REITs as a force for good

June 2018
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The rise in popularity of UK Real Estate Investment Trusts (REITs) has been remarkable. The REIT regime came into force on 1 January 2007 and by February 2007 nine of the UK’s largest listed property companies had converted to REIT status. Fast forward 10 years and there are now more than 70 UK REITs.

There has been a significant increase in new REITs since 2012, when HM Revenue & Customs (HMRC) made wide-ranging changes to the REIT regime designed to lower barriers to entry and encourage new entrants to launch REITs. The majority of REITs are listed on the London Stock Exchange (LSE), but a growing number are listed on AIM or overseas stock exchanges, such as The International Stock Exchange (TISE) in Guernsey.

This report draws together insights into the rise of REITs as a vehicle for investment in property assets with a wider purpose, in particular the emergence of REITs focusing on social property. It is based, in part, on the results of a round table discussion and further conversations with a number of existing REITs, investors, developers, operators, funders and others involved in the development of specialist REIT asset classes.

We look at what is working currently, how the use of REITs as a force for good might develop in the future and lessons that can be learnt from the use of REITs in other countries.

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"UK REITs have been around for over 10 years now, and they have evolved significantly since they were introduced. From initial take up by the large listed property companies, REITs have become more of a sector-driven investment vehicle. REITs are really contributing to place making, creating places for people to live, work and play. Adding the REIT brand on top of this helps to build trust and integrity in the economy."

Kersten Muller, Head of Real Estate, Grant Thornton UK
Our expert panel

We would like to thank our roundtable participants and other contributors for their insights:

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Our REITs discussions and interviews were based around three key questions facing the evolving UK REITs market, as detailed below. The key theme emerging is that to be successful in delivering sustainable investment in real estate with a social purpose, the key players will need to embrace change and work together to develop innovative solutions.

The consensus among our panel is that the UK REITs market is incredibly dynamic and flexible. Investors are attracted by the benefits of the REIT structure, including liquidity, onshore management and the globally recognised REIT brand, which is widely trusted by investors.

Access to capital markets is a key enabler of growth for REITs. More than 30 REITs have listed on the London Stock Exchange (LSE) over the past five years. REITs have raised more than £12 billion of equity in that period, both by way of equity raised on Initial Public Offering (IPO) and by subsequent share placing.

Many new REITs focus on specialist sub-sectors, such as healthcare and social housing. Our panel felt that the trend towards specialist REITs is likely to continue, but that effective partnerships with developers and operators is vital to ensure the model is sustainable. The consensus is that there is significant untapped potential for REITs to invest in new homes for rent.

Our international panel highlights a trend among other global REIT markets towards investing in residential property. It is clear that both government policies and changing cultures have important roles to play.

The UK healthcare sector is already benefiting from investment from REITs but there is significant untapped potential. In primary care, REITs are working with the NHS and local authorities to build out a substantial development pipeline of primary care centres.

There is massive demand for care homes and assisted living property. New REITs are entering the market, working with operators to provide capital and property expertise.

In the face of public funding changes, social housing is also benefiting from investment from REITs into suitable properties.

Specialist Build-to-Rent (BTR) REITs are emerging as an institutional asset class in the UK, although the market is still developing.
With Brexit looming, the government has an opportunity to signal that the UK is open for business and welcomes global investment in UK property, by further reforming the REIT regime. Opening up the REIT regime to new investment opportunities by widening the permitted activities in which REITs can invest would be a welcome step.

Building effective partnerships between investors, REITs, developers and operators will be key to enabling greater investment in and development of real estate with a social purpose.

How can we use REITs to make a greater impact?
1. How is the REITs market evolving?

A REIT is an internationally-recognised investment vehicle, promoted by governments to encourage the wider public and institutional investors to pool their investment in real estate.

REITs offer certain tax advantages to encourage this investment. In the UK, a REIT is not taxed on income and gains from its property rental business. Instead, shareholders are taxed on a REITs property income when it is distributed, and some investors may be exempt from tax.

To be classified as a REIT certain conditions must be met, including being listed on a recognised stock exchange. While a listing on the LSE main market appeals to a broad global investor base, this can be costly, so listing on AIM or an equivalent foreign stock exchange may be favourable. This allows the formation of REITs that are held wholly by qualifying institutional investors, or by clubs of investors.

Use of REITs as an investment vehicle has increased in popularity since changes were introduced in 2012 to relax the rules and make it easier to adopt REIT status. Since then REITs have become an attractive, onshore, tax efficient vehicle for investors, offering the benefits of liquidity and access to specialist sectors such as healthcare and social housing.
1.1 Benefit of REITs

A REIT can offer significant benefits for investors and operators alike. The REIT brand is globally recognised and trusted – most major economies have an equivalent regime. The fact that the structure is approved by HMRC – and the shares must be publicly listed – promotes transparency and effective governance to help build trust and confidence in the REIT market.

Liquidity

The liquidity of publicly-traded REIT shares on a major Stock Exchange encourages a wide base of individual and institutional investors, by providing a potential exit route through the sale of their REIT shares, rather than disposing of the underlying property assets. This allows management to focus on a long-term business plan and strategy.

Where necessary, investors can trade out quickly in the secondary market without disturbing the strategic long-term investment plan, or the operational aspects of a tenant’s business.

However, reliance on the market to determine a REITs share price introduces an element of volatility. REIT shares may trade at a premium, or a discount, to the net asset value of the business, depending on wider market sentiment.

“If someone wants to get their capital out, there’s a secondary market to trade those shares and take liquidity rather than having to force a sale of the underlying assets, which is one of the factors that has historically created boom and bust and swings of property prices.”

Mark Gross, Investment Director, Downing LLP

Onshore management

The onshore management of REITs can provide a number of benefits over equivalent offshore structures.

The G20 and Organisation for Economic Co-operation and Development (OECD) are committed to implementing the Base Erosion and Profit Shifting (BEPS) recommendations, resulting in increased scrutiny of offshore structures from tax authorities. As REITs are approved by HMRC they offer a stable and low risk platform, as well as potentially lower management costs compared to offshore structures.
**Sector specialisation**

The emergence of specialist REITs focused on specific asset classes is good news for investors and end users alike.

Investor demand for listed property funds with a focused strategy has encouraged the launch of new REITs focused on specialist asset classes within the broad real estate market. This includes REITs focused on healthcare, student accommodation, build-to-rent, logistics, shopping centres and, more recently, social housing, care accommodation and retirement living. This trend of specialisation in emerging real estate sub-sectors looks set to continue.

Investors are able to control their exposure to specific sub sectors of the real estate market, such as healthcare or housing, while a REIT management team with a focused strategy will be better placed to out-perform the market by providing state of the art property solutions in their particular area of expertise.

Specialist REITs have the ability to understand and foresee future property needs of their tenants, using their expertise and working with third party developers to deliver fit-for-purpose real estate to meet demand. This enables them to deliver long-term value for investors.

This type of constructive partnership allows both parties to focus on what they do best – allowing the REIT owner of the real estate to maximise the income and value of the property in their portfolio, while operators focus on the quality of service they provide.

“Institutional funds are shifting from direct ownership of assets into specialist REITs because they recognise this is where the sector knowledge is. At the same time they can diversify their risk by investing in these specialist REITs rather than using the direct ownership model.”

*Steven Noble, Investment Manager, Supermarket Income REIT*
1.2 REIT sector trends

In many respects, investment by REITs broadly mirrors wider investment in UK real estate. While demand for offices remains strong, partly driven by the trend for flexible co-working, investment in alternative sectors such as student accommodation, build-to-rent, care homes and social housing is increasing rapidly, albeit from a relatively low base.

These trends are set to continue, following the pattern of the more mature US REITs market, where investment in residential sectors by REITs forms a substantial portion of the market.

There have been some encouraging signs that REITs can provide the institutional investment and expertise necessary to address the UK’s chronic housing shortage, with a number of new REITs focused on residential property. For example, equity fundraising by PRS plc, a specialist build-to-rent REIT, and social housing REITs Civitas and Triple Point have seen strong demand from investors evidently keen to participate in these sectors.

ReSI Capital Management Limited for example has a focus on shared ownership homes, offering housing associations a source of equity to bridge the funding hole created by declining government grants. Associate Director Adam Rushton explains that housing associations may not be able to use shared ownership assets efficiently as security, since debt investors typically have a 10% security limit on such properties. There is a big incentive for housing associations to unlock some of the value in these properties, freeing up capital which can be used to build more homes.

Market growth

Since the financial crisis, the UK REIT market has evolved with more than 30 new REITs listing on the LSE and a further 20 REITs listings on TISE. Whilst some of these new REITs represent the conversion of existing listed property groups to REIT status, a significant number represent start up REITs, listing to raise equity on the market. This is an encouraging sign that changes to the REIT regime made by HMRC in 2012 have succeeded in encouraging new REIT entrants.
Since 2011, £12 billion of equity has been raised by UK REITs on the LSE. This comprises £2.4 billion of equity raised on IPO, plus a further £9.6 billion of equity raised in share placings by established REITs. This highlights the benefit of a REIT listing to secure equity funding to grow the business.

![Figure 2: Equity raised by UK REITs from 2011 to 2017](image)

Externally managed REITs launched by fund managers, such as Supermarket Income REIT, typically focus on high yielding, income generating investment properties. They typically either acquire existing property stock or enter into forward funded development agreements to maximise income, rather than taking on development risk themselves. LXi is another REIT specialising in funding developers. Many other REITs tend to fund ready-built, income-producing assets.

“Other REITs want to avoid the perceived difficulties of development, but we don’t see it that way because the lease is always locked in with the tenant prior to our purchase and we won’t take any speculative planning risks. By going in at the early stage with forward funding development, we can acquire an asset at a lower cost than if it was already up and running. But forward funding isn’t everyone’s cup of tea and that mindset is unlikely to change.”

Jamie Beale, Partner, LXi REIT

### Key market players

Historically the REIT market was dominated by a handful of large property groups that converted to REIT status in 2007.

Following the rule changes in 2012 there has been a renewed appetite to adopt REIT status. As well as listed property groups converting to REIT status, fund managers have been setting up new REITs as externally-managed listed funds. Institutional investors have also increasingly adopted REIT status for some qualifying private funds.

For each of these players the REIT vehicle offers a simplified, onshore structure from which they can pursue a focused business strategy that appeals to a global investor base.

Assura Plc is an example of an internally-managed, sector-focused fund. Assura invests in, develops and manages primary care property including GP surgeries and other community-based medical centres.

As an example of collaboration in the sector, Assura recently joined forces with two other primary care operators, Primary Health Properties Plc and Octopus Healthcare, to outline the potential for more than £3 billion of private investment to support the development of the NHS primary care estate. The resulting Primary Care Buildings Pledge could fund as many as 760 state of the art medical centres through third party development across the UK over five years.

We are seeing a growing trend towards this type of partnership between REITs and third party developers, with the REIT providing patient capital and property management expertise.

### Investor base

The presence of institutional investors in the REIT sector, such as UK and overseas pension funds and governments, has grown steadily over the past five years. With people retiring later and employers required to enrol employees into pension schemes automatically, pension funds have larger pots to invest in the market. The regulatory environment and recognised brand make REITs an attractive investment option for these funds.

For the same reasons, governments are looking to REITs to fund large infrastructure projects and housing developments.

While REITs are particularly appealing to institutional investors, technology is also making it easier for individuals to participate in large scale property investment projects, such as social housing. One such example would be the investment into REITs using online platforms – a concept similar to crowdfunding.

Private investors have the flexibility of selling REIT shares whenever they want as well as benefitting from the ‘feel-good factor’ of investing in socially sustainable projects. Shares in a REIT have the added advantage for private investors of tax efficiency when held in an ISA wrapper.
“REITs are a great opportunity for private investors to participate in the same investments as large private funds. For private investors who have invested in property through a private limited company it’s a great way to exit. They can sell to a REIT very tax efficiently and receive shares in the REIT so they continue to benefit from an ongoing return on investment, alongside a wider capital pool.”

Sarah Gatehouse, Real Estate Director, Grant Thornton UK
The view from Australia

The REITs market in Australia continues to evolve and has seen increasing specialisation in recent years. Sian Sinclair, Global Head of Real Estate for Grant Thornton, explains the measures that the Australian government has introduced to encourage REITs investment in affordable housing.
In its 2017 Budget, the Australian government introduced new tax concessions for REITs that qualify as Managed Investment Trusts (MITs) if more than 80% of their assets are affordable housing managed through an eligible Community Housing Provider.

Although the REIT market in Australia is relatively mature and can offer generous tax advantages for eligible overseas investors under the managed investment trust (MIT) tax concessions, the use of REITs with a social element is still in its infancy.

In Australia, a REIT can qualify as an MIT if it meets certain regulatory requirements in relation to its investors, allowing it to provide concessional tax rates of 15% on investment returns to overseas investors.

Australian REITs have traditionally invested in commercial property assets, although there has been increasing trend to sector specific REITs, such as those with interest in health assets such as private hospitals and specialist medical real estate, driven by the demands of an ageing population.

Housing issues

Housing affordability is a hot topic in Australia, to the extent that the federal government has extended the MIT tax concessions to eligible REITs that invest in affordable housing.

As part of the housing affordability measures in the 2017 Budget, the Australian government allowed REITs that qualify as MITs to access the concessional tax rate for foreign investments if more than 80% of the funds' assets are affordable housing properties that are managed through an eligible community housing provider.

In the same year, the government confirmed that MITs would be prohibited from investing in residential property generally, unless it met the affordability criteria. However this approach could be considered counter productive to the affordability objective, as this now prevents large-scale take-up by REITs of the build-to-rent asset class in Australia.

The intention was to make the investment in this class of asset attractive to foreign investors, to encourage greater supply.

These changes mark a shift on the part of the Australian government towards a more targeted approach to boosting affordable rental housing through investment tax incentives, and away from multi-family type assets by removing access to MIT tax concessions for the build-to-rent sector. Many industry observers had seen growth in the build-to-rent asset class as a promising solution to address the shortage of housing supply in itself.

The challenge with the new focus on affordable housing is creating a reasonable return for investors where assets are required to be rented at a discount to market rates and held for at least 10 years. While the changes are still in their infancy, they have yet to result in any new affordable housing REITs coming to the market.

Further refinement of the rules may be required to deliver the returns necessary to attract both domestic and international investors.

Outlook

Future developments in this area are likely to continue to be influenced by government policy, overseas REITs and the asset classes they are looking to acquire.

The market is likely to see growing interest in aged care and retirement living assets among REITs – although there is a raft of regulatory hurdles to be resolved, along with a greater focus on emerging industrial and logistics related property assets.

The Australian market is also seeing a rise in online collective property investment platforms where investors come together to invest in individual residential developments through syndicates that are typically structured as unlisted REITs.

The Australian government is seeking to remove some of the barriers to the collective investment approach and announced a new type of investment vehicle similar to a REIT, which does not take the form of a trust. The intention is to enhance the competitiveness of the Australian funds to attract foreign investors not familiar with trust structures.
The Canadian perspective

In Canada, REITs are paving the way for residential property investment, with some of the highest returns across the stock market in recent years. Greg Gallant of Grant Thornton Canada, discusses how ‘greener’ real estate assets are in demand from investors.

Offering significant tax advantages and access to strongly performing asset classes, REITs in Canada have provided investors with some of the highest returns across the stock market in recent years.

Around a fifth of Canada’s 48 listed REITs invest solely in residential property, with the remainder focused on a mix of industrial, retail and office real estate. Canada’s public healthcare system is not conducive to investment from REITs in healthcare assets.

The growing popularity of REITs has been driven in part by their ability to provide pre-tax distributions to the investors such as pension plans (which are not taxed in Canada) at considerable cost to the government.

Affordable housing

Government rent controls limiting investment yields have so far restricted investment opportunities for REITs in affordable housing.

Loosening the current restrictions on ancillary commercial assets, such as restaurants or community facilities, as part of residential developments, may be required to provide the rental yields necessary to encourage REIT investments in affordable housing. This type of commercial asset is currently not allowed to be included in the REIT structure.

Investment in student housing through REITs is permitted, however, as part of the Canadian government’s policy of encouraging participation in higher education. This asset class is expected to grow in popularity over the next few years.

Similarly, the current restrictions on non-rental income from REITs may need to be relaxed in order to encourage investment in retirement homes and other healthcare operations.
Around a fifth of Canada’s 48 listed REITs invest solely in residential property, with the remainder focused on a mix of industrial, retail and office real estate.

**Going green**

While the use of REITs as a force for social good has been limited to date, they have arguably been beneficial in encouraging investment in more environmentally-friendly real estate.

‘Greener’ real estate assets incorporating, say, cleaner air or lower heating and power costs, are increasingly in demand and offer commercial benefits to tenants, as well as potential new revenue streams to operators such as the sale of surplus solar power. This makes them attractive to investors looking for long-term stable returns.

However, opening up the tax regime to allow greater investment within the REIT structure in real estate assets that generate non-rental income is likely to be necessary if REITs are to play a greater social role in the future.
REITs in Germany

The REIT market in Germany is somewhat limited in comparison to others around the world, with tax advantages not as compelling as other types of investment fund. However, institutional investment in the residential sector is strong in Germany. Thomas Wagner of Grant Thornton Germany, looks at why German REITs have not yet taken off.
Since German REITs were introduced in 2007 take up has been very low. Only five ‘G-REITs’ have been launched under the regime to date. All focus on office and retail properties, with investment in industrial, residential and other asset types playing a small part.

G-REITs are publicly traded real estate stock corporations. They are exempt from local trade tax, which can be between 10% and 17%, depending on the municipality. However, the eligibility requirements for these structures are very strict and there has been little incentive to use them.

G-REITs must pay out 90% of distributable earnings to investors through dividends. 75% of the revenues must be generated through the letting or selling of real estate. However, if a G-REIT sells more than half of the value of its portfolio within five years, this is considered to be trading and the REIT will fall out of the scope of exemption. A G-REIT may also manage real estate portfolios held by third parties through separate management subsidiaries. The revenues from these activities must, on a consolidated basis, not exceed 20% of the G-REITs total revenues. Furthermore, if the portfolio includes, say, a solar energy capability, then this activity should qualify as an energy supply which would be harmful if the 75% requirement in terms of revenues can no longer be met.

Investor preference

Private and institutional investors in Germany generally prefer to invest directly in real estate or indirectly through open or closed-end funds. These investment vehicles can be structured in a way that mirror a number of the benefits of REITs (eg exemption from trade tax). The same is the case for regular corporate companies, including those ones traded on a stock exchange, if they limit their activity to the letting of real estate. As such these vehicles tend to be preferred by investors over G-REITs. The German real estate sector would like to see G-REIT criteria relaxed, but the government has shown little willingness to amend the regime.

Despite the shortage of affordable housing in Germany, there is little to encourage investment in this type of asset, with the majority of development in higher price brackets. Despite the clear affordability issues, the potential for G-REITs to provide a solution under current rules remains limited.

Notwithstanding the limitations of the G-REIT, the listed real estate market in Germany remains strong, and its value topped that of the UK for the first time in Q1 of this year, according to data from the European Public Real Estate Association (EPRA). Germany’s residential property companies, in particular, have grown rapidly. For example, Vonovia, the biggest property company in Germany and Europe with a market cap of around €20 billion (£17.5 billion), has more than doubled the number of homes it owns since its 2013 IPO through portfolio deals and mergers and acquisitions. It remains to be seen whether this trend by institutional investors will be replicated in the UK, and whether any incentives can be introduced.
The REIT market in Spain has mirrored the UK’s to some extent, with a change in the rules in 2012, coinciding with a recovery in the Spanish real estate market. Alongside a shift in culture from home ownership to home rental, this has resulted in an increasingly attractive market for investors. David Calzada Criado of Grant Thornton Spain gives an overview.

Spain first adopted a type of REIT structure in 2009, known as a “SOCIMI”, but the tax regime was not sufficiently attractive to investors compared to other REIT regimes of other countries and take-up was very low. In 2012, the new Spanish government revised the SOCIMI rules to make them more attractive for investors.

The new regime, together with the recovery of the Spanish economy and a period where real estate prices were at their lowest ever, has created an opportunity for a refocus on real estate. There are currently 55 listed SOCIMIs in Spain, including five on the main market. SOCIMIs have proved increasingly attractive to foreign investors.

SOCIMIs have invested primarily in commercial property assets such as offices, retail, logistics and hotels, and have only recently starting investing in residential property.

Cultural shift

Spain is seeing a gradual shift in attitudes towards rented accommodation, particularly among the younger generation, who have traditionally tended to live with their parents until they get married, before buying their own properties. In part this is due to a lack of finance to enable typical working families to afford their own homes.

This has led to the emergence of some SOCIMIs in the private rental sector, primarily catering for demand from people on lower incomes. Growing demand and rental yields have stimulated rented property development and made this an increasingly attractive market for investors. In this sense, the residential REIT market in Spain has growth potential similar to the UK, where we are starting to see private rental REITs attract investment.
Future prospects

There are no restrictions on the type of property assets in which SOCIMIs can invest and to date there has been little interest in social housing, given the lower returns. However, as the wider SOCIMI market in Spain continues to flourish, new asset classes such as student accommodation and retirement homes are starting to emerge.

Most SOCIMIs are relatively small. There has already been one merger and further consolidation in the market appears likely as they seek economies of scale.

There are currently 55 listed SOCIMIs in Spain, including five on the main market. SOCIMIs have proved increasingly attractive to foreign investors.
2. How are REITs having an impact as a force for good?

The emergence of specialist REITs focused on asset classes such as healthcare and social housing provide alternative investment opportunities that meet the demand for both a financial and a social return.

REITs are well suited to act as the owners of property assets with a social role, provided the partnership with the operator is structured appropriately. Where this works well, REITs can provide property management expertise to complement the expertise of either public or private operators in meeting the needs of their customers.

2.1 Supporting healthcare

An ageing population is increasing demand for healthcare property in both the public and private sector. This includes GP surgeries, community-based medical centres, retirement living and supported living real estate.

The care home market is experiencing a chronic shortage of beds with occupancy rates at their highest level since 2006, driving demand for new purpose-built developments to meet the increasing needs of the ageing population.

US and UK REITs are the major investor into care homes in the UK, principally in the private care sector, with significant investment in the development of private care infrastructure.

Impact Healthcare REIT plc is a good example of the separation of the property investor and the business operator role in healthcare. Impact’s diversified portfolio of residential care homes is let to experienced operators for an initial term of 20 years, providing stable and secure cash flows. This allows Impact to provide shareholders with inflation-protected income with the potential for dividend and capital growth through active asset management, as well as potential acquisitions. The operator can focus on running the business.

As well as private sector demands, recent NHS restructuring has led to a lack of focus on development of new premises. This is despite the results of a survey in 2014 by the British Medical Association which revealed that 40% of GPs said their premises were not fit for purpose.

However, specialist sectors such as healthcare currently make up only a very small percentage of the total REIT market in the UK.

In more mature REIT markets such as the US there is a stronger track record of the use of the listed property vehicles to develop infrastructure, retirement living and healthcare property assets. There is therefore significant growth potential for UK REITs to play their part in delivering property that will meet the needs of the growing and ageing population in communities across the UK in the future.
“REITs are a much needed source of long-term capital in the healthcare sector to drive future investment to help build the infrastructure we need to meet demand from an ageing population.”

Peter Jennings, Healthcare Director, Grant Thornton UK
**Assura plc**

With many GP surgeries in need of modernisation Assura plc, which converted to REIT status in 2013, is well placed to help bridge the NHS funding gap by investing in and developing state of the art primary health care facilities to serve local communities.

Assura invests in, develops and manages primary care property including GP surgeries and other community-based medical centres.

Chief Financial Officer Jayne Cottam says that by providing high-quality, sustainable and purpose-built premises, Assura aims to generate not only attractive financial returns for its shareholders but also positive social impact by investing in crucial local healthcare infrastructure.

Assura continues to invest in medical centres and recently completed a successful equity-raising and debt-restructuring programme. It is also seeing growing optimism around the prospects for development of new facilities.

**Lack of supply**

The primary care sector is experiencing increasing demand at a time when the supply of new premises has been heavily restricted by changes to the regional structure of the NHS.

Jayne explains: “About five years ago the NHS restructured and this had a huge impact on the pace of decision-making for new primary care developments.”

This is despite many of the buildings that house GP surgeries being outdated and unable to provide the broad range of services that are available in more modern premises. In a 2014 British Medical Association survey of GP practices, 40% of GPs said their premises were not fit for purpose.

**Change in the air**

Jayne says local NHS estate strategies are now being developed in detail. “That’s where we’re seeing the movement and things happening – on the ground at a more local level. So, as a provider of third-party development schemes, we’re working with those areas that are interested in reviewing their estates.”

This is encouraging, but NHS funding is still the key to getting things moving. As Jayne says: “We work very hard with local authorities and NHS trusts to build the case for these developments but ultimately it comes down to funding. You can’t build a medical centre speculatively – it’s the demand for clinical and community health space which drives these projects.”

Yet there are some grounds for optimism on funding. Sir Robert Naylor’s 2017 report on NHS primary care said that without investment in the NHS estate, plans to improve GP services as part of its Five Year Forward View “cannot be delivered”.

The Naylor Report findings included estimates that at least £10 billion of capital will be required to address current need and backlog maintenance, and supported taking advantage of private sector investment.
Primary Care Pledge

This sea change in NHS thinking means that the significant investment required in primary care property may be more forthcoming. “The most exciting thing is that we’re starting to see development opportunities coming through, albeit in small numbers so far,” says Jayne.

“We’re well placed to participate in this uplift because it’s where our expertise lies. We have an in-house team that can handle everything from planning all the way through to construction – as well as navigating the nuances of working with the NHS.”

Against this more optimistic backdrop, Assura last year joined forces with primary care property sector operators Primary Health Properties plc and Octopus Healthcare to set out the potential to invest more than £3 billion to support the development of the NHS’s primary care estate. The Primary Care Buildings Pledge could fund as many as 750 state-of-the-art medical centres through third-party development across the country over five years.

The future

“We believe we’re providing the primary care facilities for the future”, says Jayne. “One of our recent developments – the West Gorton Medical Centre – is designed to be the first zero-carbon building of its kind in the country, with roof-mounted solar panels to generate electricity and the goal of eliminating heating and lighting bills for the practice.” As well as providing rental income for investors, the BREEAM standard to which the centre has been built mean the running costs of the building for the practice should be lower.

Assura’s vision for the future extends beyond just GP surgeries. Jayne explains: “We prefer to build larger assets that provide a community support hub for wider healthcare, not just a GP centre. We see that as the way forward and we already have some facilities that are servicing more than GPs. They provide services in the community rather than at hospitals, which is more accessible for people and supports the NHS’ goal of building capacity closer to home. Some NHS regions are starting to use this more integrated primary care approach to where their budgets can best be spent – and we see that as hugely positive.”

“We also feel we could work closely with housing associations and social housing builders because you usually find that the areas with the highest health need are also the areas with the biggest need for social housing.”
2.2 Providing social housing

REITs can be an effective financial solution to social housing provision by offering housing associations a source of equity to bridge the funding gap created by declining government grants.

A sustained shortage of government funding has forced many housing associations to take on more debt in order to develop new homes. Investment from REITs allows them to develop beyond their debt capacity constraints and ultimately deliver more social housing to meet the needs of their communities.

“REITs potentially offer investors better returns than they would achieve by investing directly in the properties themselves, as well as the security and liquidity of the REIT structure. This can be through specialist social housing REITs or as part of a diversified REIT portfolio, both of which may appeal to investors who may have previously invested in bond issues in housing associations for example.”

“REITs can be a force for good as part of the solution to the UK housing crisis by adding to the portfolio of social housing available and helping local authorities fill desperately needed housing provision.”

Paul Dossett, Head of Local Government, Grant Thornton UK

“We’re seeing REITs partnering with social housing providers to provide long-term capital on attractive terms for both parties, allowing providers to invest in new stock.”

David Farr, Real Estate Director, Grant Thornton UK
ReSI Capital Management Limited is a REIT that aims to deliver returns to its investors by investing in social housing. ReSI’s objectives are aligned with those of housing associations and local authorities as each have long term investment horizons in social housing. ReSI is helping to free up capital that can be used to build more affordable homes and increase the supply of much needed temporary accommodation. Adam Rushton explains the opportunities in this sector.

Set up by TradeRisks Group, ReSI is the only UK REIT able to invest across the spectrum of social housing assets.

TradeRisks has been at the forefront of investment in social housing for over 15 years, introducing new debt investors into the UK social housing sector and arranging over £10 billion of debt funding for social housing, care and other specialist residential property providers in the UK.

Associate Director Adam Rushton says it was a natural evolution to leverage TradeRisks’ expertise to offer clients, primarily UK housing associations and local authorities, a source of equity through ReSI to bridge the funding hole created by declining government grants.

Seizing the opportunities

“There is a huge amount of investor demand for long-term inflation linked assets, which means there is significant capital to invest in the sector. This is good for the sector as a whole and, arguably more importantly, helps alleviate the demand for new affordable housing from the end user,” he says.

Whilst having the flexibility to invest across the full spectrum of social housing assets, ReSI primarily targets investments in shared ownership, temporary housing and retirement housing in response to demand from housing associations and local authorities.

Adam explains that housing associations can’t efficiently use shared ownership assets as security since debt investors typically have a 10–20% security limit on this type of property. There is therefore a big incentive for them to unlock some of the latent value in these properties, freeing up capital which can then be used to build more homes.

“An investment from ReSI unlocks capacity for housing associations to develop more shared ownership homes, benefiting from the development margin on each tranche of sales.”

Adam Rushton, Associate Director, ReSI Capital Management Limited

“The housing association can continue to manage the properties for life, maintaining continuity of relationship for the tenant. Any investment can be facilitated through a dedicated registered provider, being a wholly owned subsidiary of ReSI, which holds the assets for life. The housing associations can nominate independent directors within ReSI who have effective control of all decisions that come within the scope of the housing code. This means the housing association continues to have a controlling role in the governance of the portfolio being transferred to ReSI.”

At the same time many Local Authorities have experienced significant increases in households presenting as homeless in recent years. The issue is particularly acute in London and the outer London Boroughs due to government welfare reforms and a critical shortage of housing, both affordable and market. Together these factors have left Councils with a statutory duty to find housing for increasing numbers of households but without the permanent homes to do so, resulting in a rapidly growing need for temporary accommodation. There is now a high demand for temporary accommodation both in London and increasingly the surrounding outer Boroughs, and Councils such as Luton are now using entire blocks of flats or hostels to provide temporary accommodation for single people and families.

“By working with the Local Authority to provide long term secure investment in decent temporary housing, we can help meet the demand for accommodation.”

Case study

An investment from ReSI unlocks capacity for housing associations to develop more shared ownership homes, benefiting from the development margin on each tranche of sales.

Adam Rushton, Associate Director, ReSI Capital Management Limited
Finding the right partners

Adam believes the key to success is ensuring that ReSI has the right counterparties, which is why it focuses on only the strongest housing associations or local authorities.

“We’ve seen many REITs entering into leases with very small registered providers that have no credit. This means they’re taking on a lot of counterparty risk, on the assumption that the provider is government-backed. There is no precedent for the government rescuing such a small provider. There has already been one situation with First Priority Housing Association being put under review, which only strengthens our conviction in partnering with investment grade counterparties.”

Adam says there is a perception among housing associations that REITs only want to enter into sale and leaseback (S&L) agreements and this has led to a degree of scepticism, given that S&L may be viewed effectively as a form of expensive debt financing.

“ReSI is not an S&L proposition and we’re not looking to trade assets for short term gains. We look to build a platform as a long term investment partner for housing associations and local authorities to allow continued investment and development of social homes.”

A future force for good in social housing?

TradeRisks believes there is an undeniable need for equity to facilitate off-balance sheet development, given that housing associations can’t sustain growth through debt alone.

“As more and more housing associations begin to reach their natural gearing limits, the availability, cost and risk of further debt funding suffers as a result, so we’ll see an increasing appetite for equity-like funding,” says Adam.

“The REIT structure is a tax choice that imposes certain restrictions such as diversified ownership and the requirement to pay 90% of distributable profits as dividends, but says nothing about the company’s investment strategy, culture or values. The social housing sector focuses on the company, its investors and its management, rather than whether it has selected a particular tax status. The difference between the investment strategies, culture and values of different REITs can be huge.”

“I think there will be increasing differentiation between REITs that add development capacity to the social housing sector and those that create liabilities for the regulator and ultimately the tax payer.”

Adam Rushton, Associate Director, Residential Secure Income plc
“ReSI has a very long term investment horizon and has no interest in windfall capital gains, so its economic objectives are aligned to those of housing associations and local authorities.”

Adam Rushton, Associate Director, ReSI Capital Management Limited
2.3 Building more houses

The potential for REITs to meet the need for new homes in the current climate is gaining increasing interest. With the government’s aim of building 300,000 new homes each year, alongside funding constraints in local authorities, REITs offer investors an opportunity to be part of a financial solution to help provide more social and affordable housing.

“\nWe’re seeing the emergence of REITs in the private rental sector where investment is really needed. REITs have shown a strong income return and they’re often trading at a premium to net asset value. We’re likely to continue to see the rise of REITs as a property investment vehicle, particularly in light of the changes to the taxation of non-resident landlords in the 2017 Budget.”

Sarah Gatehouse, Real Estate Director, Grant Thornton UK

With an increasing focus on social purpose among investors, whether they are institutions, wealth managers or individuals, REITs can provide alternative investment opportunities that meet the demand for both a financial and social return by providing a platform for investment in homes that people want to live in.
Government incentives

One potential solution to building more homes could be for the government to introduce specific incentives for UK REITs.

In Australia, the government introduced tax concessions for REITs that qualify as MITs, if more than 80% of their assets are affordable housing managed through an eligible Community Housing Provider. Generally MITs are not allowed to invest in residential property unless it meets the affordable criteria. However, this restriction is preventing a large-scale take-up by REITs of the build-to-rent opportunity in Australia.

The UK could learn lessons from the Australian market by ensuring that any UK incentives are effective in encouraging investment.

Ownership aspirations

As property owners with a long-term outlook, REITs may have an important role to play in changing aspirations about home ownership by encouraging longer-term tenancies and greater security of tenure.

They may also provide an attractive alternative investment platform for buy-to-let for investors, encouraging existing housing stock to be used more effectively.

It is therefore important that policymakers continue to review the requirement of the REIT regime to ensure that they are fit-for-purpose for this emerging asset class.

“A solution is needed to the chronic housing shortage. If there is a broader investor base that’s willing to acquire income generating assets, it’s going to encourage entrepreneurs and developers to come into the development market as it creates greater optionality to realise value at the back end.”

Mark Gross, Investment Director, Downing LLP

New models of residential development

The housing crisis has led many developers to innovate new types of affordable private accommodation, both for rent and sale.

One trend that might be part of the solution is the emergence of micro living spaces. This includes co-living accommodation that comes in the form of en-suite cluster rooms with shared kitchen/living areas and shared social spaces such as residents’ lounges, bars and even cinemas. These ‘campus-style’ schemes are typically for rent to young professionals.

So far, without a clear definition for these types of accommodation in the planning system, new schemes have struggled to get off the ground. That is about to change with an initiative to recognise this type of property in the planning system.

“Having a clear industry-recognised definition for micro living is a game changer. It will help pave the way for the inclusion of these much-needed accommodation types in the planning system. It’s clear that there is a lot of momentum behind the micro living movement and we hope to be able to deliver new-build micro-apartment and co-living schemes in the not so distant future.”

Martin Skinner, CEO, Inspired Asset Management
3. How can we use REITs to make a greater impact?

It is vital that the REIT regime is continually reviewed by policymakers to ensure that it remains fit-for-purpose to facilitate investment in key real estate sectors in support of government policy.

Modernising the REIT regime

The UK REIT regime is still relatively new and there is an opportunity to widen the permitted activities of REITs to open up investment opportunities in priority areas, such as housing development, infrastructure projects and renewable energy.

There are currently restrictions on debt funding and REITs have a fixed interest cover test. This can create problems where rental income is subject to volatility while borrowing costs remain fixed, for example due to vacant space being re-developed. It also means that assets which would be highly leveraged, such as infrastructure real estate, might not be appropriate for the REIT structure, depending on the investor profile.

Arguably this aspect of the REIT regime could be modernised to accommodate funding arrangements for vital investment projects that the REIT intends to hold long term for the benefit of the income.

In terms of healthcare REITs, different business models may be required, in addition to conventional sale and leaseback arrangements. To achieve sustainable investment it will be important to learn the lessons of the past and ensure that lease terms are sustainable.

In the wake of the collapse of Southern Cross in 2011, the UK’s largest care home operator, it will be particularly important to ensure that the interests of investors and operators in the care home sector continue to be aligned to minimise the likelihood of any further failures.

Rethinking the permitted capital structure of REITs could open up new investment opportunities in circumstances where investors might prefer more flexible, hybrid structures, taking different risk.

“Externally managed REITs remain a popular operating structure, allowing the REIT to simplify its operations and lower costs by relying on the managers existing infrastructure.”

Steven Noble, Investment Manager, Supermarket Income REIT

REITs and local authorities

REITs are one of a number of vehicles that could be used by local authorities to invest in social housing.

Local authorities are in an anomalous position in that they can invest in property without always necessarily having the expertise to understand the risks involved but are prohibited from investing directly in REITs as they are classified as equities.

Reclassifying REITs as property investments rather than equities would remove this restriction on local authorities and potentially allow REITs to play a greater role in local authority social housing.
The challenge here is to secure long-term commitment in the face of ever-changing political cycles, which means it can be difficult to provide commitments lasting more than five years. Addressing the housing shortage will require longer-term commitments from both central government and local authorities and a fresh approach to partnering to build new homes.

Protecting the REIT brand

It is important to guard against REITs becoming victims of their own success as they become more popular, with the possibility of share price bubbles caused by too much capital chasing too few assets. Good governance is needed to ensure shareholders’ interests are protected.

“REITs arguably provide a return that’s much more closely linked to direct ownership of property, so if local authorities reclassified REITs from equity to direct property investments that would throw up some really interesting investments opportunities for local authorities who are currently investing in long leased real estate.”

Steven Noble, Investment Manager, Supermarket Income REIT

Effective governance and risk management is vital to maintaining success in the REIT regime. The market has seen a shift from internally managed REITs, which are more likely to take a longer term view to build the business, towards an externally managed model with appropriate checks and balances. It remains to be seen whether this shift will deliver superior returns in the long term.

Incentives for asset managers should be aligned with the social objectives of the REIT, but management incentives are typically driven by net asset value, which does not always sit comfortably with wider corporate social responsibility goals.

“If REIT managers are incentivised by fees as a percentage of net asset value, they will always try to grow the amounts of assets under management. I’m not sure the model is quite right at the moment as it’s too weighted in favour of management fees. A better model might be to align the interests of the manager and the investors, for example through the share price. The closer they’re aligned, the better it is for the underlying investor.”

Mark Gross, Investment Director, Downing LLP
It is vital to ensure that the interests of the investment manager, or employees of an internally managed REIT, are properly aligned with the shareholders’ objectives. As well as fees related to the performance of the underlying assets, external managers might be incentivised based on other metrics such as share price performance relative to peers.

Ultimately there is no single approach and the effectiveness of each case will depend on the business model.

**Purpose + profit = total returns**

One potential solution to better alignment of management incentives to social objectives is to link investment mandates to ‘total return’, which includes an element of social purpose. This would of course need to be balanced with achieving the best risk-adjusted returns for investors in the round but investors are increasingly looking for a social return element.

The concept of ‘total return’ – a return on investment that is not just about financial rewards but also purpose-led social gain – could encourage investment into socially beneficial projects, with REITs well placed to achieve this.

Adopting ‘social KPIs’ may provide a way to enhance public understanding of the good that REITs can do and encourage investors to think more broadly about how their investments have a social impact.

**Stimulating development**

With the flow of capital into REITs there will always be pressure on REIT managers to find assets to utilise the capital available, and therefore the potential to create inflationary bubbles. The key question is how to stimulate development to redress the imbalance of demand and supply. REITs may have a vital role to play in this.

Specialist REITs are generally not mandated to take the development risk of buying undeveloped land as this usually involves a level of risk that income investors want to avoid. One possible solution is for REITs to act as development partners for new social housing or care home assets which the REIT can acquire straightaway on completion.

Another option could be to encourage forward commitment to take up a given number of units at a set price once development is complete by sponsoring development and deploying capital without taking development risk. This gives developers more certainty over cashflow and credibility to help obtain further bank finance.

Forward commitments may also encourage REITs to develop new specialist property such as co-living spaces.

“Launching a co-living (or broader micro living) REIT is a case of gaining forward commitment from investors and funders to stimulate our pipeline of suitable schemes without taking risks that aren’t compatible with this type of structure.”

Martin Skinner, CEO, Inspired Asset Management
Educating the market

Raising awareness of the potential for REITs to deliver long-term social benefits calls for greater education of both investors and operators about the risks of the REIT structure.

In particular, there is a need for greater understanding of the specific risks of emerging asset classes and the inter-relationship between REIT yields and how net asset values move over time. Some observers question whether investors and operators really understand that specialist REITs come with different risks, particularly when it comes to property values.

For example in social housing, where REITs are relatively new players, education is needed so that housing associations understand the risks involved in their lease commitments.

“There has been some negative PR around REITs in the social housing sector because the regulator has seen smaller operators taking on leases with a REIT which are inflation-linked and they assume their tenants will be able to pay that rising RPI-linked rent. But with welfare reform and the changes to universal credit, some operators might get caught with obligations going one way and income going the other.”

Jon Slater, Chief Executive, ReSi Capital Management Limited
4. Recommendations

It is clear from our discussion and interviews with industry experts that REITs are having a significant impact on investment and development in vital UK property sectors with a social purpose.

To truly deliver the benefits and have the greatest possible impact on the sectors we have looked at, including supporting healthcare, providing high quality social housing and building more homes, the key players will need to embrace change; be that government, REITs, investors, developers and operators. Working together to overcome the obstacles to change will be key to success.

Demand from investors for property investments that both generate a financial return and have a social purpose is growing. This in turn is encouraging REITs to make sure that their purpose aligns with the values of their investors.

Investors therefore have a vital role to play in shaping the future strategic direction of investment in UK property. Improved partnerships between investors and REITs would be welcome to help develop innovative solutions to the pressing investment needs that we have considered in this report.

An effective tri-partite relationship between REITs, developers and operators is vital. REITs can provide both the equity funding and the property management expertise; developers can take on the development risk and return and create innovative and state-of-the-art real estate; operators can continue to deliver excellence in the end user experience and drive quality standards.

All of this requires a flexible planning system that is open to change.
Government has a vital role to play in creating structures that foster innovation, investment and development in property. REITs are a key enabler of investment in these important property assets. More could be done to demonstrate that the UK is open for business and encourage global investment in key UK real estate projects through the use of REITs.

As a matter of policy, we recommend that government takes this opportunity to review the REIT regime and consider making it available to a wider range of activities than is currently permitted.

The world has evolved significantly since the UK REIT regime was introduced in 2007, while the rules relating to the qualifying criteria have remained largely unchanged. Targeted improvements to the regime could go a long way to encouraging investment in priority real estate sectors.

If you would like to explore REITs further, or are considering investing in or setting up a REIT, please contact:

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