

REAL ESTATE INVESTMENT TRUSTS

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The last decade has continued to see the UK property investment market develop rapidly, in particular with respect to the ways in which investors can gain exposure to the asset class. This was most recently apparent with the launch of Real Estate Investment Trusts (REITs) in the UK on 1 January 2007.

REITs in the UK are listed entities that own and manage income-producing property, either commercial or residential. Most of their taxable income (at least 90%) is distributed to shareholders through dividends, in return for which the company is largely exempted from corporation tax. This presents a contrast to listed property companies in the UK which suffered from "double taxation" whereby the entity paid corporation tax and the shareholder also paid tax on dividends.

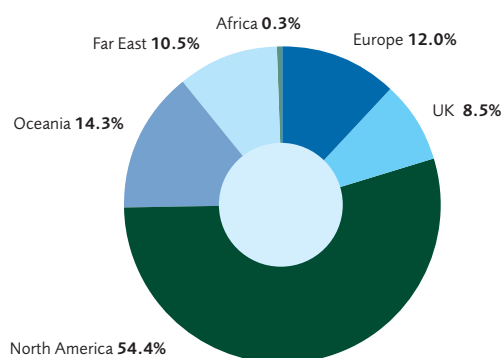
Thus, provided conditions are met (conditions which have been effectively set to ensure that REITs invest in property rather than being established as vehicles for tax avoidance), REITs in the UK should provide a tax efficient route to investing in UK property.

There were nine UK REITs established at launch on 1 January 2007. This number has now grown to 16 with a collective market capitalisation which makes the UK market the third largest in the world.

The legislation to create REITs in the UK has been part of a global trend which has accelerated in recent years. In 1994, there were only five countries with REIT legislation in place. However, by mid 2007, REIT legislation was in place in 18 countries around the world, including some of the largest property investment markets such as the US, France, Germany, Japan, Hong Kong, Singapore and Australia. The exact nature of the REIT legislation does differ around the world but the general themes with respect to structure are consistent.

The global REIT universe is now over £400 billion and consists of nearly 500 separate entities. A geographical break down is shown in the chart below.

The Global REIT Universe



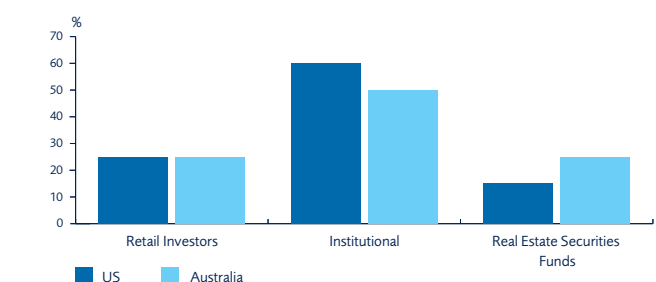
Source: AME Capital (May 2007)

North America, where the US naturally dominates, constitutes just over half of the current global REIT universe. Australia is the second largest national REIT market, making up 14% of the global share. The small contribution of Africa is due to the South African market. In Europe, France is the largest REIT market outside the UK, making up around 7% of the global universe. REIT legislation has only just been passed in Germany which accounts for the zero-weighting of Germany.

The popularity of REITs is shown not only by the rapid growth in legislation around the world but also by the growth of the REIT markets in those countries with existing legislation in place. The US and Australia are the best examples of this having had legislation for many years - the US since 1960 and Australia since 1971. Both markets have seen securitisation of real estate increase sharply and have been popular amongst both retail and institutional investors. The European Public Real Estate Association (EPRA) estimates that around a third of all real estate in Australia is securitised and owned by Australian Listed Property Trusts (LPTs are the Australian form of REITs).

In both the US and Australia, retail and institutional investors are both extensive investors in REITs - as shown by the chart below.

Investors in REITs (as at year end 2006)



Source: UBS

So, if these new structures tend to be popular with investors and are increasing around the world, what is it that makes them attractive to property investors? And do those attractive characteristics extend to the UK?

Typically, investors in property look for high and stable income returns, good diversification characteristics compared to other assets,



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relatively low volatility and reasonable returns (though lower than they would expect from equities). Investors often cite the security of capital in real estate as being a significant motivation too.

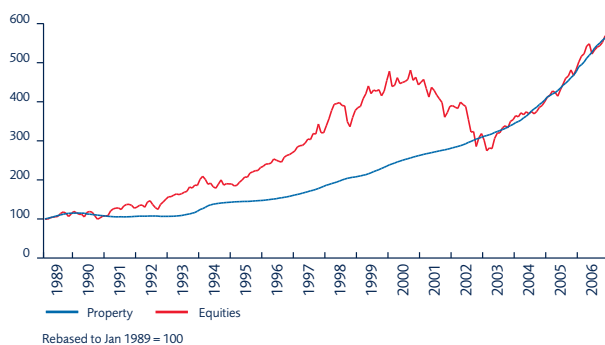
Looking at this list of desired virtues, it is apparent that the delivered characteristics of direct property in the UK over the last 20 years or so have matched up very well. Ironically, an exception is in the return characteristics where property has delivered returns at a higher level than most would have expected or predicted. However, it is pertinent to see how REITs compare to this list.

"For investors, an investment in a portfolio of REITs could well prove complementary to a direct holding in property and not necessarily a replacement option."

As listed entities, REITs provide more volatility than that of the reported indices of direct property. In the short term this volatility tends to correlate closely with equities. However, in the medium to long term the experience of REIT markets around the world shows that net asset value (i.e. the capital value of the owned underlying properties) is the key metric which determines performance. This means that property drivers are key to REIT performance. This also means that there are potentially strong long-term diversification benefits from REITs in a similar way to direct property. These features have been a reason why institutions and retail investors have sought to gain exposure to real estate through REITs.

However, it is also apparent that this short-term volatility does matter to the performance of REITs when one reviews the level of risk adjusted returns they deliver. The chart below illustrates this point by comparing the performance of UK equities and UK direct property since 1989.

Total Return Indices for UK Property and Equities (1989 to 2006)



Source: IPD, FT (July 2007)

As can be seen, the performance of equities and direct property was almost identical over the chosen time period but the volatility has clearly been significant in equities. Long-term investors can usually see through this volatility and, indeed, in equity markets it often creates buying opportunities. (It should also be noted that the smoothness of returns in the direct property market is, to some extent, governed by the "valuation" based nature of the data, as opposed to the "transaction price" nature of the equity market index).

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However, when REIT performance is considered in the round – and the volatility is placed alongside their more property-oriented characteristics – it seems clear that REITs do display investment characteristics broadly similar to property, but also exhibit features which might arguably lead them to being considered worthy as an investment sector in their own right.

For investors this means that an investment in a portfolio of REITs could well prove complementary to a direct holding in property and not necessarily a replacement option. For the UK investment property market, this bodes well as investors, attracted by the liquidity of REITs, may well seek to complement their REIT exposure with additional property exposure through other forms of vehicle. Certainly, for larger institutional investors, it seems that holding property exposure purely in either a fund that invests in direct real estate or purely in the form of REITs is likely to prove sub-optimal.

— ABOUT PRUPIM —

PRUPIM is one of the leading real estate investment managers in the United Kingdom. We form part of the M&G Group of Companies which is the asset management arm of Prudential plc in the UK and Europe. We manage in excess of £19 billion of real estate assets, of which £1.5 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with more than 6,000 property occupiers. We manage real estate investments for a wide variety of clients, providing core services and expertise in fund management, asset management and property management. These services are offered individually, or on a fully integrated basis.

Our major activities are driven by powerful research, managed by the Global Property Research Team. Our considerable scale and diversified activities allow us to draw on our own multi-dimensional inputs which give us an unrivalled information advantage. We evaluate the macro-economic environment working as part of the global research capability of Prudential. We receive detailed property related data generated by our on-the-ground surveyors. This is fed into proprietary modelling systems which form the basis of our analysis. The 10-strong Global Property Research Team was formed in 1987 and is comprised of property economists, performance measurement analysts and information officers who work together to provide leading property analysis and commentary on the UK and international property markets.

— PROPERTY RESEARCH TEAM —



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