VALENTINE THOMAS & PARTNERS

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VT Spotlight – Real Estate Investment Trusts

By Sarah Olashugba & Amanda Floyd

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Background

Real Estate Investment Trusts (REITs) were introduced in the UK in 2007 under the Finance Act 2006. This legislation allowed property companies to convert into REITs, provided they met specific criteria. The introduction was seen as a significant development for the UK property market. Since the UK Real Estate Investment Trust regime (the REIT regime) was liberalised in 2012, REITs have become an increasingly attractive wrapper for UK real estate. The core tax benefit of being a REIT is a UK tax exemption for the REIT Group on the profits of the property rental business. Key advantages of REITs include their tax efficiency, access to wide range of properties, liquidity and operational efficiency. REITs are exempt UK corporation tax on profits and gains derived from their property rental business which can potentially lead to higher returns for investors. REITs must distribute 90% of its income profits to shareholders; this is known as a Property Income Distribution (PID).

Through REITs investors can gain exposure to a diversified portfolio of real estate assets including residential and commercial properties like shopping centres, office buildings and industrial assets. In contrast to direct real estate, REITs give investors access to real estate markets without needing the significant capital required to purchase properties directly. REITs can also achieve operational efficiency as professional teams handle property maintenance and tenant management allowing investors to optimise property performance and value.

Challenging headwinds for the sector

The UK REIT sector has faced significant challenges in the past year particularly in the context of rising interest rates. The post-COVID-19 environment has brought about higher interest rates leading to increased borrowing costs. REITs often rely on debt financing to acquire and develop properties. Rising interest rates decreases property value causing REITs to be less attractive to investors.

Covid-19 left a lasting impact on working dynamics, with 44% people recorded to have worked from home at a point in 2023.

This shift has caused many companies to consider permanent flexible working arrangements, changing the dynamics of city and town centres, impacting the price of office and other commercial assets, contributing to a drop in share prices. Additionally, the growing demand for sustainable buildings has increased upfront costs. REITs must now consider investment into green technologies, sustainable materials and construction practises.

The recent failure of the Special Opportunities REIT IPO highlights the growing challenges facing the REIT sector. Despite attractive valuations, with property trusts trading at significant discounts and offering enticing dividend yields, the sector is grappling with numerous obstacles that make it difficult for new issues to gain traction.

Investment trusts are currently experiencing a challenging period, with wide discounts persisting and limited market appetite for new capital raises. The inability of the Special Opportunities REIT to meet its fundraising target of £250 million underscores this reality. Investors have easier access to existing trusts at discounted prices, reducing the incentive to back new IPOs. Despite these challenges, certain sub-sectors like industrials and logistics are performing relatively well, driven by strong demand for logistics facilities. Yet other areas, particularly office spaces, continue to struggle, with declining capital values affecting returns.

The persistence of wide discounts and limited fundraising has led to increased consolidation within the sector. Trusts are exploring options such as mergers or wind-downs to navigate the tough market conditions. However, the sector also faces structural issues, including fee structures that penalise investors during downturns, making the future of smaller, sub-scale trusts particularly uncertain.

Management Structure

REITs can be managed internally or externally. The latter arrangement involves the contracting of third-party managers to make investment decisions.

In the UK, just over half (52%) of REITs are managed externally - though these tend to be below average in size, and among the youngest in the REIT cohort. External management became the norm for new UK REITs in the period following the financial crisis when quantitative easing and the move to near-zero interest rates created fertile ground for new REITs to raise money. Yet externally managed vehicles have a mixed reputation due to their potential for conflicts of interest and a lack of alignment between the managers' fee and the best interests of shareholders. Management fees are usually based on a percentage of AUM. This means managers can be reluctant to sell assets, even when such sales would benefit shareholders, because in doing so they also reduce their own fee.

An external management structure is fine in theory, but alignment of interest must be rigorously imposed by any board. Key features such as fees based on market cap, a manager who puts their own money in, and one-year rolling management contracts seem to be straightforward alignment controls.

It was also highlighted to us that it is not just the asset manager / independent board relationships that are potentially compromised in the external structures, so potentially are the advisors. This is a consequence of the prominent role they play in capital raising and investor relations /roadshows and therefore the regular and fairly intimate dialogue they have with asset managers, perhaps to a far greater extent than they do with the Independent directors (even though technically they may be engaged by the plc board). So, when there's a problem or an issue (i.e. requirement or desirability of strategic review or management agreement renegotiation) there is a need for independent advice - an arms length, no vested interest appraisal /advisory perspective that helps the board structure their thinking, negotiate , and get to a conclusion. One of the things (macro issues aside) that continually undermines people's faith in external structure is when boards are seen to do nothing or oversee events that clearly are not value enhancing for shareholders. It is therefore evident that advisors have a role to play here too.

Finally, a potential downside for external managers in a market where we are likely to see further consolidation, is that those with lengthy contracts will be less attractive to prospective buyers given the contract would need to be bought out, adding costs for a prospective buyer.

Learnings and outlook for the sector

The sector has experienced some challenges however key learnings can be taken from these. The recent pandemic highlighted the need for REITs to focus on long term strategies through diversification; this could be geographic or sectoral. Focusing on diversification mitigates the impact of sector- specific difficulties. Ensuring REITs maintain sufficient cash reserves is critical for navigating economic downturns and can be achieved through managing debt levels.

With generalist investors shunning the property sector and ignoring the fundamentals that underpin it, many REITs with strong fundamentals and yields that now look extremely cheap, making them attractive acquisition targets. We anticipate further M&A activity (following the LondonMetric acquisition of CT Property Trust in May) to realise value for shareholders.

In addition, Private Equity (PE) is back on the prowl in the listed property space. After Brookfield's expression of interest in Tritax EuroBox earlier this summer came Starwood Capital's bid for Balanced Commercial Property Trust last week (September 2024). This is the first private equity activity / bids in the sector since Blackstone's spring take-private of Industrials REIT, which was at a premium to net tangible assets. Clearly interest rates are a significant factor in the re-emergence of PE and the recent base rate cut has given the market confidence that there is value to be had.

In a recent piece in Investors Chronicle, it was noted that recent take-privates had one thing in common: 'their portfolio, or at least part of their portfolio, is in an attractive sub-sector. This means that those specialising in regional offices or retail are unlikely to appeal. By contrast, discounted real estate investment trusts with a moderate market capitalisation and with portfolios in popular sub-sectors, such as industrial, healthcare and residential, are the most likely candidates'. The view was that there will be more deals moving forwards and of the REITs trading at a discount, Warehouse REIT (currently trades on a discount of 28% NAV per share), Impact Healthcare REIT (discount of 24%) and Empiric Student Property (discount of 20%) were highlighted as likely targets.

Our Research – Board Composition in the REIT sector

In a time of challenge, change and consolidation, having the right and most effective leadership in place on both Executive and Non-Executive Boards is critical. Valentine Thomas' board practice has been active across the REIT and wider Investment Trust sector in recent years and as a result were interested to have a deeper dive look at the sector's Non-Executive Board composition.

REITs generally follow the Association of Investment Companies (AIC) Code of Corporate Governance. These principles ensure that REITs operate with strong governance, transparency, and accountability.

The aim of our research is to shine a spotlight on the following three principles of the AIC Code:

1. **Independence**: The chairman and the majority of the board should be independent of the manager.
2. **Board Composition**: The board should balance skills, experience, and knowledge, with regular re-elections based (reviews and assessment) on disclosed performance criteria.
3. **Remuneration**: Director pay should reflect their duties, responsibilities, and time commitment.

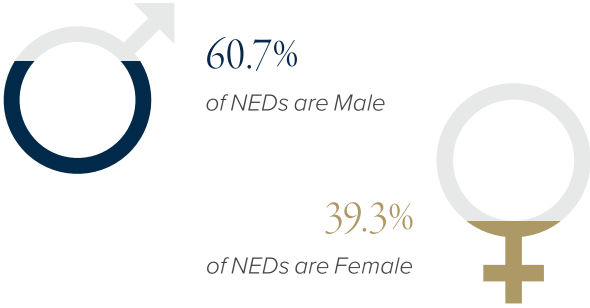
Focus has been given to the area of board composition where we have taken a survey of 25 REITs and analysed length of tenure, gender split, average age, and remuneration. Our main source for this research has been the board intelligence platform Numerable, that compiles up-to-date boardroom data from Companies House and other public sources.

We have also looked at the skills and backgrounds of the NEDs sitting on these boards to seek to understand the hiring strategy and whether there is a sufficiently diverse mix of skills and experience in the boardroom. The objective of this activity is to ascertain whether these boards are fit for purpose, to ultimately help build fairer, more diverse boards of the future.

Background

Across the boards it was interesting to note that the majority of NEDs were from similar backgrounds. Regarding career experience, a high proportion of NEDs have experience in financial services (in particular audit, corporate finance, and real estate investment / finance). Clearly having NEDs with this directly applicable sector experience in the boardroom is critical for REITs but we were surprised not to see a wider range of backgrounds and skills being sought. For example, given the challenges outlined, and the optics and narrative surrounding the sector, our view is that an obvious area for consideration is to look at the appointment of individuals with an in depth understanding of consumer / investor engagement and digital marketing.

Gender Split



The gender split details a positive sign of growth as 39.3% of the NEDs are female. However, this lags the wider Investment Trust sector where there was just below 50% female representation on the top 50 Trust Boards that we surveyed in 2023.

> "It's time for REITs to think widely about diversity of thought, as this report shows a surprisingly low level of digital engagement expertise on REIT boards. The significant progress made in diversifying REIT boards demographically since I established Women on Boards over a decade ago is to be applauded. But there is no room for complacency. This report demonstrates gender diversity falls short of the parity achieved in the wider Investment Trust sector, and back-sliding can be a very real risk as our 'Hidden Truth' report has shown within AIM listed boards. There is no shortage of fresh board talent with these skills who are ready and able to serve as NEDs. We regularly welcome diverse board candidates into our Women on Boards network who can bring a fresh approach."
>
> *Fiona Hathorn*
> *Founder & CEO, Women on Boards*

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Age – bringing a fresh perspective through age diversity

61

Average age of Board Members

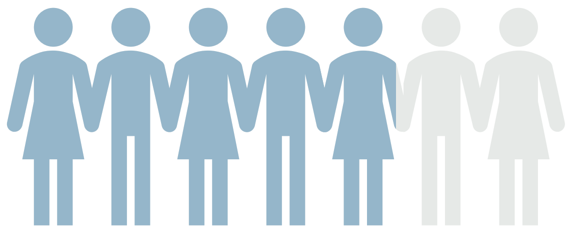
The lack of diverse experience and perspectives manifests most clearly in the lack of age diversity, with the average age on the boards surveyed being 61.

In 2023, we completed a NED Trustee Search for a leading master trust business. Aware that the future of the business relies on engaging a younger demographic of investors, we gravitated towards younger candidates than most typical NED searches. The client was acutely aware that to grow market share and future-proof their business, the right candidate needed a strong understanding of D2C marketing and must be well plugged into UX, different digital tools, and platforms to drive enhanced engagement.

Engaging Millennial and Gen Z investors and effectively communicating the benefits of investing in REITs is crucial for the future development of the sector. From what we have observed, investment trusts and REITs have been behind the curve here and many of the next generation of investors would not be clear on the nuances of Investment Trusts and benefits of investing versus Open Ended Investment Companies (OEICs) or other investment vehicles. This is not a quality of returns issue; this is a communication and engagement issue. The approach we adopted for our master trust client proved highly successful in producing a diverse slate of candidates with an experience set that taps into key trends shaping the investment industry.

> "Investment Trusts need to continue to attract a more diverse, and younger, investor base, alongside their current investor base."

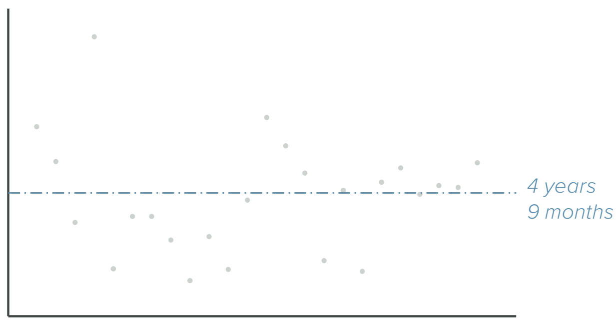
It is evident that better engagement is going to be critical moving forwards, and it has been positive to see the likes of The Engagement Appeal (TEA) looking to drive enhanced engagement by grassroot activism. TEA use several methods from circulating questions to thousands of companies ahead of AGM's, accreditation and awards program to recognise inclusive engagement, investor engagement festivals, ambassadorship programmes and corporate consultations. Ultimately, an additional key part of their mission is to get more Gen Zs on boards to ensure the right representation.



On average, boards were comprised of 4.83 individuals

Tenure

Average Tenure



There has been a spotlight shone across the wider industry on the length of NED tenures. Our research outlined the average board tenure as 4 years and 9 months. According to Spencer Stuart, the average tenure of Non-Executive Directors (including chairs) at FTSE companies is 4 years and 3.5 months. However, a small proportion of NEDs (4%) and Chairs (8%) have served for longer than 9 years. In the investment trust space, a significant number of NEDs and Chairs are serving two terms of 3-4 years and there is no official cap on terms served.

This begs the question, where should the line be drawn? According to the UK Corporate Governance Code, the recommended tenure limit for the Chair is 9 years. There is no recommended tenure for NEDs – but after 9 years they are no longer considered independent. In many instances, this acts as a 'de-facto' ceiling on tenure.

However, the Code's recommendations are not mandatory and only apply to premium-listed companies – although they are an influential benchmark across much of UK plcs. Companies are asked to apply their provisions on a ‘comply or explain’ basis. This allows boards some room to extend the tenure limit beyond 9 years, supported by comprehensive explanations to investors and other stakeholders. It must be made clear that the UK Corporate Governance Code does not apply to investment trusts which follow The AIC Code of Corporate Governance, which states there are no tenure limits. Our view is that tenure limits can be a great tool for companies to appoint younger Directors, with fresh perspectives and diverse backgrounds, who bring a different approach, and it prevents the concentration of power within a ‘cosy club’.

New perspectives and a healthy exchange of views are a key aspect of an effective, functioning board.

On the flip side, too much turnover is not fit for purpose either and having room to manoeuvre seems sensible in certain circumstances that may favour a higher level of continuity and stability. If a company is in in the middle of a corporate transaction, for example, or in need of stability during a period of market flux (like the Coronavirus pandemic), security is preferable. Identifying and recruiting the right candidates for board roles is not an easy task and may take some time. When they’ve been appointed, the Chair or CEO may have to invest significant time to ensure that new Directors properly understand the issues. It is often said that Directors are not fully effective until they have spent at least a couple of years in the job and hit peak effectiveness at 3-5 years in post.

Equally, there is a concern from experienced NEDs in the sector, that governance requirements are running the risk of overshadowing ‘competence to task’. Speaking with Robin Archibald, Chair of AEW REIT, Robin emphasised the importance of these requirements not compromising board members having the requisite skills and experience to fulfil the role, especially if there is no executive representation on the board. This is where good recruitment expertise comes in.

> “What does a board actually need and who can provide the advice to find it.”
>
> *Robin Archibald, Chair of AEW REIT*

There is a fine balance to be struck and clearly there is a danger of ‘playing by numbers’ around certain diversity criteria and this losing some of the key ingredients in being a competent board that understands the product or portfolio, with good chemistry that can give constructive challenge. The issue is even more acute in the REIT sector given the technical nature of the vehicles themselves (understanding of platforms, tax wrappers, etc.), with issues more akin to real commercial companies than an index tracking fund or even conventional equity fund. This is one of the reasons that REITs fees tend to be higher as the oversight requires much more input than other funds, especially when there are challenges on the portfolio or more likely the structure. Therefore, it is essential that REITs have property expertise in the NED makeup, not to second guess the managers but to understand the dynamics which are much more complex than for a listed equity.

Remuneration

£46,493

Average pay

The compensation reflects the value placed on the expertise of the board and the impact of the role they perform.

The average pay on the boards we surveyed is £46,493 per annum. According to Trust Associates Non-Executive Directors Fees Review, remuneration across the wider Investment Trust sector has risen by an average percent increase of 6.9% from 2022-23 where across the companies surveyed in the sector it averaged out at £30,000 per annum. It was interesting to see that average remuneration was considerably higher for REIT NEDs vs the wider Investment Trust sector, perhaps a by-product of this being a specialist part of the market and as a result there being a smaller candidate pool to recruit from.

NEDs are expected to manage corporate governance and risk and as a result of increased risk and responsibility (workload and liability), in an inflationary climate, their compensation is likely to rise further.

Final Thoughts

It is evident that there will be further change in the sector despite the challenging fundamentals. The serious lack of institutional and wealth management investment across the closed-ended sector will continue to be problematic. The retail community is vital to the sector but replacing wealth management with opaque demand through platforms, who themselves are reluctant to host some closed-ended funds, has its own difficulties, so it will be interesting to see how this plays out. With private equity back in the market, a further flurry of deals could be on the horizon which will change the face of the sector. It will be fascinating to see how leadership navigates through these choppy waters. Our research demonstrates that there is definitely scope to inject new perspectives at the top table. This is going to be vital to ensure REITs capitalize on market opportunities and remain relevant to the emerging demographic of investors.

About Us

1. **We are a partner** owned business. We lead every search and adopt a partnership approach to each engagement.
2. Founded in 2004, we are dedicated to investment management **across the EMEA region**.
3. We are a **leading search boutique** in the investment management area, with an **outstanding global network** and a database of more than 52,000 front office professionals.
4. We have **no shareholders** to service – our **clients come first**.
5. Given our size, we can offer our clients **flexibility** for each engagement.
6. We have a **small and controlled off-limits list** compared to larger firms, allowing us **greater access to the talent** market.
7. Reputation for Diversity appointments.
8. Market leader for **Team Lifts**.

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100+ Collective Years of Asset Management Search Experience

Team of **7** dedicated to Investment & Wealth Management

The Authors

Sarah Olashugba

Executive Search Analyst

Sarah is instrumental in capturing key market news and maintaining our expanding information database. As a Business Management student set to graduate this summer, Sarah is enthusiastic about acquiring new skills and knowledge that will enrich her professional journey.

Amanda Floyd

Partner, Investment Management

Amanda is a Partner at Valentine Thomas, with 15 years' international headhunting experience across the investment management and real assets sectors. Amanda has built up an impressive international track record and client portfolio across Europe, the US, Asia and the Middle East.

Amanda works on a cross-asset class basis, spanning both traditional and alternative asset classes with considerable experience across real assets investment (both real estate and infrastructure). She has extensive experience conducting board (executive and non-executive), investment, and distribution searches across a wide range of channels, as well as advising on succession and talent planning.

As a partner and ambassador of Women on Boards UK, Amanda is dedicated to bringing more female and diverse talent onto Boards and leadership teams and has been a leading industry voice on the need for more diverse representation on fund, pension and investment trust boards.

Amanda has in-depth sector knowledge of the investment market and holds the CFA accredited Certificate in Investment Management (IMC).

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Valentine Thomas & Partners is a leading investment and wealth management executive search firm covering the EMEA markets.