A REIT by any other name

We examine the differences between AIC REITs and the other London-listed property companies...

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Analysts:
Thomas McMahon
+44 (0)203 795 0070

One of the sectors most damaged by the sharp and sudden hike of interest rates in 2022 was property. Property is generally bought for income, and so higher yields on government bonds put pressure on property valuations and on the share prices of Real Estate Investment Trusts (REIT) that own them. The last couple of years have seen a surge of corporate activity in the investment trust sector as a result. This can be seen from two perspectives: boards and managers responding to weak share prices and wide discounts to sell assets, or strategic and institutional investors taking advantage of a cyclical downturn to add to a portfolio. Either way, it has left a new landscape for the average REIT investor to navigate. Options for generalist commercial property exposure are now thin on the ground in the AIC sectors. As well as some mergers and some wind-ups, there has been an uptick in companies shifting their listing category while remaining REITs, switching from being categorised as funds, and having investment trust status, to becoming categorised as equities and property operating companies, thereby leaving the investment trust space and the AIC nest. In our view, the looming UK rate-cutting cycle means property should be becoming interesting again for the average investor. Here we ask whether investors should be restricting themselves to investment trusts for their exposure or looking outside the AIC, and what the pros and cons are of the two structures.

Rush for the exits

Supermarket Income REIT (SUPR) recently completed the internalisation of its management function and will shortly be reclassified as a property operating company rather than a fund. Without getting into the technical details too much (lawyers and accountants don't like clear language), the company will remain a REIT (or Real Estate Investment Trust) but no longer be considered a fund or, er, investment trust. For simplicity's sake, we will refer to the two types of REITs as AIC REITs and non-AIC REITs. The board of Urban Logistics REIT (SHED) proposed the same course of action as SUPR, to leave the AIC universe and switch from being a fund and an AIC REIT to a non-AIC REIT, although this saw some pushback from major shareholders. SHED has since agreed to sell itself to LondonMetric instead, a property operating company and non-AIC REIT. Last year we saw Tritax EuroBox, an AIC REIT, follow a similar course, being bought out by non-AIC REIT's Brookfield and Segro. So, these are three REITs leaving the investment trust sector one way or another, following several similar transactions in prior years. LondonMetric had previously bought LXi REIT and CT Property REIT, for example, thereby taking out two more AIC REITs.

This is a response by boards to what has been a tough time for alternative asset investment trusts in the past three years, with the rapid hike in interest rates over 2022 being the key factor. This reduced demand for high-yielding assets by the typical investment trust investor, leading to wide discounts emerging. Pressure on fees has also impacted alternative assets as AIC REITs have had to report Reduction in Yield figures—comprehensive sums of various costs which equity-classified REITs don't have to declare. While this legislation is currently being revisited, high look-through costs have driven away many professional investors whose offerings look more expensive if they include a fund rather than an operating company for property exposure. Meanwhile, the shuttering of open-ended property companies has also affected the closed-ended sector. Many investors will invest in both open-ended and closed-ended funds for property, and if they wish to reduce their exposure but their open-ended funds are hard-closed, their only option is to take advantage of the liquidity in investment trust shares and sell those.

It's easy to see why boards and managers might be willing to try another structure amidst this turmoil. For the typical investment trust investor, the question is what this alternative structure might offer them. Should they stick with the tried and tested AIC REITs, or are there opportunities in the non-AIC REITs that should be considered too?

Race to the summit

Let's first look at performance. Have equity property companies, i.e. non-AIC REITs delivered better or worse returns to shareholders? We created a combined peer group of the London-listed REITs of both types in Morningstar. The table below shows the best 20 performers from this super-sector over five years. Of these, the best four by share price total return, and seven out of the best ten, were actually AIC trusts. These haven't necessarily delivered the best returns from their portfolios, but the share price total return represents the gains investors can realise. One of the issues for investors in non-AIC REITs is tracking what the NAV or portfolio returns are. We discuss this in more detail below, but due to various tedious bits of plumbing in the information tubes, estimated NAVs and discounts won't be calculated and made easily available to investors.

It's interesting to note here that the top AIC trusts benefitted from significant discount narrowing over this period. While non-AIC REITs also calculate NAVs and one can track a discount or premium, we think the discount may be more important to investors' preferences and more impactful on the share price in the AIC space, where the data is more readily available and where investors are trained to take it into consideration. Certainly, all commercial property was significantly out of favour in 2020 as the country shut down, and so the share prices of REITs of both flavours should have benefitted from an improvement in sentiment over the period.

Five-Year Performance (%)

	INDUSTRY	ASSOCIATION OF INVESTMENT COMPANIES (AIC) SECTOR	AIC MEMBER	5-YEAR SP TOTAL RETURN (ANN.)
AEW UK REIT		Property - UK Commercial	Yes	17.9
PRS REIT		Property - UK Residential	Yes	13.6
Schroder Real Estate		Property - UK Commercial	Yes	11.9
Care REIT		Property - UK Healthcare	Yes	10.6
Palace Capital	REIT - Diversified			10.0
NewRiver REIT	REIT - Retail			9.8
Warehouse REIT		Property - UK Logistics	Yes	9.4
Tritax Big Box		Property - UK Logistics	yes	9.3
Value and Indexed Property Income		Property - UK Commercial	Yes	8.9
Empiric Student Property	REIT - Residential			8.4
Urban Logistics REIT		Property - UK Logistics	Yes	7.3
British Land Co	REIT - Diversified			6.8
Schroder European Real Estate Investment Trust		Property - Europe	Yes	6.8
LondonMetric Property	REIT - Industrial			5.8
Land Securities Group	REIT - Diversified			5.2
Town Centre Securities	REIT - Diversified			3.7
Target Healthcare REIT		Property - UK Healthcare	Yes	3.6
Real Estate Investors	REIT - Diversified			3.5
UNITE Group	REIT - Diversified			2.7
Safestore Holdings	REIT - Industrial			2.3

Source: Morningstar

Past performance is not a reliable indicator of future results

One of the reasons for the top performers being AIC REITs is corporate action. The board of PRS REIT (PRSR), for example, has announced a strategic review and is considering offers to acquire the company. The shares surged in the second half of last year as this process came into view. Care REIT (CRT), meanwhile, was acquired by US peer CareTrust REIT (CTRE) earlier this month. Clearly, there are strategic and institutional buyers who see a lot of value in the share prices of the AIC trusts. We think it is important to note that asset sales after these transactions validate the prices paid. For example, LondonMetric announced last week it had sold some of the assets it acquired in the LXi REIT transaction at a price above those implied by their acquisition. So it was not just one institutional investor seeing the value implied by the LXi share price pre-acquisition as being far too low.

Looking over a five-year period means looking back to pretty much the nadir of the first COVID lockdowns when it was unclear how and when economies would reopen, and so the future of commercial property was highly uncertain. A ten-year period might be a more normalised time frame to consider. The table below shows the top performers over a decade have been almost exactly evenly split between the two types of REIT. In fact, the key driver of returns seems to be sector rather than structure. Over the past ten years, it has been the logistics and industrial-focussed REITs that have led the market, whatever the structure. They have benefitted from some secular trends in the economy which have pushed retail online and physical retailing into larger stores closer to transport infrastructure. Turning back to the five-year table, we highlight that the retail and or broader commercial property trusts outperformed, reflecting the fact they were hardest hit by the lockdowns. So, the value sectors have outperformed most recently but the growth sector for over a decade.

Ten-Year Performance (%)

	INDUSTRY	ASSOCIATION OF INVESTMENT COMPANIES (AIC) SECTOR	AIC MEMBER	10-YEAR SP TOTAL RETURN (ANN.)
Safestore Holdings	REIT - Industrial			11.0
Segro	REIT - Industrial			8.9
Big Yellow Group	REIT - Industrial			7.3
Tritax Big Box		Property - UK Logistics	Yes	6.5
LondonMetric Property	REIT - Industrial			6.3
UNITE Group	REIT - Diversified			6.0
Target Healthcare REIT		Property - UK Healthcare	Yes	4.9
Primary Health Properties	REIT - Healthcare Facilities			3.3
Schroder Real Estate		Property - UK Commercial	Yes	3.1
Value and Indexed Property Income		Property - UK Commercial	Yes	2.3
Custodian Property Income REIT		Property - UK Commercial	Yes	2.3
Empiric Student Property	REIT - Residential			2.2
Assura	REIT - Healthcare Facilities			2.1
Picton Property Income	REIT - Diversified			1.7
Palace Capital	REIT - Diversified			0.2
Real Estate Investors	REIT - Diversified			-0.9
Derwent London	REIT - Office			-3.3
British Land Co	REIT - Diversified			-3.5
Town Centre Securities	REIT - Diversified			-3.7
Workspace Group	REIT - Office			-3.8

Source: Morningstar

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What we take from these tables is that there is no reason for investors to fear their AIC trusts moving to the other side as a negative sign for returns, but equally it isn't obviously going to give a boost based on the historical track record. What about diversification? One reason for investing in real assets like property is to generate returns with lower correlation to equity markets. It is definitely true that the correlation of the share prices of the non-AIC REITs has been higher to the FTSE All Share than the AIC REITs. The difference is significant and appears over both five- and ten-year time frames—the table below is ordered by five-year correlation, high to low. In the interests of space and readability, we again show the highest 20 once more, which is enough to make the pattern clear. The reader will have to take our word for it that eight of the lowest ten correlation scores over five years came from AIC trusts and ten out of ten looking back a decade. The higher correlation may be explained by the commercial property companies appearing in the ex-investment trust indices that most passive and indeed active funds will use. There is also perhaps an element of different shareholder bases: if AIC REITs are being bought by investors as real assets and investment decisions are being made on that basis, then it stands to reason that share prices might perform differently than those of companies being treated as equity investments. We think it is striking and even a little surprising that the share prices of AIC REITs have this diversification benefit because it is a common argument raised against real asset investment trusts that by being listed, they bring equity beta and so dilute the diversification benefit. Diluted it may be, but it is still clearly there.

Correlation Of REITS To UK Equities

	INDUSTRY	ASSOCIATION OF INVESTMENT COMPANIES (AIC) SECTOR	AIC MEMBER	5-YEAR SP TOTAL RETURN (ANN.)	10-YEAR SP TOTAL RETURN (ANN.)
UNITE Group	REIT - Diversified			0.87	0.84
Land Securities Group	REIT - Diversified			0.86	0.85
British Land Co	REIT - Diversified			0.85	0.84
Derwent London	REIT - Office			0.80	0.72
Shaftesbury Capital	REIT - Retail			0.76	0.75
Hammerson	REIT - Retail			0.75	0.75
LondonMetric Property	REIT - Industrial			0.75	0.75
Great Portland Estates	REIT - Office			0.74	0.72
Empiric Student Property	REIT - Residential			0.74	0.72
Urban Logistics REIT		Property - UK Logistics	Yes	0.73	
Primary Health Properties	REIT - Healthcare Facilities			0.73	0.58
Tritax Big Box		Property - UK Logistics	Yes	0.72	0.72
CLS Holdings	REIT - Office			0.71	0.68
Supermarket Income REIT		Property - UK Commercial	Yes	0.69	
Segro	REIT - Industrial			0.68	0.69
Workspace Group	REIT - Office			0.68	0.73
Value and Indexed Property Income		Property - UK Commercial	Yes	0.68	0.75
Town Centre Securities	REIT - Diversified			0.64	0.67
Assura	REIT - Healthcare Facilities			0.64	0.67
Big Yellow Group	REIT - Industrial			0.63	0.62

Source: Morningstar

Past performance is not a reliable indicator of future results

Head-to-head

There's no question that looking outside the AIC sectors will bring a lot more options to the table, which is in itself a good thing. But what other advantages are there of fishing in this larger pool?

Positives of non-AIC REITs

A potential advantage of the non-AIC structure is cost-cutting, which is a reason often cited by REITs proposing to convert, including SUPR. It is more of a benefit for larger REITs which can bear fixed costs more easily, as a smaller company will be harder-pressed to pay for the various front- and back-office costs without impacting net income. In a way, the analogy is with asset management. An asset management company can fairly easily absorb or launch new funds while adding few if any new personnel, with the costs of running the funds borne by existing teams and functions. Profitability, therefore, increases as AuM does. Similarly, a REIT that can purchase new portfolios from other REITs can strip out management and other roles and absorb lots of the costs via their existing spend. That said, while scale is beneficial, we hear often from peers in the space that **Picton Property Income (PCTN)**, a relatively small commercial property REIT, runs a very tight ship on costs.

This may be thanks to the greater alignment of interests between manager and shareholders which comes from PCTN being internally managed, meaning the managers are employees of the company, not external contractors. Any externally managed REIT is required to be an AIC REIT. However, an internally managed REIT can choose to be a non-AIC REIT, as PCTN has.

This means that non-AIC REITs are always internally managed. We think the advantages are intuitive: the chief executive, or manager, has no other role than managing the company so it makes sense for him or her to sit on the board, and it is normal in the equity markets for the CEO to have a place on the board alongside independent directors.

Financially, CEO compensation will likely be linked to share price performance too, which is often not the case with AIC REITs, as performance fees are unfashionable these days. This means there is arguably a greater incentive for the CEO/manager and other company employees to cut costs elsewhere in the business if there is a direct link to their compensation rather than them being covered by contracts with the board and separated from the management fees. And we know that PCTN, for example, ensures its dividend is covered before calculating any bonus pool, which externally managed AIC REITs don't do. Meanwhile, some managers we speak to argue that external managers are incentivised to grow the portfolio rather than take a balanced view as to what is right for the company, thanks to the flat percentage fee which rises in pounds and pence as the size of the portfolio does. Finally, the CEO/manager of a self-managed REIT will have only one portfolio to run, unlike those hired to run AIC REITs which typically will run a number of portfolios to a similar strategy and may have other research management or operational duties to their employer, the fund management group.

There is also the benefit of potentially greater liquidity. This may come at the expense of diversification, looking at the numbers above, but greater passive participation and presence in the benchmarks of active managers should mean there is a broader set of potential shareholders. This could in theory reduce bid/offer spreads and even lead to lower discounts to NAV.

Negatives of leaving the fund space

On the negative side, a lack of data is a major issue for the average investor, and certainly for retail. Being classified as an equity rather than a fund will mean leaving the AIC sector. It will also mean reclassification by Morningstar, which provides data behind the majority of sites that serve investment trust investors. Daily NAVs and discounts are therefore not likely to be calculated, displayed, and graphed, and finding out the current discount to NAV will be an investigative exercise in itself. A quick Google of some of the non-AIC REITs such as PCTN reveals extremely out-of-date NAVs and discounts being displayed on trusted sites. Investing in non-AIC REITs requires much greater research and self-reliance.

That said, REITs will generally publish EPRA figures for various metrics including NAVs. These are very well-defined and comparable and give investors the essential information they want. Importantly for an investor in funds, the EPRA earnings figure will show what the operational earnings from the portfolio are after deduction of interest costs and management costs. This is a pretty handy estimate of the cash cover of the dividend and won't be affected by the sorts of costs or gains that net income—as calculated for a typical listed company—would, most importantly fair value gains or losses in the value of the property portfolio.

It is also harder for investors to understand the cost burden on their investment in a non-AIC REIT. AIC REITs publish ongoing charges figures (OCFs) which give percentage figures of the costs incurred. There is a clear definition of what should be included, meaning that comparison between REITs is easy. The costs for a non-AIC REIT will have to be interpreted from the income statement. Given the flexibility of accounting rules, it is harder for a non-professional to be sure of exactly what they are reading, and the different lines may not always be entirely equivalent. While the EPRA cost ratio is provided by non-AIC REITs, this is expressed as a percentage of gross rental income rather than net assets, so is not directly comparable. PCTN is an exception in publishing its own, different, Cost Ratio which is analogous to an AIC REIT's ongoing charges figure, a legacy of its past as an AIC REIT. But this is not available for the other non-AIC REITs.

AIC REITs must have an independent chair and a majority of non-executive directors must also be independent. The same requirement does not apply to non-AIC REITs, which follow governance codes that apply to UK companies. We believe that fully independent boards can add real value at times, focussing on shareholder value and considering the strategic direction of the company. AIC REITs are required to publish investment strategies, and the board can play a role in ensuring this is being adhered to. There are risks in a board being too close to the manager, and the controversy at SHED highlights one potential contentious point. At SHED, activist investor Achilles argued the deal between board and manager was too generous regarding its proposed new strategic direction. It's an interesting question as to whether an internal or external manager is more likely to be replaced if performance is poor. While we do believe that independent boards play an important role in scrutinising the managers of investment trusts, it is not as if CEOs being sacked is unknown in the broader equity market. What can't easily happen is the swift and wholesale transfer of management to a whole other management company with its own resources and infrastructure.

Conclusion and outlook

We think property looks intriguingly out of favour, even if there are plenty of reasons to be wary, as there always are near market bottoms. Commercial property is GDP-sensitive, and growth remains low in the UK. The economy needs less office space and town centre retail than it did ten years ago, while environmental regulations are providing threats and opportunities. But we think we may be past the point of maximum pessimism, and with more rate cuts to come in the UK, the outlook is positive. We note that share prices have quietly been advancing, with **Schroder Real Estate (SREI)** shares up 21% over the past 12 months, yet still trading on a 20% discount to par. Meanwhile, the economy still needs lots more logistics space, data centres, and housing, all of which areas have strong potential for income growth and capital values. It's interesting to note that Marcus Phayre-Mudge, manager of **TR Property (TRY)**, which can invest in both AIC and non-AIC REITs as well as their European equivalents, has been running with a high level of gearing in recent months, which was at 17% at the end of March.

In our view, investors with a total return perspective shouldn't limit themselves to considering AIC trusts, even if they will have to get out of their comfort zone a little to consider non-AIC REITs. We think the managers of non-AIC REITs will be much more focussed on the share price, whereas with an AIC REIT, the manager will largely leave this matter to the board and focus on the portfolio. In a recovery period, this could help boost returns, and we think that with property portfolios trading at discounts across the two types of REIT, it might be attractive for all minds to be focussed on the share price. It's particularly interesting to note TRY's largest holding at the moment is LondonMetric, the acquirer of many AIC trusts' cheap portfolios. This means Marcus and his team are another institutional investor that sees attractive returns in the post-sales price, not just the pre-sale price—i.e. that these assets are attractive from a growth perspective, not just based on the cheapness implied by the AIC trusts' discounts. TRY itself is an investment trust, and trades on an 8% discount at the time of writing, so there is an added layer of value there too.

AIC trusts have some advantages that shouldn't be forgotten. In particular, we think they are likely to provide more diversification within a multi-asset portfolio than a non-AIC REIT. Investors looking for income and steadier performance may therefore find the AIC trusts a better option. SREI, mentioned above, is one of few remaining AIC trusts with a generalist approach. It trades on a discount of 20% at the time of writing and yields 6.5%. You can watch a recent presentation with the managers **here**. Ultimately, though you can't eat diversification, and the aim of investment is to generate returns to consume one thing or another in good time. While there is growth potential in the AIC REITs, particularly given current discounts, we think non-AIC REITs can be a powerful element in delivering these returns, but investors will need to have different expectations regarding risk and correlation and a greater capacity to do research to properly take advantage.

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