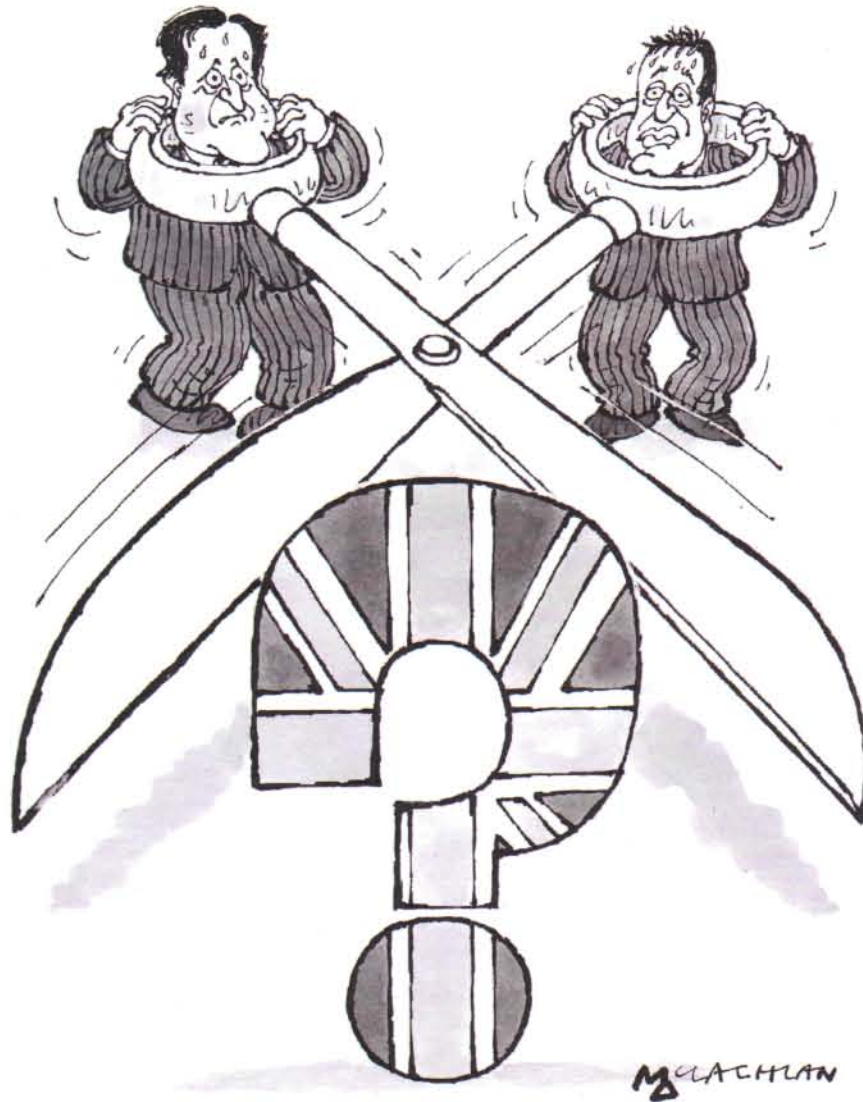


IfG

Investing for Growth

June 2010



'Budget Bites'



Edited by Pam Spooner

Commercial Property Bulls Running Again

Over the past month there have been plenty of bullish noises from the City of London about demand for office and other commercial developments in the Square Mile and other prime central London locations. Indeed, some commentators are suggesting that a bottom has been reached in terms of asset and rental values, particularly for prime sites.

Property giants British Land and Land Securities both reported stronger full year numbers, in late May, and both issued positive statements on recovery after better conditions became apparent in the second half of 2009/10.

Land Securities, for example, reported a pre-tax profit of over £1 billion, against the £4.8 billion loss declared for the year to 31st March 2009; most of the 2010 'profit', however, came from a valuation surplus of over £860 million after the previous year's write-downs. Revenues actually fell 20% to £251.8 million. British Land reported a return to profit, with its portfolio valuation rising 13.5% against the prior year, and NAV up 27% to 504p.

The optimism from these commercial property leaders was largely focused on the office market in central London. While British Land's statement centred on its £475 million commitment to re-starting new office developments in the city, it also referred to "modest recovery" overall this year amidst a "fragile" economic recovery; thus, as ever in property, location seems to be key to the recovery underway.

Last week Jones Lang La Salle reportedly said that, "There will be 20m sq ft of office lease expiries and breaks in the City before the end of 2015". This is the result of 25-year leases from the 1980s boom coming to an end and of breaks in 1990s leases, rather than any boom in City employment. Property professionals suggest that many 1980s buildings are 'not fit for purpose' and that there will be little difference in price in moving to newer, greener office space.

The Q1-10 report at the end of April from the Royal Institution of Chartered Surveyors (RICS) gives a clearer picture of the current state of the wider commercial property markets of the UK, and also highlighted London as seeing advances in rent levels. The report

said that available space in central London had declined for the second successive quarter, so that rental expectations have moved "above zero" for the first time since the last quarter of 2007.

The RICS figures in fact showed the biggest jump on record in expectations for central London office rents, resulting in a boost to the national average rental expectation. Away from London, available office space continues to rise "at a broadly similar pace to Q4", the report said.

Letting activity for both office and industrial space rose for the second consecutive quarter nationally, although RICS reported that investment demand outside of the capital was less buoyant. Indeed, some surveyors in the RICS report were voicing concerns at the end of Q1-10 about prospective demand for office space, given the likelihood of cuts in public sector spending. Several UK regions have become very dependent on government spending, so that UK budget cuts will be scrutinised closely for potentially positive and negative impacts on commercial property markets.

As RICS members in Barnsley put, it "Very much a static market with a lot of people waiting for the next announcements on government action". Although many observers fear major negatives because of public sector job cuts, there are some UK property pundits who are already looking for the opportunities, both at home and abroad.

This month we publish a note on a tax and pension-efficient way to approach commercial property investment – from a commentator who has plenty of experience in these markets, and who is currently looking, IFG is told, at a variety of opportunities in the UK and Europe. The contributor has no connection to IFG but his article could prove interesting food for thought for anyone looking to diversify their portfolio whilst equity markets remain volatile.

Standardised Tax Exempt Unregulated Funds

It has to be said that these exempt unit trusts ("EUTs") and exempt property unit trusts ("EPUTs") are actually a cost effective way of putting pension cash into commercial prop-

erty, or other qualifying arenas such as forestry, secured loans or collectables.

We can start by looking at what kicked this idea off. Back in April 2006 the overhaul of pensions' legislation by the government was intended to remove most of the restrictions on investments made through personally managed pensions. But, just a few months before "A-day", the then Chancellor Gordon Brown decided to back-track on some of the earlier liberalization proposals. The main change was to withdraw all the tax benefits of using Self-Invested Personal Pensions (SIPPs) and Small Self-Administered Schemes (SSASs) to invest in residential property (in particular buy-to-let homes) and in exotic assets; such as art, antiques, wine and other niche collectables.

As well as this there was a restriction placed on the gearing aspect, in that the maximum a pension fund could borrow to invest in any sort of property was restricted to just 50% of the net asset value (NAV) of the pension fund prior to the planned acquisition, i.e. one third of the total purchase price.

One of the effects of these restrictions was to deprive pension fund investors of much of the potential to diversify their risks by investing in assets whose returns are uncorrelated with classic pension fund assets, such as equities. The restrictions also deterred investors, who often had valuable experience of the less conventional asset classes, from applying their experience and wisdom for the benefit of enterprises and individuals seeking investment in those assets.

Most discretionary fund managers took these restrictions at face value and advised their clients accordingly without considering other structures which would allow clients to invest in these and other asset classes. These were the apparent and somewhat draconian consequences of the new rules. But in reality the changes only applied to direct investments made by SIPPs.

What must be noted is that they do not prevent a SIPP holder investing in intermediate funds, such as EUTs and EPUTs, which can then themselves invest in the restricted assets, all in accordance with HMRC rules. In fact, these funds, even when UK-based, are exempt from capital gains tax, although any income

arising from the fund, after deductible expenses, is subject to income tax. However, even this income tax is usually reclaimable by the fund unit holders.

There are some fairly strict restrictions on who can actually hold units, (such as most UK pension schemes and other persons exempt from UK tax on capital gains otherwise by reason of residence) and, for the purposes of the UK's financial services regulation, it is an unregulated collective investment scheme. As a consequence, and depending upon the underlying assets to be acquired by the fund, the investor, unless he is a certified or self-certified sophisticated investor or high net worth individual, has to go through an Independent Financial Adviser (IFA). Other types of investors who are exempt from UK tax on capital gains (domiciled overseas) may also invest.

The SIPP and SASS market has been conservatively valued at some £200billion, with a further £10billion being held in protected rights pension policies. By its very nature the EUT/EPUT can be of such size as the investors wish. To comply with HMRC rules, it needs to have a minimum of only two investors, unless it is investing in residential property; in this case the EPUT must be a "Genuinely Diverse Commercial Vehicle", according to HMRC's definition. Specifically, no single investor is allowed to own more than 10% of the fund and none is allowed to occupy or use any of the properties in the fund, of which there must be at least three, with none (in terms of its acquisition cost) accounting for more than 40% of the value of the fund.

For syndicates of SIPP investors, or for SSASs, the use of an EPUT as a vehicle to invest in particular properties has a further attraction. The direct purchase of a property by a group of SIPP investors, perhaps members of a professional services partnership, can be problematic. They are all likely to be required to

have the same SIPP provider; otherwise the SIPP trustees would be concerned about a lack of control. Further complications arise if others join the partnership later or if there is a partnership dispute.

By contrast, if these investors own a property through an EPUT, it will be relatively easy and inexpensive for one syndicate member to sell all or part of his interests to another - or for an SSAS to do so to an individual SSAS member. The units owned by the seller merely need to be valued and then transferred. But note that such EPUTs, in contrast to the familiar, regulated unit trusts, offer no secondary market or method of redemption; they are fixed-term funds. There are likely to be few opportunities for selling an investment prematurely other than to an existing investor.

To provide an example of a current innovative use of EPUTs, it is worth looking at Altyon, which is based in Mayfair, London, and currently has an EPUT open. The Altyon EPUT is a tax-efficient onshore structure with an FSA-regulated operator. Altyon offers access to two of the most respected names in property, namely Simon Holley and Simon Blake, of the Holley & Blake partnership that was bought out by CB Richard Ellis in 2006. In 2009 they set up Altyon.

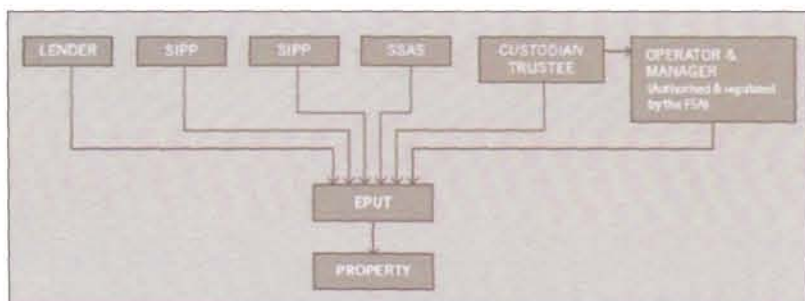
Holley and Blake were described in Property Week (18th September 2009) as two of the UK's top industrial property agents. Holley remains a consultant to CB Richard Ellis, one of the world's largest real estate services firms. CB Richard Ellis will provide research, refer transactions and serve as valuer to Altyon. Also, Altyon offers access to off-market deals through Holley and Blake's abundance of contacts and associates, and advises high net worth individuals and investors with significant capital to invest.

Altyon has taken the EPUT structure and applied it on a much larger scale for the poten-

tial benefit of the whole SIPP and SSAS market which wants to invest directly into the geared commercial property arena. To invest and participate in these types of commercial property opportunities is usually only available to ultra high net worth individuals and wealth funds. The Altyon funds will comprise a succession of EPUTs and limited partnerships each with a maximum subscription level of £25m. The minimum investment is £20,000 for pension investors (including SIPPs & SSASs) and £50,000 for all other investors; investors will be locked for five years into what will be closed-end funds.

There are a variety of solicitors' firms specialising in financial services law that will devise and structure an EPUT for a group of clients. However, the professional fees charged for doing so are likely to be high. And any EPUT will still need to be operated by a suitably FSA authorised operator. The Altyon EPUT annual management charge is 2%, and is apportioned between the property advisor and operator. The operator, Consortium Investment Management, is authorised and regulated by the FSA. There is an initial 5% charge by the operator to cover all commission payments, marketing and equity raising.

Regarding performance, the target IRR is a minimum of 12% per annum, with a 10% hurdle rate. When the Partnership is eventually wound up (expected to be five years after the first property purchase) the Property Adviser will be entitled to receive a performance fee equal to 25% of any profits of the Partnership once Investors have received an initial priority return equal to 10% per annum, rising to 30% of any profits of the Partnership once Investors have received a priority return equal to 15% per annum on their original investment (not on the net amount after the deduction of fees etc.). This gives the fund management an incentive to perform consistently at the highest levels throughout the life of the fund.



June 2010

Simon Holley, the Chairman of Altyon Partners LLP says of their latest EPUT:

"The EPUT offers investors the chance to pool investments in a tax-efficient way, giving access to the larger deals available whilst also spreading risk with portfolio diversity. The EPUT is SIPP/SSAS qualifying, so the pension investors who wish to move some of their portfolio into commercial property may do so, with different SIPP/SSAS providers being

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able to invest in the same building.

The fund will focus on some of Altyon's areas of expertise: secondary property and land; distressed industrial situations; conversion/change of use opportunities and off-market transactions. Together, these areas provide the potential to benefit from returns from a wide sector of the UK property market. The secondary market typically trails the prime sector, so with the recent signs of recovery in the UK prime market, this could be a good time to begin investing in secondary opportunities where value can still be found.

By pooling investors' buying power, a fund provides access to a wider range of real estate opportunities that would not be possible through individual direct investment. In addition, Altyon believes that its direct market access is enhanced by its strong investor base and reputation for discretion when operating, particularly in distressed or sensitive situations. Altyon can provide investors with access to a number of market areas with strong

upside potential, including projects that are in need of additional funding and offer short and medium term value, distressed or unusual assets and acquisition of land from developers and house builders.

The fund term is a 5-year fund with a 2-year run off period. The gearing of the fund is flexible, but 60% seems to be the expected figure. The EPUT is not subject to tax on capital gains (as all of the unit holders are UK pension funds) but does have a 20% income tax liability on its taxable income (rental revenue etc, but taxed after allowances) that unit holders should be able to reclaim.

Further details on EPUTs/SIPPs/SSAS and on the Altyon EPUT and can be found at www.altyon.com, where there is also a video interview explaining the Altyon EPUT. If anyone is unsure of any investment decision they should take advice from an investment advisor (IEA) authorised under the Financial Services and Markets Act 2000. □

Simon Holley BSc MRICS

Chairman, Altyon Partners LP
www.altyon.com

Simon has 30 years' experience in the commercial property market, which includes significant exposure to the sector during both growth and recession periods. As a consequence of this extensive experience Simon has access to off-market deal flow; additionally, he advises major corporates, such as Oracle Corporation and Nokia. Simon was formerly a partner of the highly successful Holley-Blake property partnership, which was founded in 1991, until it was acquired by CB Richard Ellis (CBRE) in 2006. Simon then assumed the role as Chairman of Agency & Development, responsible for major clients in the commercial and industrial sector. CBRE employs over 21,000 people worldwide with 420 offices in 57 countries. In Europe the business turns over US\$1.3 billion annually with more than £11.6 billion investment assets under management. Simon still provides consultancy and advice to CBRE.