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REITs Are Heating Up In European Markets

By Vera Sprothen
From The Wall Street Journal Online

The good times may be peaking for U.S. real-estate investment trusts but in Europe the party may be just about to begin.

REITs have been in favor for years with U.S. investors searching for high and steady dividend yields. But with interest rates apparently on the rise in the U.S., REITs' earnings prospects could be hampered. In Europe, in contrast, interest rates aren't expected to rise so quickly -- and more countries plan to introduce REITs before long.

European REIT structures -- publicly listed organizations that own properties like shopping malls, hotels or office buildings -- exist only in the Netherlands, Belgium and France. But Germany and the U.K. are pushing their own REIT legislation that would provide the typical tax advantages for REITs, a move that could significantly widen investors' choice.

Two weeks ago, the German Ministry of Finance said it aims to have REITs introduced by January. The U.K. government might have a framework for its own property-investment vehicles set up later next year. Finland, Sweden, Italy and Spain may follow.

Compared with the 146 U.S. REITs, which carry a total market value of approximately $250 billion, or about €194 billion, according to Morgan Stanley, the European market remains small. It consists of about a dozen listed REITs with a total market value of $70 billion. But they are increasingly popular.

"There seems to be a common perception among investors that the European market with REIT developments still in their infancy is becoming even more attractive than the American one," says Fraser Hughes, research director at the European Public Real Estate Association, or EPRA.

Last year, European REITs outperformed their U.S. counterparts. The European benchmark, the EPRA index, generated a total return of 41.73% in 2004, measured in euros, while the U.S. benchmark, the EPRA/National Association of Real Estate Investment Trusts index, returned 24.19%, also in euro terms. Like many others, research analysts at UBS AG contend that U.S. REITs are overvalued by as much as 10% and may slide in the coming months.

There are signs of that happening. In January, U.S. real-estate stocks fell 8.1% in dollar terms, according to the EPRA index, while European real-estate stocks rose 2.2% overall.

Also favoring European REITs is the notion that they are better value at their current price than U.S. REITs, when measured on the underlying net asset value of the properties they own. According to Martin Allen, analyst on property equities at Morgan Stanley, the U.S. REIT market has since 1990 traded at an average premium of 3.6% to its net asset value.

Many European REITs, on the contrary, have been trading at prices closer to their actual underlying net asset value or even at a discount. In the Netherlands -- the most established continental European REIT market, which often serves as a benchmark -- property-investment trusts have been priced at a long-term average of 4.3% below their NAV.

On average, the gross dividend yield for European REITs is expected to rise to 4.7% in 2006 from 4.5% this year, according to UBS. The average gross dividend yield for U.S. REITs, in contrast, is expected to fall to 4.0% in 2006 from 4.7% this year.

So far, interest in European REITs has come mostly from banks and institutional investors, but they may whet the appetites of more individual investors. "As a consequence of our aging society, people focus more on real estate. And against that background, REITs have a big advantage: They provide a sufficient level of liquidity for the smaller investors," says Scott Crowe, head of global real-estate strategy at UBS.

"As the demographic shift in Europe moves heavily towards the retirees, they demand an asset class that delivers a healthy stable income, and price appreciation without taking a roller-coaster ride," says Mr. Hughes of EPRA.

Selecting the right REIT is, of course key, as they can be more volatile and carry a higher risk than, say, bonds related to real estate. Checking out the underlying real estate of the portfolio is a must, analysts caution. Markets for retail property are on the upswing both in the U.S. and in Europe, but markets for office property differ widely.

The entry of Germany and the U.K. could boost the market further, says Boudewijn van Loen, a real-estate portfolio manager at F&C Asset Management PLC. "It will make it easier for a lot of existing real-estate companies to become a REIT and allow the market to grow."

Although in the U.K. a lot of the real estate is publicly listed, in Germany it isn't. According to Oliver Puhl, head of real estate investment banking at Morgan Stanley in Frankfurt, as much as €60 billion of German corporate property could be structured in REITs.

A German task force of financial experts called Initiative Finanzplatz Deutschland, set up by the Finance Ministry in 2003 to make Germany more competitive as a financial center, called for REIT legislation in a report to the government last week.

The report argued that REITs could benefit investors, Germany's capital markets, and the broader economy. If Berlin doesn't act, experts warned, "Paris or London, and not Frankfurt, might become the central trading spot for European REITs."

Email your comments to rjeditor@dowjones.com.

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FEATURES

A Continental Flair

[January/February, 2001]

By Michael Fickes

Real estate companies in Europe are becoming interested in investigating the advantages of the REIT structure for application to their own markets. But the systems for cross-border tax structures, presumably under European Union agreements, are still a long time off. But some companies are beginning to pursue the concept within national borders, and in two countries, the legislative structures are already in place.

Sidebar

EPRA Works Toward Cross-Border Standards

Founded just over a year ago in November, 1999, Amsterdam-based EPRA has so far attracted 78 members, established the first real time index of public real estate companies across Europe, and laid a foundation for promoting a pan-European public real estate industry.

Belgium and The Netherlands Take the Lead

In Brussels, a real estate company called Cofinimmo pays no corporate income taxes. A dozen other Belgian real estate companies offer the same benefits to their investors.

Likewise, a dozen or so real estate companies in The Netherlands pass most of their net incomes through to investors in the form of untaxed dividends.

These companies resemble, but are not identical to, U.S. real estate investment trusts. The Dutch vehicles have done business since the mid 1980s, while the Belgian companies only recently came to the public market, following legislation enacted in 1995.

Only a couple of European Union countries have enacted legislation creating real estate business structures similar to U.S. REITs, but interest in the concept runs high across the continent.

Property companies in the rest of Europe operate as limited partnerships or conventional corporations.

While the REIT-like business in Europe may seem small, the entire real estate industry on the continent comprises a significant number of companies, both public and private. "There are only about 300 listed property companies across Europe," says Quinton Hill-Lines, deputy chief executive of the European Public Real Estate Association (EPRA). "It's a small sector."

Indeed, EPRA research estimates the size of the real estate sectors listed on European stock markets at) 80 billion, or about one percent of the total)7 trillion capitalization of these stock markets.

On the other hand, EPRA believes that interest in forming public real estate undertakings is growing. Since 1998, 17 new companies have gone public in Belgium, Denmark, Finland, Italy, Sweden, and the United Kingdom. In addition, real estate markets in France, Holland, and Spain have shown strong returns. Outside of Belgium and The Netherlands, public real estate companies have generally adopted conventional corporate structures and resemble public real estate operating companies (REOC's) in the U.S. Turkey, which is not yet in the E.U., has adopted a structure similar to U.S.

REITs.

Formed in 1996, Cofinimmo operates on what may be the leading edge of the European real estate industry. The company is a SICAFI (Société d'investissement a capital fixe en immobilier)—a French acronym (pronounced See-Cafy) which translates to a "fixed capital real estate investment trust."

Like a U.S. REIT, a Belgian SICAFI is a real estate business structure that does not pay corporate income taxes. In exchange for this benefit, SICAFI's must invest in property in a diversified manner, maintain a debt ratio of 50 percent of the market value of their assets, and distribute at least 80 percent of their net income.

An FBI (Fiscale Beleggingsinstellingen) , the acronym given to Dutch real estate businesses with REIT-like qualities, receives similar tax treatment.

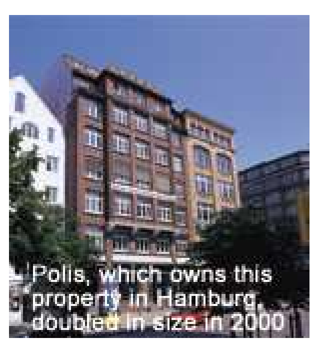
According to industry observers FBI's based in The Netherlands tend to be larger than Belgian SICAFI's because the FBI's have been around longer. In addition, The Netherlands has a highly developed pension fund industry, which invests large sums in FBI companies. "In proportion to its population, The Netherlands may have the largest pension fund industry in the world," says Bernard Cardon, CEO of Cofinimmo. "In Belgium, we are not entirely unfunded—I have no figure—but we are closer to the Latin countries of Europe, which generally use pay-as-you-go pension systems."

Despite its relative lack of pension fund investment support, Cofinimmo ranks as the largest real estate investor in Belgium, according to Cardon. "We have)1.6 billion in holdings, which translates to about $1.36 billion in U.S. dollars," he says.

The Cofinimmo portfolio contains more than 108 office properties, and spans more than 760,000 square meters (approximately 8.2 million square feet) of space.

The company specializes in office properties and has seen net rents increase 9.5 percent over the past year. The occupancy rate of Cofinimmo's office properties rose to 98.25 percent from 97.03 percent during the first six months of 2000.

Cofinimmo has grown rapidly since its founding in 1996 through investments in Belgian office properties. Growth beyond Belgium's borders poses problems, however. "Belgium is a small country," Cardon explains. "To grow more, we should invest in properties in other countries. The problem is that we receive tax advantages only as long as we invest in Belgium. If we buy a building in France or Germany, we will have to pay local taxes and not be able to receive refunds in Belgium."



Polis, which owns this property in Hamburg, doubled in size in 2000

From time to time, other European governments have considered creating REIT-like structures, but with little success. "There has been lobbying for the concept in the U.K.," Cardon says. "But the Treasury there did not see the advantages. The French government is divided about the idea. Finland tried to do something recently, but didn't succeed. There is a movement to create a Swedish instrument."

Despite legislative reluctance, the European business community's interest in the REIT concept has grown side-by-side with real estate as an industry in its own right.

Historically, European real estate has not functioned as an independent industry. Manufacturers, retailers, and other business enterprises simply owned and managed the real estate necessary to their own operations.

And pension funds and other institutional investors that own real estate tend not to manage property aggressively. "Many hold property as a bond-like asset, buying it and keeping it as an income machine," says Andy Schofield, director of global property research in the London offices of Henderson Global Investors.

As the current owners of real estate—companies and investment funds—divest their holdings, however, observers believe a more dynamic real estate industry may begin to emerge.

Will the absence of pass-through tax vehicles offering special tax treatment for public real estate ventures hinder the development of a more aggressive industry?

Perhaps not.
In Germany, for example, special tax depreciation rules helped to finance property development for many years. "These tax treatments provided investors with a higher depreciation than the technical depreciation would generate," says Alan Cadmus, president and CEO of Polis Grundbesitz und Beteiligungs AG, a real estate holding company headquartered in Berlin. "In the past, for example, an investor could deduct 50 percent of the cost of a building from personal taxes. So if you invested $1 million in East Germany in construction work, you could deduct $500,000 from your personal tax bill. This provided a big subsidy for construction work for individuals on their own or investing through a limited partnership."

This tax structure led to the development of large tax-transparent limited partnerships in Germany, continues Cadmus.

But these tax treatments were eliminated in 1999, when a new government altered the tax laws.

"Even though tax driven real estate investments have been stopped, the real estate market itself will not stop," Cadmus says. "We can continue by applying the U.S. REIT concept. We do not have REIT structures, but there are attempts in Germany to establish corporate structures that operate like REITs."

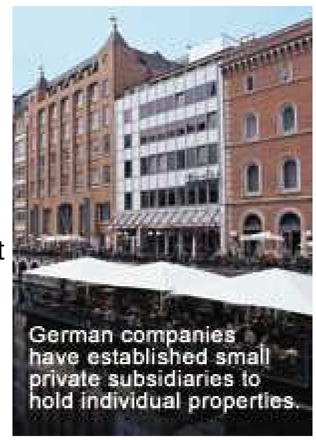
Polis itself aspires to create such a structure. Two years ago, Cadmus visited the U.S. to study REITs and to compare them with German corporate structures. "Most real estate corportions in Germany have strategies for investing in large pieces of real estate or some other strategy for reducing risk," he says. "But these companies have not offered persuasive stories to the German capital markets."

Cadmus has set up Polis with the idea of creating a real estate company with a more REIT-like investment story. Cadmus began by forming a partnership between Polis and a small private bank, which invested in the company's first two office projects. Currently, Polis owns six office buildings with a net asset value of approximately DM 100 million or (US)$40 million.

The Polis strategy aims at developing, owning, and managing office buildings equipped with advance technology in major German urban centers. For the time being, Cadmus expects development to proceed in west Germany, believing that east German development has reached the top of the current cycle.

Pursuing its development goals, Polis doubled in size during 2000. Cadmus expects the company to double its holdings again next year. At the beginning of 2002, if all goes according to plan, Cadmus will take Polis public with an IPO, featuring a German corporation designed to mirror the real estate operations of a U.S. REIT.

Unconventional Thinking


German companies have established small private subsidiaries to hold individual properties.

By German standards, a public Polis will be an unconventional concept.

"We invest in real estate," Cadmus says. "For German tax reasons we do not do this directly. Instead, we establish small private corporations that own each piece of real estate. In every case, Polis owns 100 percent of the shares in these companies, which do nothing but hold the real estate."

After the IPO, Polis shareholders will have indirect interests in all of the real estate owned by those small private corporations.

Essentially, Polis aims to become a publicly traded holding company that owns a series of single asset corporations, without worrying about tax consequences.

"We are early with this idea," Cadmus says. "I'm optimistic that as one of the first of these kinds of structures, we will be an attractive concept for the capital markets. Our idea is to focus on real estate as a business, not as a tax shelter."

While some observers will doubtless point to the clumsiness of a holding company structure, Reinhard von Hennigs, an attorney with Nelson Mullins Riley & Scarborough, LLP of Atlanta and Munich, calls the concept innovative and potentially marketable.

But why not simply operate as a limited partnership? Even though the extra depreciation benefits have been eliminated in Germany, limited partnerships still pass income through to the partners before taxes. "In U.S. terminology, limited real estate partnerships in Germany work like closed end partnerships, and there is no market for trading shares," Hennigs says. "German investment law has tried to form a kind of market under a statute called Kapitalanlagegesellschaftengesetz or KAGG. This statute provides a way to designate a safety value for the shares of a real estate limited partnership. It also requires the partnership that issues the shares to be willing to buy back the shares for face value. Although this provides some liquidity for the limited partners, the face value of those shares is often discounted by a large percentage in a buy-back transaction."

The system provides liquidity, albeit discounted liquidity, for investors but also limits the partnership's investment capabilities. "Because these partnerships don't want to be forced to sell real estate to buy back shares, they tend to limit their net real estate investments. Sometimes net investment in real estate are as low as 50 percent," Hennigs says.

The Polis concept aims to create an alternative to the problems posed by the partnership structure. "This is an exciting development," Hennigs says. "Essentially, companies like Polis are saying forget about the tax problem. Create a corporation and drive investment with dividends."

The theory goes like this: the corporation can invest as much as it wants in real estate, without the need to maintain large amounts of cash to pay back investors, who can cash out by selling their shares on the public market. The increased corporate holdings combined with aggressive real estate management will overcome the problem of taxation at both the corporate level and shareholder level.

Despite the complexities of German corporate law, the Polis idea suggests what the future of the real estate business could look like in Europe. Given the reluctance of all but two countries to legislate REIT like structures to date, the alternative lies in creating a real estate business structure that offers business efficiencies great enough to overcome any drag on investment created by tax structures.

Clearly the market in Europe for REIT- or REOC-like companies in Europe is still evolving. The European Union will have some impact as the cross-border tax hurdles will likely be reduced in time. For now, investment in individual countries is possible through the structures currently in place under the national laws. But, a broader approach in the future could help to open real estate opportunities to more investors.

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1 - Europe

1.1 General introduction / history

Netherlands	BI	1969
Belgium	SICAFI	1995
France	SIIC	2003
Italy	FII	1994

Below, we briefly describe the origin of the various REIT regimes and the underlying principle behind the introduction of a REIT regime in each country.

Netherlands

The regime for the fiscal investment institution (fiscale beleggingsinstelling: hereafter also referred to as, 'BI') was introduced in the Dutch Corporate Income Tax Act of 1969. Before 1969, Dutch tax law contained a special regime that brought investments in certain portfolio investment companies under the scope of the participation exemption regime[2], provided certain conditions were met. The BI regime replaced this regime.

The underlying principle of the Dutch legislator for introducing the BI or investment institution was to provide for a vehicle through which individual investors could pool their portfolio investments. This vehicle would bring its investors into the same after tax position they would be in if holding the investment directly. As in the US, it was expected that the introduction of such regime would have a favourable influence on the real estate sector.

The BI regime is a pure tax regime. Unlike, for instance, the Belgian regimes, application of the BI regime is not dependent on satisfying certain regulatory requirements (security laws). BIs, which are listed or marketed to the public, fall under the supervision of the Dutch Financial Market Authority, as does any other investment fund. Dutch quoted BIs are amongst the biggest institutional real estate investors in Europe.

Belgium

On December 4, 1990 the Belgian government introduced new types of corporate investment vehicles that were subject to a favourable tax regime. Amongst them was the investment institution with a fixed capital. In 1995, the SICAFI (société d'investissement à capital fixe en immobilière) structure came into existence, an investment institution specific to real estate investments.

The Belgian legislator created a favourable tax regime for the SICAFIs in order to boost the development of Belgian real estate. Collective investment was very popular in Belgium; however, the Belgian legal and regulatory system only provided for limited possibilities to collectively invest in real estate at that time. One reason to introduce the SICAFI was to broaden these possibilities; another was to compete with similar vehicles in Luxembourg and the Netherlands.

The SICAFI is best described as a listed property fund with a fixed amount of corporate share capital whose role is to provide tax neutrality for collecting and distributing the rental income.

SICAFIs are subject to a specific regulatory regime. The rules governing SICAFIs can be found both in the regulatory laws and in the tax laws. SICAFIs are subject to strict supervision by the Belgian Banking and Finance Commission. Part of the tax regime of the SICAFI (e.g. with respect to its tax base) can be found in the abovementioned law of December 4, 1990. Other tax rules regarding the SICAFI can be found in the Belgian tax codes (e.g. income tax code, capital tax code).

[2] Under the participation exemption, dividends derived from and capital gains realized upon alienation of shares in a qualifying subsidiary are exempt from Duth corporation tax in the hands of the shareholder. Generally, the participation exemption applies if a Dutch corporate investor holds shares representing 5% or more of the nominal paid-up share capital of a subsidiary company.