Report to: Income Generation Sub-Committee, 11th March 2021

Report of: Head of Finance

Subject: REAL ESTATE INVESTMENT TRUSTS (REIT)

1. Recommendation

1.1 That the Sub-Committee note the proposal to extend the Council's investment instruments to include real estate investment trusts.

2. Background

2.1 At its meeting of 16 January 2018 the Committee approved a proposal for the Council to invest in a diversified property fund as part of a wider strategy to diversify its investment portfolio and secure low-risk property investments. In April 2018 the Council invested £3m in the CCLA Property Fund, which holds a range of commercial property. The annual yield in 2020/21 has been 3.8%, compared to the interest received on cash investments of 0.07%.

2.2 As part of the 2021/22 budget settlement HM Treasury announced that it intends to prevent local authorities from using PWLB loans to invest directly in properties purely for the purposes of generating income. The Council therefore needs to continue to identify forms of investment that will provide income streams in excess of the rates achievable through cash investments.

3. Information

3.1 A real estate investment trust (REIT) is a special type of company in the UK that invests in real estate – buying property and letting it out to tenants. The type of property can be commercial or residential. As well as investing directly in bricks and mortar, they can also invest through partnerships and joint ventures, and even in other REITs.

3.2 REITs vary in size. There are the well-known 'blue chip' companies like British Land, who are generalists, or more specialised companies such as Primary Healthcare Properties who invest in doctor's surgeries. Investments in a REIT are made by buying its shares through the stock market, the London Stock Exchange. Although they were first introduced for retail investors, they are also available to institutional investors, both UK and overseas.

3.3 There are two benefits to investors, which are inextricably linked. REITs (1) provide access to property investment without the need to identify and acquire suitable properties and (2) reduce investment costs.

3.4 A REIT can be thought of as a fund, similar to the CCLA fund, pooling its shareholder's capital and investing it on their behalf. Property acquisition requires specific skills and is time-consuming. By doing it through a fund, the investor has access to professional expertise, whose job it is to generate returns for their investors. The fund also provides a ready-made diversified property portfolio . The fact that the shares are listed on the stock market also makes it easier to access, and withdraw from, the property market: shares are more liquid than real estate, though how liquid they are will depend on the stock in question.

3.5 The second benefit is the tax advantages. REIT's pay no tax on their rental profits and no tax on their capital gains. The capital gains exemption is something they share with many other UK fund vehicles, but the exemption on income provides an additional benefit. This exemption is allowed because REITs are required to pay out at least 90% of their rental profits to shareholders. They are effectively a conduit for passing on the rent. However, unlike partnerships, capital gains aren't passed on to investors each time a property is sold – gains are only taxed if and when investors sell their shares. As the Council pays neither Income Tax nor Capital Gains Tax, the gross benefit generated is fully retained.

3.4 There also some further conditions that a REIT needs to satisfy. For example, at least 75% of the business income and assets must come from renting out property. However not all property related activities, such as property development, count as property letting. Hence having too much property development could jeopardise the REIT's status. It's for this reason that some UK property companies have decided not to become REITs.

3.5 There are also stringent rules on the amount of debt a REIT can enter into. This controls the level of risk from interest rates that an investor is exposed to but also limits the opportunities for investment and growth of the trust.

3.6 Like the CCLA, any investment in a REIT should be seen as a long-term commitment and certainly for at least 5 years.

3.6 As an example, Fundamentum Social Housing REIT plc invest in a diversified portfolio of social housing properties across the United Kingdom, with a focus on Supported Housing. An extract from their recent factsheet, which is included as **Appendix 1**, is as follows:

Despite logistical challenges posed by the COVID-19 pandemic, our housing partners have continued to house vulnerable adults during this time. The assets in the portfolio are located across a total of 13 Local Authorities and leased to 6 different housing providers. The average lease term across the portfolio is 20 years, with all leases subject to annual rent increases linked to CPI. Full rents have been paid to date across the portfolio. Over the last quarter, we have made three further property acquisitions, located in varying geographical locations from the Midlands to the Northwest. The assets have been leased to 3 different providers, who will be overseeing the referral process of housing the tenants.

3.8 This fund was set up in November 2019 and has a current market capitalisation of £17m. The dividend paid for the year to December 2020 was 2%.

4. <u>Preferred Option</u>

4.1 The preferred option is to carry out a review of investment opportunities with a range of REIT's in order to gain the benefits of their tax advantages and also to increase the diversification of the Council's investment portfolio.

5. Alternative Option

5.1 The alternative options would be (1) to make no further investments in property based funds. Whilst this would avoid any risk for the Council in doing so, it would significantly impair the Council's ability to generate income or (2) to make an additional investment in the CCLA property fund. This currently provides a good return of circa 4% from a diversified property portfolio. However, the Council's investment would be in only one fund, which is not good practice.

6. Implications

6.1 Financial and Budgetary Implications

An investment of say, £2m would provide an annual income of approximately £60k, assuming a 3% yield. This compares to the PWLB interest rate on 10 year borrowing of 1%.

6.2 Legal and Governance Implications

None arising from this report.

6.3 Risk Implications

Property based funds represent a means of investing in the property market with a higher degree of diversification than by buying individual properties, hence reducing the associated risk. REIT's are often in more specialised in specific sectors than the more general CCLA fund, hence the need to review a range of REIT's and select those with the preferred level of risk and return.

6.4 Corporate/Policy Implications

The Council's Treasury Strategy allows for the Council to invest in REIT's up to a maximum of £3m.

6.5 Equality Implications

None arising from this report.

6.6 Human Resources Implications

None arising from this report.

6.7 Health and Safety Implications

None arising from this report.

6.8 Social, Environmental and Economic Implications

None arising from this report.

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Background Papers: **None**