OAK INVESTMENT MANAGEMENT GROUP

FEBRUARY (2) 2012: Friction Costs in Real Estate

Costs of 'dealing' real estate assets are some of the most expensive for any asset class. In the UK, the cost of buying real estate above a threshold of £1 million is 5%. In Germany the transfer tax is payable on purchasing real estate of 3.5% or 4.5%. In France the rate is just under 5%. Either SDLT in the UK or transfer taxes in other European countries are on top of other forms of professional fees such as due diligence and conveyance that can add between 2% and 5 % to the all-in cost of buying the asset.

For small (typically owner-occupier residential purchases) there is very little that can be done to mitigate these costs. This is a 'lump it' situation for the individual owner, that makes the market as a whole much less efficient, less active and less volatile (within a lower and higher limit) or much more volatile (when it breaks through these limits) then it would otherwise be.

For bigger commercial (as well as very high value residential) interests in real estate, there are ways to mitigate these friction costs in real estate. One is to use an off-shore Special Purpose Vehicle (SPV) to own the underlying real estate – which contingent on strict criteria being met by identity of the buyer, the European country in which the real estate is located and from which the management operates can mean that a sale of this real estate is regarding not as an asset sale, but rather of the corporate entity that owns it. Savings can be substantial as transfer of shares are taxed much less than transfer of assets. In the UK the difference between the two respectively is 5.0% and 0.5%. Even with additional due diligence work for the lawyers which would be required this could already a substantial saving. Furthermore, this can go hand in hand with no capital gains tax as a result of the asset being held off-shore by a non-resident, non-domiciled owner.

There is a strong possibility that there will be a change to the rules governing such off-shore SPV structures in the forthcoming 2012 UK budget. The likelihood is that any innovation made by the Chancellor George Osborne would be assessed very closely by his European counter-parts, who have all become increasingly frustrated by the well developed mitigation techniques developed under the current rules. Though aimed at UHNWs this could have unintended but massive consequences on the commercial real estate industry, as the techniques used are essentially the same.

Another way to hold returns linked to real estate without the friction costs associated is through REITs, which though onshore have special privileges under the tax code contingent on strict criteria being met. The challenge which has hampered their development in Europe (as opposed to the USA) is that from the start in order for them to work well there needs to be a deep market. Because they did not do so, there is a shortage of regular demand which in turn hampers their value of bringing equity type liquidity to an alternative and illiquid asset class.

Real Estate is a capital intensive business, and is very visible both in terms of value as well as regular cash flow. As an asset class, therefore, it is an easy target for governments seeking to raise revenue. But for the real estate professional intimate knowledge of the rules, forward planning of corporate affairs and a disciplined investment management process can mitigate the worst.

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