

A proposed pan-European REIT could level the playing field with the US, writes *Jonathan Lawrence*

US vehicle is role model for the divided states of Europe

In the US, it is easy for REITs to diversify across state borders and specialise in distinct real estate sectors or subsectors, but this option is not available on an EU-wide basis using a REIT structure. Only 13 of the 27 EU members allow a version of these tax-transparent vehicles and each of these vehicles have specific national criteria.

Last November, five trade bodies published a report by Pier Eichholtz and Nils Kok of Maastricht University, called *The EU REIT and the Internal Market for Real Estate*, which identified the disadvantages European property companies, investors and lenders experience due to the lack of a pan-European REIT. The authors pointed to six key areas where European firms are at a disadvantage.

Distorted competition: Investors from member states without a REIT regime are at a disadvantage at home. If they invest in REITs abroad they are treated differently from domestic shareholders under the various EU regimes. For example, investors in Luxembourg pay no withholding tax, but investors in the UK pay a 22% tax rate.

Impediments to specialisation: Almost three quarters of European listed property companies with a market capitalisation of \$50m-plus are generalists, while fewer than a quarter invest in more than one country. In contrast, US REITs can diversify across state borders and so be geographically diversified. In addition, there are many “super-specialised” US REITs, which only invest in a single real estate segment.

Effects on investment performance: Research and experience shows that larger property companies benefit from economies of scale. US REITs have increasing growth prospects and lower costs, leading to a direct relation between profitability and firm size.

Disadvantages to individual EU states: Regional diversification of real estate investments is attractive, but in smaller EU countries, diversity is not available within their borders. Even in larger EU member states, such as Germany or France, regional differences are not likely to be substantial enough to obtain diversification benefits.

Poor allocation of capital: Even in stronger markets than we have now, listed real estate companies without a tax-exempt regime tend to trade at a discount to net asset value. This is because investors in the shares of non-REIT companies will not usually be willing to pay exactly the asset value of the property company because they face a double layer of taxation, which makes the company less valuable than its assets.

Market safety and security: The patchwork of regimes gives property firms an incentive to incur high debt levels in countries without REITs. The report cites the examples of Belgium, Canada and France, where the debt ratio was 50%-60% before the introduction of REITs, fell in the year of REITs’ introduction, and stabilised at 20% three years later.

Proposed EU REIT structure

To overcome the above disadvantages, the report proposed an EU REIT structure with the features listed below.

Cash distribution: The report suggested an obligatory 80%-100% of net earnings should be returned to investors. Sufficient tax income would be generated by taxing profits at shareholder level, while managers would not retain too much free cashflow.

Corporate governance: Internal rather than external management of REITs is favoured. A report in 2000 showed that REITs managed by external advisers

underperformed internally managed REITs by 7% per year. While in Europe, incorporation of tax-haven companies has led to increased use of external management, in the US, externally managed property companies have virtually disappeared.

Leverage: The report calls for no restrictions in this area. Leverage restrictions across the EU vary from a maximum 25% ratio in Belgium to no restrictions in France. In the US, debt-holders are an additional monitor of REITs’ soundness, and US REITs had a 65% average debt ratio from 1992 to 2003.

Ownership requirements: The recommendation is for no shareholder restrictions. Some EU REIT regimes and US REIT regulations oblige property companies to meet certain requirements regarding their shareholding structure – a rare example of the US regime being relatively restrictive.

Mandatory listing: This should be scrapped, the report says. Of the 13 EU member states with REIT-type companies, six require REIT shares to be stock-exchange listed, but neither the long-standing Netherlands REIT nor the US REIT require mandatory listing.

Operational restrictions: The report calls for no compulsory requirement to diversify portfolios and argues that there is no reason to restrict EU REITs’ investment or development activities. It suggests that developments should be taxed under the prevailing corporate tax regime if, for example, they are sold within three years of completion, as under the UK regime now.

Open-ended v closed-ended: The report favours the latter, because when crises hit, open-ended structures are unstable and lead to loss of investor confidence in the market.

The report makes an interesting case for reform and should be considered by real estate companies, investors and lenders. The European Public Real Estate Association and other bodies have continued to lobby for an EU REIT, but there is no timetable for any legislative changes yet.

European REITs by country			
France and the UK have the lion's share			
Country	No of REITs	Market cap £bn	% of local listed RE
France	36	38.4	86.4
UK	16	25.6	52.3
Netherlands	8	7.5	73.5
Belgium	14	3.8	75.9
Turkey	13	0.9	100
Germany	2	0.6	4.4
Greece	2	0.5	24.2
Bulgaria	18	0.3	97.9
Total	109	77.6	38.8

SOURCE: AME CAPITAL

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