Level playing minefield for tax

Property investors are taxpayers in some parts of Europe but not in others, forcing tax-paying real estate companies into more entrepreneurial and specialist activities

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"Having to pay taxes is a competitive disadvantage in real estate," according to real estate securities analysts at Goldman Sachs.

Any resident European taxpayer, corporate or individual, will hardly be shocked by this conclusion; after all, wouldn't we all be better off if we didn't have to pay taxes?

However, the conclusion, contained in a new report from Goldman Sachs, highlights that, far from operating on a level playing field, property investors across Europe are traipsing over a veritable moonscape of tax regimes.

And, the authors argue, tax-paying investors in property are distinctly disadvantaged. "Real estate is one of the few sectors where taxpayers compete for assets with non-taxpayers," the report notes. "Investment yields are driven down to a level at which only the most tax-efficient player will earn his cost of capital."

If a tax-paying investor owns shares in a €100 portfolio yielding 7 per cent, up to €7 can be distributed each year as income. But if that portfolio is subject to a 30 per cent income tax, investors can only receive €4.90. Whose shares would you buy?

With investors in listed securities now fully comfortable buying shares outside their home markets, what is to stop the inevitable drift of capital from states that tax property securities to those that do not?

And, given the myriad tax regimes on property securities throughout Europe, how can investors pick and choose between property securities listed on various bourses?

Tax-efficient vehicles are prevalent in the Netherlands and Belgium, and, to a lesser extent, France.

The UK, the analysts argue, offered a fairly tax-efficient regime up until 1997 with the abolition of advance corporation tax. Non-taxable investors then lost the ability to reclaim a 20 per cent rebate of ACT paid on dividends.

While the arithmetic of the argument is hazy it is clear that, after 1997, UK property shares became even less tax-efficient than they had been previously.

Moreover, when the effects of tax are taken into account in calculating return on capital employed (ROCE), they matter. On average, Europe's largest property companies see ROCE reduced by 11.3 per cent by tax leakage, with Dutch tax-efficient vehicles coming out on top.

Spain's Metrovacesa is Goldman Sachs' poster child for the effect of the tax hit, with a 26 per cent fall in ROCE through tax charges.

Separately, the analysts note that tax is not the only characteristic that makes sweeping judgments about value in property shares hard to make. The use of gearing varies widely not only from country to country but also within countries and by the most common measure of value – the discount at which a share trades when compared with its gross assets minus debt – is utterly ignored.

The maths goes something like this: two companies own portfolios with total assets of €100 and the shares of both trade at a 10 per cent discount to net asset value. Company A is ungeared but Company B borrows another €100 and invests in property. Its gross assets rise to €200 but NAV remains at €100.

Company A's shares remain at a 10 per cent discount to net and gross assets – €90 – but Company B's shares, at a 10 per cent discount to gross assets, would fall to €80. Company B then appears to be trading at a wider discount to NAV, suggesting either that its shares are a buy or that it is underperforming.

Indeed, the Goldman Sachs analysts argue, much of the criticism directed at British Land, focused on its above-average discount to NAV, is misplaced. Its discount is wider simply because it is more highly geared than most of its competitors. When discounts to gross assets are taken into account, British Land's shares are at one of the smallest discounts of any large UK property company.

Thus, differentials in the discount to NAV at which European property shares trade come down to tax and gearing. It is a neat theory but one that does not stand up under close scrutiny.

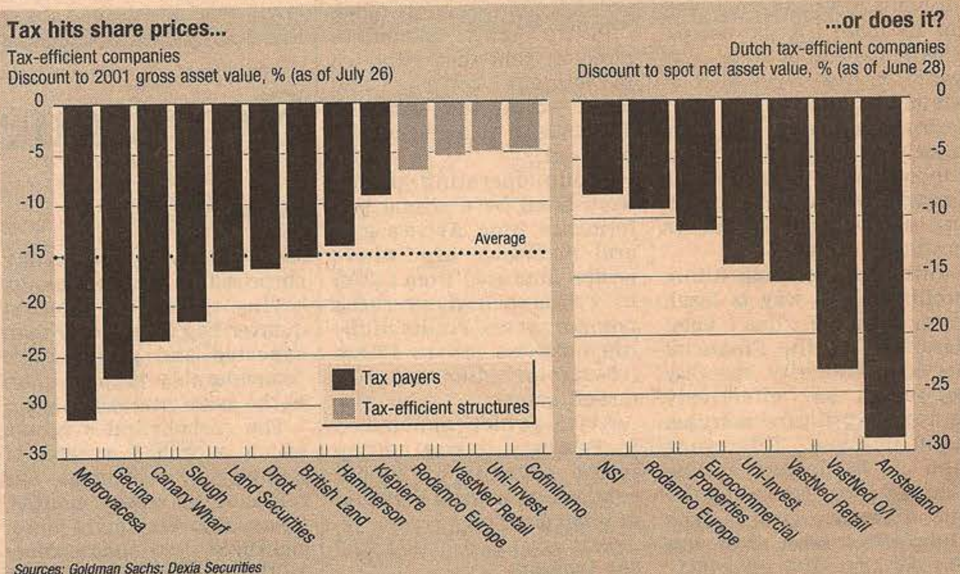
For example, while all Dutch companies have the same tax-efficient regime, companies as of June 30 were trading at discounts to NAV ranging between 8 and 29 per cent.

Gearing is limited by law to no more than 60 per cent of property assets, with most hovering around 40 to 50 per cent, according to Amsterdam-based Dexia Securities. Among those with higher gearing is Uni-Invest, trading at a discount of 14.2 per cent, among the narrower margins.

But even if individual company share price performance flies in the face of the Goldman Sachs theory, the new report does highlight some home truths facing Europe's quoted real estate sector.

Tax-paying entities need to be much more entrepreneurial, driving far higher rates of return out of the properties in which they invest, if they hope to compete for investment capital with non-taxpayers.

Bond-like property assets that will deliver cash but little capital uplift are for non-taxpayers only. "Tax-paying real estate companies should ultimately only engage in more entrepreneurial activities that are either too specialised or complicated or not allowed for most non-taxpayers, for example, developing, trading, services," the analysts conclude.



Sources: Goldman Sachs; Dexia Securities