Welcome to our seventh issue of SANNE connect, our regular technical bulletin aimed at fund managers, their advisors and investors.

Following on from a turbulent 2016, and with the dust now beginning to settle as we approach the end of 2017, this issue of SANNE Connect delves into the real estate world to hear from industry leaders and their views of what continues to drive the markets, where the challenges still lie and what it means for investors as we move into 2018.

I am delighted that Amanda Howard, Partner, Head of Funds and Indirect Real Assets and Patrick Groves, Funds and Indirect Real Assets from CMS London authored our first guest article. They unravel, explore and highlight some interesting trends following the Brexit vote and the opportunities, appetite and demand for liquidity for open ended property funds.

We also feature an article from Jason Bingham, SANNE’s Head of Real Estate and Stephanie Henwood-Darts, Associate Director in the EMEA Real Estate business, who provide an interesting case study around the UK Private Rented Sector. The article highlights the potential thriving opportunities for both institutional investors and the local communities and schemes in which they operate.

Our second guest article is authored by Zaeem Youssouf of EY. The article provides some useful insight into the growth of the UK real estate funds industry, and looks at the relevance, developments and effectiveness of intra-group financing when implementing property holding and development structures.

Our final guest article features Daniel O’Connor, Partner and Fiona Dalton, Counsel from Carey Olsen. They unpack and explore the attractiveness and appeal of why Jersey property structures remain the vehicle of choice for holding UK and European real estate.

I hope you find this edition of SANNE Connect interesting and engaging.

Enjoy the read.

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Open ended property funds and liquidity

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The Perennial dilemma
To what extent do open ended funds really offer liquidity to investors? And is there appetite for change in the real estate funds industry?

What is an open ended fund?
In essence, it comes down to fund term and liquidity. Open ended funds are defined firstly by their indefinite lifespan, and secondly by the ability of investors to unilaterally subscribe for, or redeem their investments at regular intervals. Contrast this with closed ended funds which typically have a finite duration, with subscriptions confined to a limited initial marketing period, and generally no option for investors to withdraw their investment until the fund’s assets are sold, (although investors in both open and closed ended funds are generally free to transfer their interests on the secondary market).

As always, the reality is more complicated. The detailed mechanics of open ended funds can vary significantly. They are influenced by factors such as the investment strategy, jurisdiction of establishment and investor base, particularly whether the fund is targeted at retail (general public) or non retail (institutional) investors.

However, liquidity remains the central characteristic of open ended funds. This is the case both for investors looking for ready access to their cash (particularly where the fund or market is not performing) and managers who have a duty to protect the fund and investors as a whole from the impact of high levels of redemption.

Are open ended funds truly liquid?
In a real estate context, the answer if the market is honest is “not really”. It takes time (and expense) to sell an office block or retail park for example and, for that reason, property is a relatively illiquid asset class.

If the property market hits an unstable period where investors are keen to reallocate capital to other asset classes, it might be difficult to sell the fund’s property assets quickly enough to meet all investors’ redemption requests without selling at a...
substantial discount or selling the fund’s prime assets because they are the most marketable. That kind of “fire sale” of assets harms the remaining investors.

Safeguards have therefore evolved to restrict outflows of cash from the fund when necessary. The obvious solution is to suspend redemptions altogether. Where a market shock could trigger a liquidity crisis and spiralling discounted asset sales, redemption suspension is a necessary evil. However, there may be reputational consequences for managers in imposing a suspension. This is therefore usually kept as a last resort, for exceptional market circumstances like those that followed the collapse of Lehman Brothers and the UK’s Brexit vote.

So, other means of restricting or controlling redemptions have been developed, including:

- Lock in. No redemptions during a fixed period after subscription (e.g. two years).
- Early redemption charges. A penalty imposed at manager discretion to ensure that investors who wish to redeem may do so during a lock-in or suspension period, but they suffer a penalty in doing so, helping to protect the interests of remaining investors.
- Notice period. No redemptions without a fixed period of notice (e.g. quarterly).
- Redemption “gate”. No redemption in any given period above a fixed proportion of the fund’s total value (e.g. 10%).
- Redemption vintages. Redemptions are honoured pro rata per redemption vintage (e.g. all redemptions received in a quarterly period), rather than on a first come, first served basis. The aim is to dissuade investors from making redemption requests merely in order to be “at the front of the queue”.
- Ban on revoking redemption requests. If redemption requests are irrevocable, periodic redemption requests to reserve a place in the redemption queue are less likely.

These restrictions may seem to undermine the purposes of open ended funds by moving away from the unilateral redemption rights that distinguish them from closed ended funds. However, there is increasing recognition of the crucial role these limits on liquidity play in protecting the interests of the fund (and the investors as a whole) from collapsing under a stampede of investors rushing for the exit during market downturns. It is worth noting that US open ended fund managers often retain much greater discretion over the timing of redemptions, and can satisfy redemptions in an orderly manner without any obligation to force sales of assets. However, European investors prefer greater certainty over when their capital will be returned. Deferral rights in Europe therefore are unlikely to exceed 24 months, after which the manager will often be required to sell assets to meet any outstanding redemptions, if sufficient liquidity cannot be found elsewhere (e.g. through secondary market trades).

Are the models converging?

The restrictions that limit liquidity in open ended funds, combined with the inflexibility of the finite term of closed ended funds, has led inevitably to talk of hybrid or “evergreen” products. Although, there is no uniform definition, these vehicles typically combine elements of both models. For example, rights of redemption are granted to investors at certain defined windows during an indefinite term. Alternatively, a fixed life vehicle with an option to roll over allowing individual investors to either redeem or to continue their investment at the expiry of the fund’s term.

A number of closed ended funds opt to engage with investors towards term end to modernise fund governance and convert to a semi-open ended ‘evergreen’ style as a half-way house between the closed and open ended model. However, it remains to be seen to what extent managers have the appetite to establish funds that stray too far from tried and tested routes.
Since 2011, the Private Rented Sector (PRS) has been the second largest housing tenure in the UK behind owner-occupation, overtaking social housing. Against the backdrop of a national shortage of housing stock growth has taken place at a steady pace over the last 20 years. Successive Governments have increasingly looked to the PRS to play a greater role in providing an increased supply of new build housing.

Despite an increased interest, there still remains a lack of new housing supply even today. According to the Royal Institution of Chartered Surveyors (RICS), the UK will face a shortfall of 1.8 million rental properties by 2025. In addition, 86% of buy-to-let investors have no plans to increase their portfolio of properties which may be partly driven by landlords no longer being able to benefit from income tax relief on buy-to-let mortgages from April 2017. This makes it all the more urgent for the UK to develop an alternative and sustainable solution to the supply of rental housing.

Market dynamics

The PRS still faces a number of challenges in the UK. Its fragmented ownership and lack of suitable available stock can make investment portfolio construction challenging. This is compounded by the aged and small-scale physical nature of existing housing stock.

As detailed above, housing supply is limited and is set to remain far below levels which can begin to address the under supply of housing in the UK. While large-scale rental development will boost supply in this sector in the short-term, the overall size of the PRS will still be linked to the movement of equity in the housing market.

The raised house price to earnings ratio has fuelled growth in the PRS and will likely continue to do so as less and less individuals
are able to afford to buy their own home. The
demand created by the difficulty in
accessing mortgages has been another key
feature of the market, even though, to some
extent, it was eased temporarily by the
Governments ‘Help to Buy programme’. However, when interest rates start to rise,
mortgages will again become more
expensive and will likely drive demand for
rental property.

There will also be continued demand for
rental property as a more flexible tenure,
especially among urban workers. If house
prices were to fall sharply in the future, this
could weigh on the growth of the rental
sector as home ownership becomes more
affordable for potential buyers. Despite
changed attitudes towards renting, the
abolishment of Stamp Duty Land Tax for first
time buyers, which was announced as part of
the Autumn 2017 Budget will undoubtedly
impact house prices and could affect the
demand for PRS.

What are the investment
considerations?

The idea of many short-term tenants in a
residential block, as opposed to a single
longer-term tenant or several occupants in a
commercial building has proved a sticking
point for some. However, the idea that many
“rolling” tenants can provide as much
security of tenure if not more than one single
tenant is starting to gain currency. After all, if
a single tenant in a commercial building
defaults, all rent owed could be lost, and the
relatively time consuming search for a new
tenant must begin. However, if one tenant in
a residential block moves out, another can
be found quickly, and the overall income
stream is relatively unaffected.

The timing of “rent reviews”, as well as
turnover of tenants, means that the PRS also
provides a real-time inflation hedge, as rents
tend to grow in line with or at rates above
inflation. It is increasingly being seen
as a source of long-term income
among investors.

Reputation for our clients is a key factor.
While the institutional PRS model is well-
continued overleaf...
developed in some other European countries and the US, some fund managers looking at the market in the UK may be entering it for the first time. As such, they must navigate being responsible for tenants’ homes, with the management issues arising from that. In some cases they may decide to hand over the management of the schemes to experienced third parties. In other countries, institutional investment has resulted in a more professional lettings market – such a development in the UK could help improve the standard of rental accommodation across the board.

There are other key advantages for PRS developers and investors. In large mixed-use schemes, one or more blocks of privately rented stock can be a major attraction, helping to bring the area to life immediately. All prospective tenants and purchasers will also be reassured that the development will remain in top condition; after all, this is necessary to attract new tenants. As a result, units will be built to the very highest specifications to maintain these levels.

Our view
We are seeing significant opportunities for our clients looking to invest or develop in the PRS. The market is evolving and large injections of investment will mean a new level of stock in the market, creating a more vibrant investment market as well as higher quality accommodation for tenants. The current largest group of private tenants are 25 to 34 years of age, however this range is set to increase, with an expectation that many will never own their own home.

The default setting for some investors is how to maximise income through rents. But the question they should be addressing is how they can create a profitable model taking into account the budget constraints of their consumers. The ideal position will be to pitch the cost of the building where the majority of the demand lies.

A thriving PRS market will give more choice to tenants, provide better services and will enhance the overall rental experience, which may lead to longer-term renting in the UK. The growth of a commercially successful UK PRS will not only benefit institutional investors with exposure to the sector but will also assist tenants and the local communities that these schemes support.

“The timing of rent reviews, as well as turnover of tenants, means that the PRS also provides a real-time inflation hedge, as rents tend to grow in line with or at rates above inflation.”
In October 2015, amid a flurry of activity from the newly elected Conservative Government, the UK Treasury published a consultation on restricting the relief available for interest expenses incurred by companies within the scope of UK corporation tax.

Through various consultations, a referendum, snap election and seemingly continuous re-writes, the basic proposition has endured, with final legislation published in the Finance (No. 2) Bill 2017 on Friday, 8 September 2017.

The interest restrictions have been introduced as part of the UK’s implementation of Action 4 of the OECD’s Base Erosion and Profit Shifting (BEPS) Agenda. The measures were enacted on 16 November 2017 with the law taking effect from 1 April 2017.

The interest restrictions will take effect from 1 April 2017. All groups will be able to deduct up to £2 million of net interest expense and similar financing costs in the UK per annum. Above this de minimis threshold, the new rules will cap deductions for the net interest expense to the higher of:

- 30% of taxable earnings before interest, taxes, depreciation and amortisation (EBITDA) in the UK (the Fixed Ratio Rule); or
- A proportionate share of the worldwide group’s net interest expense, equal to UK taxable EBITDA multiplied by the ratio of worldwide net interest expense to worldwide EBITDA (the Group Ratio Rule).

Alongside this, a consultation was launched in April 2017 to bring non-UK companies receiving UK sourced rental income within the scope of UK corporation tax. Whilst this does mean the rate of tax applied on rental profits reduces from 20% (going to 17% from 2020), it will bring such companies within the scope of the interest restrictions. These measures are now intended to take effect from April 2020.

**Interest restrictions**

The measures introduce an annual cap on the amount of interest a company can deduct from taxable profits in a given tax year.

The new corporate interest restriction will take effect from 1 April 2017. All groups will be able to deduct up to £2 million of net interest expense and similar financing costs in the UK per annum. Above this de minimis threshold, the new rules will cap deductions for the net interest expense to the higher of:

- 30% of taxable earnings before interest, taxes, depreciation and amortisation (EBITDA) in the UK (the Fixed Ratio Rule); or
- A proportionate share of the worldwide group’s net interest expense, equal to UK taxable EBITDA multiplied by the ratio of worldwide net interest expense to worldwide EBITDA (the Group Ratio Rule).
This is an exemption from the interest restrictions for companies providing public infrastructure assets that meet a public benefit test. Public infrastructure is broadly defined as assets forming part of the infrastructure of the UK or buildings that are let as part of a UK property business on a short term basis (i.e. less than 50 years).

The infrastructure meets a public benefit test if it is procured by a public body or its use is regulated by a UK Infrastructure authority.

UK Property Development
As companies undertaking UK property development may now be in the scope of UK corporation tax, the measures will affect companies undertaking UK property development irrespective of where the company is located and the form of the financing taken. Property developments are typically highly leveraged, with a long period during which the development company is unlikely to record any profits.

Of particular importance to property development companies, will be the treatment of capitalised interest. The treatment varies based on the accounting standards used by the group in drafting the financial statements as well as whether the property under development is held as investment or as inventory. This will determine the point at which capitalised interest is taken into account for calculating the interest cap, and may therefore have a significant impact on the overall restriction of interest.

UK Investment Property
The UK Government’s stated intention of bringing non-UK companies receiving rental income within the scope of corporation tax is to ensure such companies are subject to the same interest restriction rules as any other UK resident company.

Investment property is typically highly geared with investor and external financing. Whilst smaller, single property groups and
companies may benefit from the £2 million de-minimis, larger investors in the UK property market are likely to be affected by the proposed change.

**Looking ahead**

Going forward, these changes will be important for investors in UK property to consider when implementing property holding and development structures. However, the measures also provide an opportunity for groups to revisit structures to determine whether they are still relevant, particularly in respect of structures with intra-group financing. The introduction of the interest restriction measures can therefore be used as an opportunity to rationalise and simplify holding structures.

In particular, groups should consider:

- The applicability of the public benefit infrastructure exemption
- The accounting policy of the Group and treatment of the property within the Group’s financial statements
- For developments, the forecast completion and sale to determine when restrictions will apply
- The purpose and effectiveness of intra-group financing for property investment

The potential introduction of corporation tax on UK rental income and the introduction of the interest restrictions will take investment in UK property into new territory. Prima facie, these new measures will negatively impact investment returns. However, the effect on returns can be mitigated through a thorough review of the investment structure, accounting policies and calculation methodology. Indeed, in the case of UK rental income, the change in the basis of taxation may actually increase overall return on investment.

Ultimately, the impact of the measures will have to be assessed on a case by case basis. It is clear, however, that the taxation of overseas investment in UK property is an area of focus for the UK Tax Authorities.

“All groups will be able to deduct up to £2 million of net interest expense and similar financing costs in the UK per annum.”
Investors have long been aware that there is no “one size fits all” when it comes to real estate holding structures in Jersey.

Jersey companies, unit trusts and Limited Partnerships remain vehicles of choice for holding UK and European real estate. These vehicles can all be established as investment funds, if required. We have seen an increase in the use of a Jersey company as a UK Real Estate Investment Trust (REIT), and listings of REITs (whether Jersey companies or non-Jersey companies) on The International Stock Exchange (“TISE”). Further, we anticipate growth in the establishment of Jersey Funds following the introduction of the new Jersey Private Fund Regime this year, which provides a fast-track process for establishing new funds and simplifies their regulation. Whilst we predominantly see investment in UK commercial property, we are also seeing German and Dutch commercial property being acquired and held through Jersey structures.

Jersey investment funds are outside the scope of AIFMD (the European Union’s Alternative Investment Fund Managers Directive), while retaining access to UK and other European investors through national private placement regimes. This has proved a popular and cost-effective solution, with the reduced compliance costs more than offsetting any application fees in target markets. The new Private Fund Regime now brings all the speed and certainty of the ever-popular Expert Fund Regime to funds with 50 or fewer investors, at a reduced cost.

The types of investors investing in real estate via these vehicles continues to vary widely. Real estate remains popular with pension funds from across the globe, most notably...
the UK, Europe, Canada, and the Far East (Malaysia, Singapore and South Korea), including Sovereign Wealth Funds.

Historically, prime London real estate was a favourite for pension funds and, while this trend continues, we are seeing more investment across the regions from these entities (typically shopping centres and retail parks). We continue to see Jersey vehicles used for joint venture arrangements, which work well because of their tax neutrality and flexibility. The Middle East, India and China are all pairing up with Western parties in the joint ventures market.

Another addition to the real estate market is the emergence of the family office, established for preserving and enhancing the family’s private wealth. Real estate typically features in these wealth portfolios. Family offices are becoming more commercial in their approach to the holding of investments and are acquiring new real estate structures as well as restructuring their existing properties into some of the investment vehicles mentioned below. The investments held in these structures can also be leveraged (if desired), to free up equity for future investment to enhance the existing portfolio.

**Key features and advantages of Jersey vehicles used in real estate transactions:**

**The use of a Jersey Company as a UK REIT**

The principle attraction of the regime is that a REIT is not liable to pay UK corporation or Capital Gains Tax on the profit (including rental income) arising from its property investments.

The principle qualifying conditions of a REIT are as follows:

- The REIT must be incorporated in Jersey. Jersey corporate law is based on UK corporate law, but provides a more flexible regime with regard to capital maintenance, distributions and share transfers and issues.

- The REIT must be a UK tax resident. It is straightforward and common for Jersey companies to become UK tax resident by being managed and controlled onshore, usually accomplished by a majority of the board being UK residents and board decisions being taken in the UK.

- The REIT must be listed on a recognised stock exchange. For these purposes TISE is a recognised stock exchange. In September 2016 TISE updated its ‘Listing Rules’ in order to streamline the process for listing a UK REIT and to remove certain previous listing conditions. It is a flexible and cost-effective alternative to a full London Stock Exchange listing.

“**The principle attraction of the regime is that a REIT is not liable to pay UK corporation or Capital Gains Tax on the profit (including rental income) arising from its property investments.”**
• The REIT must not be a close company for UK purposes. i.e. not controlled by five or fewer participants (with exceptions for institutional investors).
• The REIT must not be an open ended investment company and the only shares the REIT can have in issue are a single class of ordinary share capital and various classes of relevant preference shares – a common structure with Jersey companies.
• The REIT must not be party to any participating or other types of prohibited loans.

Carey Olsen has listed more UK REITs on TISE than any other Jersey sponsor.

Jersey real estate holding vehicles are extremely flexible, as well as being quick and easy to establish, with no ongoing regulation for non-funds and a flexible and proportionate regime for investment funds.

The principal features of the three most popular vehicles are set out below:

1. The Jersey Company
• Distributions - any amount if solvent (capital or income)
• No stamp duty on transfer of shares
• Shares “Jersey situs” not subject to Inheritance Tax

• No upper limit on the number of shareholders
• No audit or accounts filing (unless more than 30 registered shareholders)
• Any accounting standards, any currency
• Tax neutral - usually zero percent tax rate, no VAT
2. Jersey Limited Partnerships

- General partner can be any legal form, need not be Jersey
- No upper limit on the number of limited partners
- No requirement for UK FCA registered operator
- Contributions can be any form – none required from general partner
- LPA - no prescribed content requirements, not filed
- Distributions - any amount if solvent (capital or income)
- No stamp duty on transfer of interests
- Interests “Jersey situs” not subject to Inheritance Tax
- No annual return
- No audit or accounts filing (unless regulated)
- Any accounting standards, any currency
- Tax - transparent, no VAT
- Limited public records (no public record of limited partners)
- No legal personality - managed by the general partner
- Limited partner(s) may have more involvement than other jurisdictions

3. Jersey Property Unit Trusts

- Governed by Jersey trust law and trust instrument
- No corporate governance regime
- Trust instrument - no prescribed content requirements, not filed
- No maintenance of capital rules or restrictions on distributions

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Global real estate administration done differently

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Established for over 25 years and listed as a FTSE 250 company on the Main Market of the London Stock Exchange, SANNE employs more than 1,200 people worldwide and administers structures and funds that have in excess of £200 billion of assets.

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Our dedicated team of more than 125 real estate professionals comprises of qualified accountants, chartered secretaries, chartered surveyors and lawyers who deliver tailored services to a highly valued international client base through our global network of regulated businesses. We have offices and service clients from 15 leading financial jurisdictions across the Americas, EMEA and Asia-Pacific & Mauritius.

SANNE’s Real Estate team service more than 90 clients globally and manage more than 1,000 structures and funds. We administer a large portfolio of global real estate assets that includes commercial offices, retail and leisure, industrial and logistics, hotels, residential, development, student accommodation and care homes.

Speak to our team and find out more about our services and operations. We would be delighted to hear from you.

Meet SANNE’s Real Estate team at MIPIM 2018

Information on Sanne and its regulators can be accessed via sannegroup.com

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In excess of £200bn assets AUA
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