

The REIT Way To Buy Property



By David Stevenson | Motley Fool 10 October 2007

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Following today's podcast, here's the promised article on REITs.

There are two parts...

First, a Foolish guide called 'What is a REIT?'

Second, my current view on commercial property, where I answer questions like: 'How do REITs rate right now?' & 'Which REIT looks the best bet?'

WHAT IS A REIT?

A Real Estate Investment Trust (REIT) is a stock market listed property investment company. A UK REIT must have a full listing (AIM companies are explicitly excluded) and must be resident in the UK for tax purposes.

At least 90% of a REIT's taxable income is distributed to shareholders through dividends. Which means the REIT pays no corporation tax.

When did REITs start?

REITs were first launched in Britain on 1 January 2007.

Before UK REITs, quoted property companies were hit by double taxation: corporation tax, **and** the income tax paid by investors on their dividends.

So property companies were disadvantaged compared with direct investors, for example buy-to-let buyers, who had to pay tax only on rental income.

Why were REITs introduced in the UK?

The Government wanted to broaden investment into UK commercial property such as offices, high street shopping centres and out-of-town retail parks, and to encourage retail investors into the sector by allowing REITs to be held in tax-sheltered personal finance packages, such as ISAs and SIPPs.

Introducing REITs meant taking the tax factor out of the choice between direct and indirect property investment.

How can you invest in REITs?

You can buy REIT shares directly using a share dealer like [The Motley Fool Sharedealing Service](#).

...Or you could buy into funds that invest in REITs, either specialist REIT funds or those that hold both REITs and also physical commercial property.

What are the benefits of investing in REITs?

Buying individual properties is time consuming, complex and maybe risky.

Selling can also be difficult and it can take ages to get your money back.

With a REIT, small investors can now invest indirectly in a diversified property portfolio. Much more liquidity means that they can buy as many, or as few, easily tradable units as they like, instead of having to lump all their cash into just one or two properties.

Because UK REITs distribute at least 90% of their profits in dividends, yields can be attractive to income-seeking investors. And the REIT may focus less on capital growth than on maximising the payout.

UK REIT investors can buy into parts of the property sector that used to be inaccessible to private punters, like some of the higher yielding areas such as industrial sites and shopping centres.

Transaction costs are low compared to buying property directly, where stamp duty charges can range up to 4%. Buying shares in a UK REIT is subject to stamp duty of just 0.5%.

What are the potential risks of REITs?

REITs are stock exchange listed companies. So their share price performance is inevitably affected by what's happening in the market.

Over the shorter term, i.e. periods of less than 18 months, the performance of REITs stocks is likely to be more closely correlated with that of other shares than it is with commercial property prices.

But this can also present opportunities. That's because the stock market is always '**ahead of the game**'. Share prices 'price in' collective expectations at least twelve months into the future.

So if you like the general idea of buying commercial property, but believe that the valuation of **actual buildings** may be heading south for now, look at the recent performance of REIT share prices.

That'll show you what the stock market thinks is going to happen next...so **read on to see what we think about REIT shares now...**

What's happening right now in commercial property?

The market appears to be peaking out. Big style.

Investors have been piling into the sector for years. Yields, namely rental income as a percentage of value, have fallen rapidly in recent years as valuations have shot up. Property shares were given a further big boost by the introduction of REITs.

So what is happening now?

Only 85 commercial property deals took place in the month to 3rd October, compared with an average of 125 a month over the past half year, according to a Royal Institution of Chartered Surveyors study that tracks transactions over £250,000. The last two weeks have seen just 30 deals done.

The credit crunch appears to be hurting.

Last week RICS forecast 5% price drops both this year and next, with a "short and sharp" adjustment that would force yields upwards.

Although rising rents, particularly for offices, would partly offset this, RICS has cut its forecast of total returns, i.e. capital appreciation plus income, for this year from 8% to 3%. And for next year, RICS is predicting total returns of zero as yields continue to rise to about 5.3%.

The £58.5bn Investment Property Databank (IPD) database is another important survey -- it monitors valuations by Britain's biggest commercial property players.

This lags behind the market as valuers wait for market evidence before revaluing portfolios, yet last month IPD still reported that retail and industrial property prices fell slightly in August while offices remained static. Total commercial property returns were zero, the first time the index had failed to produce a positive return since the end of 1992.

Capital Economics has forecast a 12% price drop between 2008 and 2010. More dramatically, some agents have recently forecast price falls of up to 10% between now and Christmas.

As I've already said, REITs look a better bet than property funds at the moment. REIT share prices are already pricing in a lot of the downswing.

And what are the property companies up to?

Sometimes actions speak louder than words.

British Land has been trying to sell off up to 75% of its Meadowhall shopping centre in Sheffield. But the £1.2bn sale has just been shelved, making this the largest property deal to fall victim to the credit markets crisis.

The company said: "Despite a range of investor interest, the uncertainty in financial markets made the prospect of realising an 'appropriate' value unlikely at the present time."

That's another way of saying that nobody wanted to pony up anything like British Land wanted. Though for the moment, the company doesn't sound too concerned about the delay.

How do REITs rate right now?

So what do signs do you want to see before you buy REITs?

As I said in the podcast, a few weeks ago I was hoofing round the City of London on the way to a meeting. It felt like walking round a building site. Cranes dominating the skyline. 'To Let' signs on empty offices everywhere.

There's an old stock market adage...sell when everyone else is buying, and buy when everyone else is selling.

Never is that saying truer than in the commercial property arena.

The classic 'sell' signal is when the whole world and his wife are piling in to bricks and mortar, almost regardless of price, hoping to make a turn by selling on to buyers even further up the line.

The converse is equally true. When prices have dropped right back and purchasers have gone on strike, believing that values must fall further, it's time to start buying. And that's where we're approaching.

Property stocks are already down over 30% on average this year. But I haven't yet seen quite enough gloom and despondency yet. When landlords start to sound really depressed because they can't find any buyers, anywhere, then I'll start getting interested in buying REITs.

Which REITs look good to buy?

I'm going to take the old fashioned approach here. By looking at net asset value ratios. In other words, the value of buildings held by the property companies compared with the current share prices.

As I've already explained, the published numbers are behind the curve because valuers don't cut valuations until property prices fall.

Top of my watch list is **Segro** ([LSE: SGRO](#)), the industrial park developer formerly known as Slough Estates. My attention has been drawn to recent positive action, like halving its senior management and planning to switch part of its UK portfolio into Europe.

Having just dropped out of the FTSE 100 (let's wait for that to filter through fully into the share price), earlier this year the company sold its £1.5bn US business and returned £250m to shareholders. Good move!

At 511p, Segro is currently trading on a discount to published net assets of 34% and a yield of 5.1%. The shares reached 780p at the start of 2007, since when they have underperformed the FTSE index by over 45%.

I'm waiting for the shares to fall another 10% or so, a bit below the recent lows and equivalent to a 15% discount on a 30% fall in property prices from the peak. That would build in enough pessimism for me to be a buyer!

