Bolton, Head of European Equities, and includes Ian Hally, Investment Director – Real Estate Securities and UK equity fund managers Joel Marks and Chris Bamberry.

The Funds

SWIP manages three real estate security funds. These funds build on the expertise of SWIP's pan-European equity team to invest in real estate securities and in REITs in the countries where they are currently available. The three funds are a complementary offering to SWIP's direct property fund, The SWIP Property Trust, to provide greater choice and flexibility to investors looking to invest in commercial property.

SWIP European Real Estate Fund

The SWIP European Real Estate Fund was one of the first of its kind when it was launched in 2005. It aims to provide a total return by investing in the UK and European real estate markets through a portfolio of REITs and real estate-related companies listed on UK and European stock exchanges.

Launch date: 20 September 2005

SWIP UK Real Estate Fund

The SWIP UK Real Estate Fund provides an indirect investment route into the UK property market, by investing in a portfolio of real estate companies listed in the UK. The fund is designed to complement other funds in the SWIP property range and provide investors with choice and flexibility within their portfolios. The fund will also have exposure to UK REITs when they become available from January 2007.

Launch date: 25 May 2006

SWIP Multi Manager Global Real Estate Securities Fund

The SWIP Multi Manager Global Real Estate Securities Fund invests indirectly in the global commercial real estate market through a portfolio of REITs and real estate-related companies listed on international stock exchanges. SWIP manages the fund and provides expertise on the UK and European real estate markets.

The fund combines SWIP's European real estate expertise with global real estate capability from Cohen & Steers and Invesco Institutional to provide retail and institutional investors with access to the growing global real estate market. The non-European manager selection is made by Russell Investment Group.

Launch date: 1 June 2006

You should remember that;

The value of your investment is not guaranteed and can go down as well as up depending on investment performance.

You may not get back the amount you invested.

Past performance is not a guide to future performance.

Funds may have holdings which are denominated in different currencies and may be affected by movements in exchange rates. Consequently, the value of your investment may rise or fall in line with exchange rates.

Tax rules relating to OEICs and Unit Trusts may change.

Commercial property is less liquid than other asset classes and values could be affected if properties need to be sold at short notice. It is a specialist sector which could be volatile in adverse market conditions.

Property valuation is a matter of judgment by an independent valuer. Valuation is therefore generally a matter of a valuer's opinion rather than fact. The value of capital income will fluctuate as property values and rental income rise and fall.

The level of risk depends on the underlying investments in each fund. Further details of the risks relating to investment in the SWIP fund range can be found in the Simplified Prospectus or Key Features Document.





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