McKinsey on **Real Estate: Commentary**

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How **European companies** can unlock value from real estate

New laws to introduce real estate investment trusts in Germany and the United Kingdom could allow companies to unlock the value in their commercial property.

Article at a glance

In Germany and the United Kingdom, companies whose businesses are unrelated to real estate hold more than €1 trillion worth of property. Such illiquid assets represent an opportunity.

Newly proposed laws to introduce real estate investment trusts in these countries could allow companies to unlock value from excess real estate. REITs also benefit investors and tax authorities.

However, a robust market for REITs won't develop unless companies sell their excess property. Here, the proposed laws fall short.

Unless lawmakers amend the proposed legislation to remove certain restrictions and disincentives, the market for REITs in Germany and the United Kingdom will be stunted and the promise of REITs unfulfilled.

How **European companies** can unlock value from real estate

Alan W. Morgan, Bonnie Stone Sellers, and Scott A. Thomas

In Germany and the United Kingdom, more than €1 trillion of commercial property is owned by companies with primary businesses unrelated to real estate.[1] Most of these properties are illiquid assets—occupied by their corporate owners—and therefore often receive scant management attention. This dynamic could change given newly proposed legislation to introduce real estate investment trusts in these countries in 2007.[2] By selling property to REITs, companies can unlock value from real estate and use the proceeds to reinvest in core business operations—actions often viewed favorably by shareholders and rating agencies. However, we find that the proposed laws include restrictions and disincentives that, unless rectified, will discourage corporate participation and leave the promise of REITs unfulfilled.

The potential is significant. REITs are companies that own income-producing properties, such as office buildings, shopping centers, or hotels. They enjoy tax benefits because they pass on a high percentage of their rental income to shareholders. Shares in public REITs are traded like any other stock. REITs are transparent, liquid, and closed end—an efficient structure that, for many investors, trumps both direct ownership in property and other indirect property-investment vehicles.[3]

Through REITs, retail and institutional investors gain access to an alternative asset class and to new investment opportunities. Government authorities benefit from taxes paid on the capital gains from conversions to REITs and property sales to them, from the boost to domestic markets through foreign capital investment in them, and from the repatriated earnings of offshore-property investments. In fact, the benefits extend to any party wishing to cash out its real-estate holdings to a REIT, as well as to the investment banks that underwrite public offerings of the shares. If governments provide tax incentives promoting property sales to REITs, companies will have strong motives to sell their real estate and would thus benefit by capturing the difference between a property's book and market value.

Legislation has already established REITs in Australia, Canada, France, Japan, and the United States. Since the passage of France's REIT law, in 2003, Germany and the United Kingdom have been the only G-7 economies without such laws. Their absence doesn't preclude German and British companies from selling excess property, but the price is steep: gains are subject to tax rates of 40 percent in Germany and 30 percent in the United Kingdom. By contrast, since 1997 the US capital gains tax rate has hovered at around 15 to 20 percent, thus encouraging transactions. In the United States, companies with operations unrelated to real estate hold just one-quarter of all commercial property. In Germany and the United Kingdom, the figures are 55 and 39 percent, respectively.[4]

A second reason companies hesitate to sell excess property is a lack of clarity on the part of managers (who, historically, have been satisfied with ownership) about which properties to hold and which to sell. The decision should take into account the balance between control and flexibility. If a company must control a property (say, to conduct proprietary research), ownership makes sense. In our experience, however, the flexibility a lease allows—to relocate to better infrastructure, for example—often outweighs the need for control. Leases can also be more cost effective because fixed real-estate charges become variable. In addition, a lack of managerial clarity often leads to poor property management and inflated occupancy costs. We find that most companies

1 The estimated market value is derived from a DTZ Holdings report, September 6, 2005.

2 *UK Real Estate Investment Trusts (UK-REITs)*, HM Revenue & Customs, 2005; *Introduction of German REITs—Summary of recommendations*, Initiative Finanzstandort Deutschland (IFD), December 22, 2005.

3 REITs would offer German investors an attractive alternative to the existing open-end property funds that currently dominate the market there.

4 DTZ Holdings report, September 6, 2005.

greatly underestimate the potential savings from managing such costs better.[5]

Given this landscape, the prospect of REIT laws in Germany and the United Kingdom is a welcome one. We believe that, if well drafted, they would create an efficient investment product and enable corporations to unlock shareholder value from excess property. In discussion papers, legislators in both countries explicitly recognize the importance that excess corporate property plays in creating a vibrant REIT market—the German report even suggests that incentives are needed to meet this goal. Nevertheless, the proposed laws fall short.

Our analysis of the draft legislation and interviews with a range of key stakeholders (including bankers, lawyers, property fund managers, corporate executives, and the authors of the proposed laws) highlight a number of restrictions and insufficient incentives. Together, these issues will dissuade many German and British companies from selling their excess property and reduce the overall benefits of REITs. Four areas stand out (exhibit):

1. Insufficient tax incentives. Although laws in both countries will provide companies with a tax benefit for converting to or forming REITs, the German law offers the benefit only to companies that sell their property to a REIT in exchange for shares, not cash. We expect that the UK law will also include this kind of provision. In Germany, the motivation is a belief on the part of lawmakers that it would jump-start a market formed initially by larger players. In the United Kingdom, which has a larger base of commercial-property companies than does Germany and is therefore likely to form a market more quickly, this provision seems intended to maximize tax revenues (sellers insisting on cash can always pay tax at the higher, prevailing rate).

Clearly, the provision will dissuade some corporations—particularly those with smaller property portfolios—from disposing of excess property. Furthermore, it exposes sellers that receive REIT shares to market risk and cumbersome transaction costs not associated with cash sales. It also creates an unnecessary administrative hassle for REITs,

EXHIBIT

Corporate property owners take note

Draft legislation for real estate investment trusts (REITs)

	United Kingdom	Germany	Suggested approach
Tax benefit on sale of property to REITs for cash	Unknown	No	Yes[1]
Maximum shareholder level	Yes, 10%	None	None
Property holding period	None	5 years on 50% of portfolio	None
Financing limitation	40% financing cost coverage ratio	None	None

[1] At least for a limited number of years, as under French SIIC (Société d'Investissements Immobiliers Cotées) law, to facilitate a more robust start to the industry.

[5] Bonnie Stone Sellers and Scott A. Thomas, "Managing the cost of real estate," *The McKinsey Quarterly*, 2004 Number 4, pp. 19–21 (www.mckinseyquarterly.com/links/20890).

which must issue additional shares to purchase property in order to maintain the tax break. Instead, the tax should apply uniformly to stock and cash purchases. Both parties benefit from cash sales, as they enable REITs to purchase property from companies at an effective premium to other buyers. Recognizing that a similar omission hampered corporate participation in REITs in France, legislators there moved to amend the law this year. Germany and the United Kingdom should learn from the French experience.

2. Ownership restrictions. The UK proposal calls for an ownership cap of 10 percent on shares of individual REITs. British lawmakers fear that, without such a provision, EU rules and treaties might allow some foreign owners to avoid taxes, thus lowering the tax revenues the UK authorities could collect. But ownership restrictions clearly discourage corporations that wish to maintain management control from forming REITs. Moreover, this particular restriction would limit the ability of REITs to accumulate large portfolios through M&A. The German law is considering a combined corporation-trust arrangement to eliminate the need for an ownership cap. Perhaps the UK proposal should consider this approach as well.

3. Holding periods. To limit trading, the German law proposes a rolling holding period for any newly formed REIT: five years on 50 percent of its property. However, this measure hampers the ability of a REIT to react to market forces and to reposition its portfolio for maximum shareholder value. Any restriction on the freedom of REITs to run their businesses would stunt the nascent market and should therefore be eliminated.

4. Financing limitations. The UK proposal stipulates an overly conservative financing coverage ratio of roughly 40 percent. While market conditions may impose financing restrictions, the executives we interviewed expressed concern that incorporating such a limitation into the law would likely reduce the purchasing power of REITs, thus inhibiting their growth and artificially limiting returns to investors. In our view, the market should decide this issue.

Legislators in both countries recognize that ensuring corporate participation in REITs is essential. The rewards could be significant: by one estimate, €60 billion in commercial property would be transferred to REITs in Germany alone.[6] We urge lawmakers to broaden the scope of the legislation along the lines we have suggested. The demand for REITs is clear; improved laws can help ensure that companies provide an adequate supply of real estate to meet it. Q

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[6] *Introduction of REITs in Germany—Final report and recommendation*, IFD, January 31, 2005.