REITS A BIG BANG FOR INVESTMENT MARKETING OR A DAMP SQUIB?

Andrew Porter takes a look at the new entrant to the financial services investment market and questions whether property companies are taking investors seriously.

- Since January 2007 UK-listed property companies have been converting to new REIT status, and triggering a wave of interest in commercial property investment.
- Success will depend on take up from retail investors, who are typically underexposed to the sector.
- Significant market education will be necessary to unlock this demand, but REIT property companies seem content to delegate the task to fund managers and financial advisers.
- Asset management companies are launching new property funds.
- The launch of Reita, a central hub of knowledge and information is also a useful initiative.
- But will it be enough to herald a new asset class for private investors ?

The REITs opportunity

REITs (Real Estate Investment Trusts) are designed to offer investors tax-efficient income and capital growth from rented property – commercial or residential – with a return closely aligned with direct property investment.

This is achieved by taking away the 'double taxation' (corporation tax and capital gains tax, plus tax on dividends) that drags down the share prices of ordinary quoted property companies and historically has caused them to trade at a discount to their underlying asset values.

In return, a REIT must distribute at least 90% of its rental income to shareholders in the form of dividends, which are then taxed at the investor's normal rate.

But UK private investors will also be able to hold REIT investments in tax-efficient wrappers such as ISAs and SIPPs in order to avoid all forms of future taxation on their investment. A cap on gearing also makes REITs less vulnerable to interest rate fluctuations, and therefore more suitable for retail investors.

UK private investors are typically under-exposed to commercial property, which provides stable long-term cash flows and low correlation with equities and bonds for more balanced portfolio diversification.

Arrival of a new investment asset class?

Investing in REITs is a more direct proxy for investing in property itself. Yet REITs can be traded just like any other share on the London market, with easy access, instant pricing and minimal investment outlay.

The arrival of UK REITs therefore makes commercial property investment more accessible, transparent, tax-efficient and liquid. It will greatly expand the investment choices available to UK private investors, and has already triggered the launch of new retail property funds by the asset management industry.

"We're off to a flying start," says Paul Haddock, product development manager at the London Stock Exchange, "with up to 15 property companies expressing interest in converting to REITs, representing over 50% of the quoted sector."

"Success will depend on private investor demand" says Haddock. "There is no doubt that commercial

property has been under-sold until now. The opportunity for direct property investment in ISAs, SIPPs and even CTFs make the retail investment sector very important to the success of UK REITs."

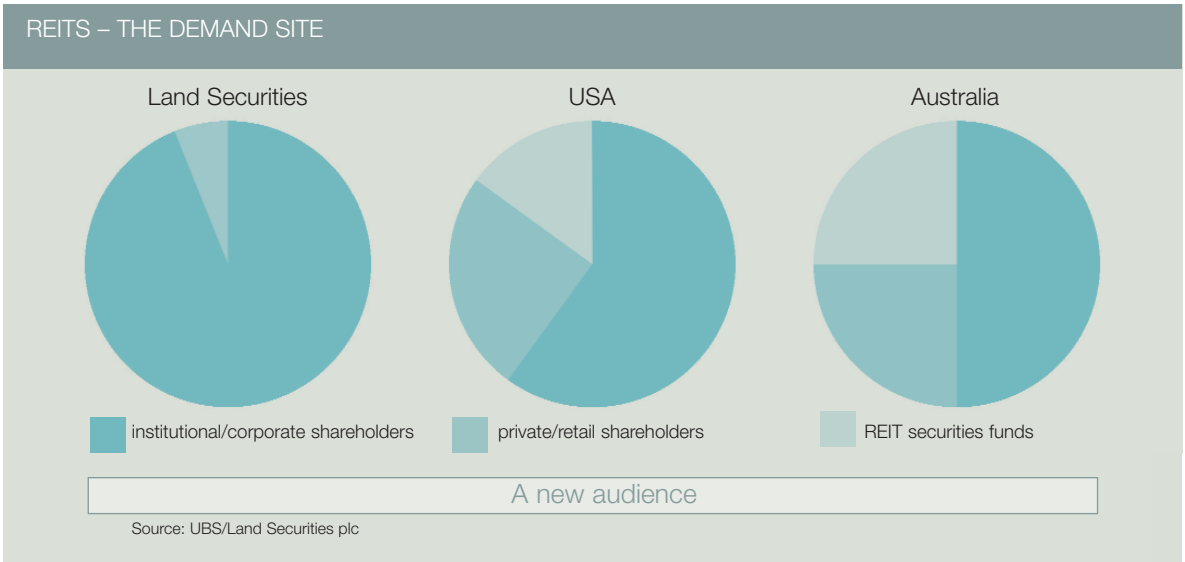
Given that Britain's largest quoted property companies currently attract very few direct private shareholders, it's little wonder that UBS describes the impact of UK REITs as tapping into "a new audience".

The low volume of retail investors in commercial property in the UK is in stark contrast to the USA, the world's largest market for REIT-style investments, or Australia, acknowledged as the world's most mature commercial property investment market.

Yet commercial property has outperformed equities over all investment time frames for the past 20 years, and has been a star performer since the dot com bubble burst when investors retreated to more tangible assets, marking a significant re-rating of property as an asset class.

But real estate is a cyclical industry that few retail investors or their advisors genuinely understand. Property values can fluctuate -although in recent years they have only seemed to go up. But it is the rental income streams from commercial property that make it attractive as a long-term investment.

"Rents are bomb-proof," according to Alan Carter, Equity Real Estate Consultant at Citigroup. "What matters most is the quality of your leases and tenants". Strong stable cash flows from rents make commercial property particularly attractive to income investors. And REITs will become the only sector in the FTSE where the annual dividend is mandatory.



Will private investors be attracted to REITs?

The arrival of REITs was eventually achieved after a sustained period of lobbying of the UK Government by the British Property Federation, among others. They promised a potential pool of additional investment into property in the order of £35 billion from small UK investors.

That would be a phenomenal achievement, but few have questioned whether such an ambitious forecast is realistic. What would drive so many private investors into a new asset class for the first time?

Richard Hunter, Head of Equities at IFA Hargreaves Lansdown, points out that including UK REITs in a tax-efficient ISA wrapper will qualify for both capital gains and income tax exemption, but non-REIT funds in ISAs will still be subject to income tax.

And as Philippe Tannenbaum, Head of Research at Eurohypo AG, a leading commercial real estate bank, says, "when you don't pay tax, it changes your life."

UK private investors may already have some exposure to commercial property, especially via with-profits or managed funds invested within their pension. But few have chosen directly to invest in the sector; partly for reasons of accessibility and partly, it seems, through ignorance.

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Older investors, approaching or in retirement, use their investment capital to generate incremental income. REITs are seen as ideal for this investor profile.

REITs wanting to attract retail investors should consider their dividend distribution policy. In France, for example, the leading REIT-style property company, Unibail, tempts retail investors with a quarterly income distribution.

But perhaps the biggest trigger for new retail investment into REITs will come when the category expands into residential property development. Gareth Lewis, Director of Finance and Investment at the British

Property Federation, agrees. "The UK's stock of residential property is estimated to be worth £3,500 billion, compared to commercial property stock worth about £650 billion. The potential is huge," he says.

Education, education, education

The complexities of the commercial property market make it a minefield for naïve investors. And there is little doubt that private investors and their advisers need better education and more information before they can make judgments or recommendations on the best investment opportunities available. So who will educate the market?

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In August 2006, The REITs and Quoted Property Group launched Reita. Reita is funded by leading property development companies and their advisers, alongside several investment banks, fund management groups, the London Stock Exchange, the British Property Federation and other property bodies.

Its aim is to raise awareness and understanding of REITs and investment in quoted property vehicles. It does this primarily through its website (www.reita.org), by providing a central source of information for private investors and tools for financial advisers.

Reita sees its role as helping to increase both the size of the market and the number and range of investors in commercial real estate. But with a total budget in its first year of just £600,000, its marketing resources are limited.

According to Dave Butler, Project Director at Reita, there is a significant commitment to "go retail" from the leading property companies already converting to REIT status. Reita is encouraging its members to adjust to the new landscape. The world of investment marketing is new to them, with a language of its own. Property companies are unfamiliar with IFAs and brokers, and the marketing channels available to reach them.

There is also the financial media to deal with, with hundreds of journalists and new titles that are interested in covering the REIT story. Reita is planning to hold a media management workshop for its members.

Retail investment distribution models

"Investment products are sold, not bought", claims Dave Butler. "It's essential that we educate the advisers – IFAs and private client brokers – to open up the retail market opportunity."

"Stimulating more retail investment into commercial property is our ultimate aim, but whether it comes directly from the public, or via IFAs and via investments held in pooled funds, doesn't really matter," he says.

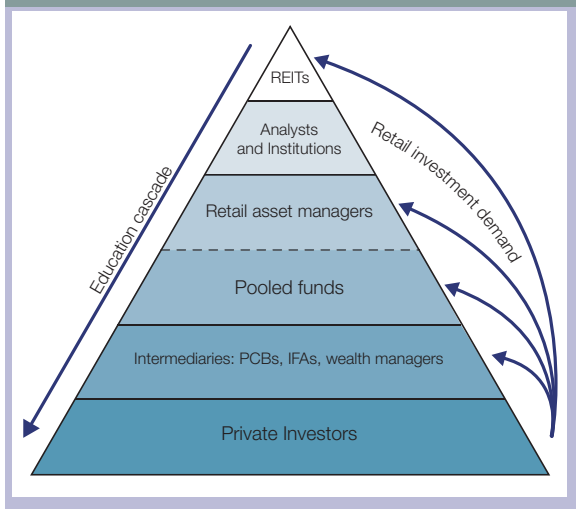
Private investor demand is likely to segment between those who want to make their own investment and asset allocation decisions (the minority), and those who prefer to take advice when confronted with complex investment choices.

The role of advisers will also vary. Private client stockbrokers and wealth managers may have discretionary control over clients' portfolios, and choose to hold a combination of direct equities (REITs) and pooled funds.

For the broader market, IFAs are more likely to recommend funds than individual REITs, not least because their income depends on commissions derived from product sales, but also to diversify risk by recommending clients invest in balanced portfolios.

"Private investors should take advice," says Paul Cameron Taylor of London-based IFA firm, PQR. "They should be looking to invest in commercial property funds, not individual REITs, in order to spread their risk and trust the expertise of fund managers who understand the sector."

RETAIL INVESTMENT DEMAND FOR REITS



"We look for the fund managers with experience and a strong track record in these markets," he says, "and we look at charges, to scrutinise the fund's expense ratios and assess the total cost of ownership. An individual investor cannot be expected to do that for himself."

But few IFAs are comfortable recommending commercial property investments to their clients, or feel qualified to differentiate between funds and fund managers.

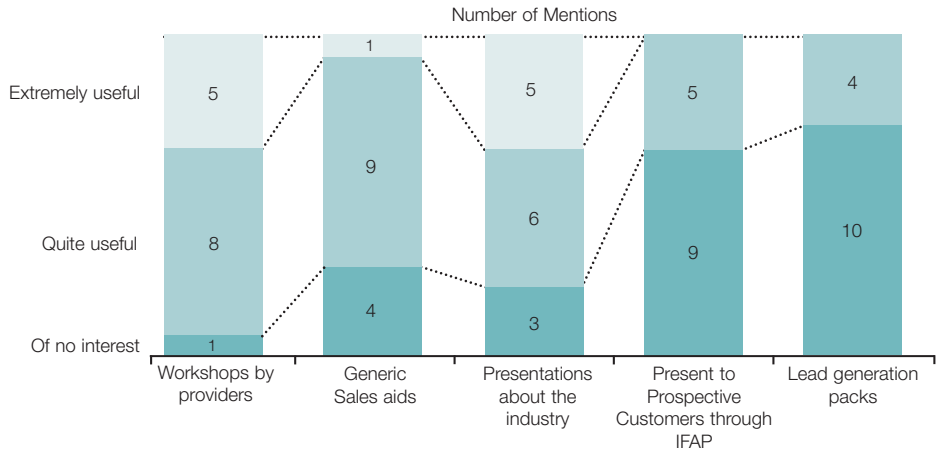
A research study conducted in May 2006 by NMG showed that only 18% of investment IFAs felt they were well informed about REITs, yet 60% were already convinced that commercial property should play a part in their clients' portfolios.

A second smaller study in June 2006 showed that IFAs would value a range of services on commercial property investment.

complexities of the commercial property market, and difficult for us to explain it to them."

Yet that is exactly the challenge. Property companies converting to REITs have the opportunity to promote their asset class, differentiate their brands and make themselves more attractive to both institutional and private investors. But persuading them to engage in more active market education could be an uphill task.

WORKSHOPS BY PROVIDERS, SALES AIDS SUCH AS CASE STUDIES AND INITIAL PRESENTATIONS ABOUT THE INDUSTRY WOULD BE MOST USEFUL TO IFAS



When asked spontaneously what other support the organisation should should provide, respondents mentioned: risk profiles, generic information on REITs/Fact sheets and comparison information of REITs against one another and against other types of investment.

Base: All respondents 14

Source: Reita

Will the fund management industry respond to the challenge?

"We've got a responsibility to help educate advisers," says Barry Maclennan, Investment Director at Standard Life. "It's our role to add value, and to help establish commercial property as a mainstream asset class for retail investors."

Leading fund management groups have been gearing up for the arrival of UK REITs with the launch of several new UK-authorised property unit trusts. In fact, property funds were the biggest single selling sector in 2006, accounting for some 20% of net retail sales.

Fund managers who have already signed up to become members of Reita include AXA, Fidelity, Henderson, Insight, Merrill Lynch, Prudential / M&G and Scottish Widows.

So what is the property industry doing?

"We don't know any private investors," says Philippe Tannenbaum of Eurohypo AG. "We deal only with highly sophisticated analysts and professional investors. It will be difficult for the private investor to understand the

"Property companies have had it too easy for too long," says Simon Butterworth of Capital Financial Publishing. "With so much money floating around, they've never had to struggle to raise capital. They don't appreciate the scale of the task to educate individual retail investors, as well as institutions and IFAs."

"We welcome private investors," says Emma Denne, Head of Corporate Communications at Land Securities, "after all, Marks & Spencer probably wouldn't be around today without them. They are long term holders, which means they are more loyal and add stability to our shareholder register."

"But our internal message is - business as usual" she adds. "We'll still be a public listed company - it's actually a misnomer to call us an investment trust. We're in a B2B market, so despite our size it's hardly surprising that most consumers have never heard of us."

Across the industry it seems, UK property companies have done very little to change their marketing and communications behaviour in the run up to REIT conversion.

They see retail investor demand being stimulated by fund management groups, who control asset allocation within their own funds, and delivered through advisers and brokers who have face-to-face relationships with private clients. While they are prepared to support Reita, they do not expect to increase their own direct contact with members of the investing public.

The lesson from the AITC

Conventional investment trusts are listed companies in their own right. Not all IFAs are qualified to recommend them and, of course, they don't offer commissions like open-ended funds. So, targeting private client brokers and discretionary wealth management advisers, rather than traditional IFAs, investment trust companies use a variety of marketing techniques to address the retail market.

"You've got to hit the road," says the Director General of the Association of Investment Trust Companies (AITC) Daniel Godfrey. "Our members target the discretionary and advisory firms that are most likely to generate regular business from their client base."

Presentations, round tables, e-mail newsletters and webcasts are among the most frequently used marketing tools, rather than advertising or direct mail. "There are probably just 50 firms in the UK that offer the most potential, and no more than 200 in total that are really worth keeping in touch with," says Godfrey.

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Lessons from abroad

The phenomenal success of REITs in the US has been due in no small part to the marketing efforts of NAREIT (the National Association of Real Estate Investment Trusts), which not only acts as the trade association for over 200 REITs listed on various US exchanges, but also funds a major educational website and campaign called Invest in REITs (www.investinreits.com).

Like Reita in the UK, these sites explain the features and benefits of investing in property, targeting retail investors as well as intermediaries. They provide a comprehensive directory of the quoted investment vehicles, selectable by geography and sector specialisation.

Opportunities to differentiate

Individual REIT companies might undertake more of their own marketing activity if they start to differentiate themselves through sub-sector specialisation, which has been a significant trend in the US.

"The High Street is certainly no one's favourite at the moment, but grade A City and West End accommodation commands a premium and still offers more room for growth," according to Barry Maclennan of Standard Life.

Maclennan also sees potential in the logistics sector, where large warehouse and distribution businesses hold property as a core asset. Conversion of these assets to a listed REIT would effectively make them sector specialist funds.

Large scale retail developments, ports and PFI infrastructure projects offer additional opportunities for sector specialisation. Creation of residential REITs might start at the higher end of the rental market, such as retirement homes or purpose-built student accommodation.

But most commentators are wary about REITs challenging the UK buy-to-let market in the short term. The attraction of low-cost borrowing to fund residential property purchase is offset by the responsibilities of becoming a landlord. REIT investment in residential property could change all that by taking away the hassle, as well as offering much lower investment costs and greater opportunities for diversification.

Opportunities for leadership

The leaders of the new REIT sector will be those property companies which recognise they can play a part in the education process of growing the market for commercial property investment. Some REITs will inevitably be more active than others.

Conclusions

UK REITs offer access to a new asset class for retail investors, but the sector needs a significant educational drive before it will become widely accepted and understood.

UK property companies converting to REITs clearly have an interest in attracting retail investors, but don't yet see it as their responsibility to educate them, or their advisers.

The Reita initiative is centrally funded by the property and investment industry, but its resources are limited.

Fund management groups are the most likely advocates of marketing, but without a more significant investment in education the market will not expand rapidly in the short term. The much-heralded 'Big Bang' could become nothing more than a gentle ripple through quiet backwaters, and that would be a massive missed opportunity. ◻

Andrew Porter is former Chief Executive of an international advertising and marketing communications agency.