

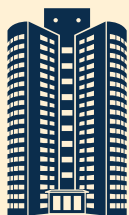


Note by EIC

7 August 2014



Foreign REITs – The Model for REIT Market Development in Thailand



Highlight

- Global REIT market capitalization is on the rise, owing to the fact that many countries have established REIT regimes. Thailand can use foreign REIT practice as a model to develop our REIT market, especially issues related to REIT management fees, debt financing, and performance evaluation and comparison.
- EIC believes that good corporate governance, including operating transparency and the prevention of conflicts of interest, will be important factors in enhancing investor confidence and driving the REIT market in Thailand to sustainable growth.

Global REIT value is on the rise, with many countries establishing REIT regimes. Real Estate Investment Trusts, or REITs, were first created in the United States in 1960. Since then, more than 30 countries around the world have established REIT regimes and formulated REIT legislation. Currently, total global REIT market capitalization is valued at more than USD 1 trillion, accounting for 2% of total global stock exchange market capitalization. The US has the largest REIT market, followed by Japan, Australia, UK, Singapore, and Hong Kong. When global REITs were affected by the subprime mortgage crisis and the economic crisis of 2007-2008, REIT values declined immensely in line with stock markets around the world. However, global REIT markets experienced a great recovery after 2009, especially in Asia, where they enjoyed a quicker comeback than in the US and Europe (Figure 1). In Thailand, REITs are covered by a set of regulations under The Trust for Transactions in Capital Market Act B.E. 2550. EIC believes that the Act and regulations implemented by the Securities and Exchange Commission (SEC) in Thailand are similar to regulations in Japan, Hong Kong, and Singapore, enabling Thailand to use those models as a framework in developing the market (Figure 2).

According to further study of foreign REITs, EIC believes there are four important factors for successful REIT establishment and management. Areas that REIT founders and managers should consider thoroughly in order to formulate frameworks and communication to enhance investor confidence are outlined as follows:

1. Management Structure : Who will take the role of REIT manager and trustee? What are REIT manager and trustee responsibilities? What are the fees for REIT managers and related parties?
2. Capital Management : What are the leverage policy for REIT? Should it be for short-term debt financing in order

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to acquire new assets, or long-term debt as a source of capital? What is the debt-to-total-capital ratio?

3. Asset Portfolio Management : Does the REIT specialize in owning certain building types, such as retail, office, residential, or industrial? Or is it a diversified REIT? Will the manager consider investing in assets abroad?

4. Corporate Governance : This includes risk management for investment, preventing conflicts of interest, internal regulations, asset valuation, and complaint and dispute resolution.

1) Foreign REIT frameworks can be studied and used as a guideline for REITs in Thailand, especially in REIT manager's compensation.

Foreign REITs use various methods for management compensation (Figure 3). For example, they can be paid based on asset value ratios, variations based on property income, or performance related fees. In some cases, management fees are also paid based on the REIT's acquisition or disposition value. The reason the management fee is paid in accordance with a REIT's actual operating income or performance is to encourage REIT managers to employ active management strategies. EIC believes that management fees that are paid based on performance fees - calculated from net profit by taking into account the cost of debt - should persuade REIT managers to focus more on protecting the benefits of unit holders and avoiding excessive interest expenses.

2) Capital management by means of debt financing for REITs must be carefully exercised. Debt can cause higher volatility of unit trust value.

One of additional features when converting from a Property Fund to a REIT is that a REIT can have more borrowed capital. A Property Fund can borrow up to 10% of total assets, whereas REITs can borrow up to 35% of total assets or 60% if the REIT is investment grade. This change brings the important question of whether or not a REIT should borrow. There are three factors to consider in answering this question.

- Comparison of average debt-to-total-capital ratios of Asian REITs indicates that Japan has a higher debt-to-total-capital ratio than Hong Kong and Singapore. This can be explained by the fact that Japan has a low capitalization rate of around 2.4% (Figure 4). Therefore Japanese REITs are more leveraged in order to increase dividend yields. However, a high level of financial leverage can result in greater REIT price volatility (explained in Figure 5). Statistics show that returns for Japanese REITs fluctuate more than REIT returns in Singapore and Hong Kong (Figure 4 by comparing monthly return standard deviation).
- REITs are exempt from corporate tax; therefore there is no benefit to create debt for tax shielding purposes. In other words, REITs enjoy no tax advantages from debt financing, unlike other taxable businesses.
- Studies show that REITs with high debt-to-equity ratios will have higher financial distress costs¹. During the subprime mortgage crisis, real estate and REIT values declined, forcing REITs with high debt-to-equity ratios to divest assets at low prices and raise capital on stock markets at high cost in an attempt to pay off

¹ Sun, L., Titman, S. D. and Twite, G. J. (2014), REIT and Commercial Real Estate Returns: A Postmortem of the Financial Crisis. Real Estate Economics.

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interest and loan capital. Looking at overall performance after the markets recovered from the crisis reveals that REITs with high debt-to-equity ratios had lower returns than those with low debt-to-equity ratios.

According to these three findings, EIC believes that although leveraging is a financing method that can result in higher dividend yields and attract investors, it also means greater price risks for REITs. Therefore, debt financing for REITs must be implemented wisely to avoid higher price volatility, which could lead to losing investors who have low tolerance for investment risks. REIT managers who wish to raise capital through debt financing instead of equity might do it with appropriate market timing. Debt should be created when the cost of debt is low or during times when the stock market is weakening and the cost of equity therefore high².

Due to the fact that REITs are able to borrow, it is best to rely on a REIT's asset yield ratio when examining its performance. Property Fund regulations allow only up to 10% in total asset borrowing, which is not a very high loan percentage. As a result, dividend yields are similar to asset yield ratios. Comparison of Property Funds that have similar assets based on dividend yield is fairly acceptable, however, this is not the case for REITs. REITs with high leverage usually have a high dividend yield but also higher price fluctuation. Thus, REITs should be examined based on asset yield ratio. The method widely used internationally is to consider Funds from Operations: (FFO)³, which measures how much cash is generated by a REIT's asset portfolio. Investors are advised to analyse REITs by examining the FFO to total asset ratio and then considering the capital structure, such as the debt-to-capital ratio. REITs with a high debt-to-capital ratio are suitable for yield-oriented investors who are able to handle greater risks.

3) REIT managers can exercise good asset portfolio management to create more value for REITs. Acquiring additional assets is not very common for Property Funds, however, a REIT manager will play a more fruitful role in implementing strategies and acquiring high yielding assets for REITs. Large REITs, mostly in Japan, Hong Kong, and Singapore, usually have a higher number of projects (Figure 6). Investors often expect the REIT manager to implement effective asset management by means of acquisition, divestment, or development, or to enhance the value of assets to maximize REIT value.

Cross-border acquisition of REIT markets in Asia is expected to rise. It is interesting to note that Singaporean REITs are rather large, despite domestic assets being limited and too costly to be acquired by REITs. Some Singaporean REITs are investing in assets in other countries, especially in China, increasing the diversification of Singaporean REITs' portfolio (Figure 7). EIC holds the view that there are signs that cross-border acquisition of REIT markets in Asia are on the rise, owing to the fact that assets in some countries, such as Singapore and Hong Kong, are very expensive.

4) Good corporate governance is an important driver that will help drive REIT markets in Thailand towards sustainable growth. Several case studies of Asian REITs reveal that potential conflicts of interest

² Cost of equity is the summation of risk-free rate and equity risk premium. During times when the stock market is weakening, the cost of equity is high because general investors become more risk averse and demand higher equity risk premium to compensate for taking higher risk in equity investment.

³ According to the accounting standard, firms may not be required to disclose Funds from Operations. Still, practitioners can calculate Funds from Operations using the formula: Funds from Operations = Net Income + Depreciation + Amortization - Gains on Sales of Property

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usually arise from weaknesses in governance practices. This is because in Asian markets, REIT managers, sponsors, and major shareholders are sometimes related, or often have different and occasionally conflicting interests. For example, when REIT sponsors are also major shareholders or when a sponsor's subsidiaries take roles as REIT managers. Conflicts of interest can lead to unfavorable impacts for minority shareholders if REIT managers acquire overpriced assets from sponsors or divest underpriced assets to sponsors. This relationship between REIT managers and sponsors can affect investor confidence. In addition, some studies show that strong corporate governance has a positive correlation to REIT performance⁴. In the past, there were not many property fund acquisition and divestment transactions, hence corporate governance structures were often neglected. This should not be the case for REITs, as they are likely to face more acquisition and divestment transactions. EIC is of the opinion that initiating good corporate governance at an early stage will be essential for successful REIT markets in Thailand, especially in safeguarding the benefits of minority shareholders. Important practices include creating a strict set of rules regarding trustee roles and responsibilities in preventing conflicts of interest, formulating fair practices that allow minority shareholders to raise issues against transactions that are not beneficial for a REIT, and enforcing transparent and fair valuations when high value assets are being priced for the purpose of REIT acquisition or divestment. Although these practices are not legal requirements, both regulators and relevant parties should encourage the following of these practices for their mutual benefit.

Implication

- **Successful REIT market development will benefit the real estate industry and economy.** REIT markets in many countries in Asia, such as Japan, Hong Kong, and Singapore help nurture the real estate industry and the domestic economy⁵. This is because diversifying from real estate into investment assets in the form of REITs makes investment more convenient and promotes liquidity, which helps enhance asset value. In Thailand, the idea of capitalizing real estate into financial instrument is not a new trend, as property funds have been established for quite some time. However, conversion to REITs may take the participants some time to understand different regulations and practices. EIC believes that REITs will eventually receive good feedback from real estate entrepreneurs and investors.
- **The major framework for successful REIT market development and management is to build investor confidence.** Successful REIT market development can be achieved through many elements, such as good quality assets, REIT management that possesses proper asset management skills; and investors that provide liquidity. EIC insists that good corporate governance, maintaining transparency, and the prevention of conflicts of interest are important factors in boosting investor confidence and driving the REIT market to achieve sustainable growth.

⁴ Sing, Tien Foo (2013), Does Corporate Governance Matter for REITs? – Re-Examining 'The REIT Effect'

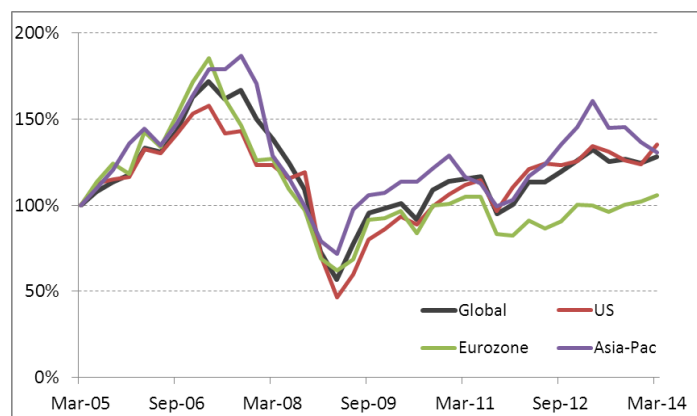
⁵ Atchison, Yeung (2014), The Impact of REITs on Asian Economies. Asia Pacific Real Estate Association

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Figure 1: Performance of REITs by region



Remark: Base date = March 2005

Source: EIC analysis based on data from Bloomberg

Figure 2: Comparison of REIT regulations in Thailand, Japan, Hong Kong, and Singapore

| | Japan | Hong Kong | Singapore | Thailand |
|-------------------------------|--|---|--|--|
| Regulatory Body | FSA | SFC | MAS | SEC |
| Main governing law | Code on Real Estate Investment Trusts and Securities and Futures Ordinance (SFO) | Financial Instruments and Exchange Law, Investment Trust and Investment Corporation Law | Code on Collective Investment Schemes—Property Fund Guidelines, Securities and Futures Act (SFA) | Trust for Transactions in Capital Market Act B.E. 2550 (2007) and Securities and Exchange Act B.E. 2535 (1992) |
| REIT Legal Structure | Unit Trust or Corporate (all listed on stock exchanges are corporate) | Unit Trust | Unit Trust or Corporate (generally trusts in practice) | Trust |
| Management Structure | External | Internal / External | External | Internal / External |
| Mandatory Listing on Exchange | No | Yes | No, but due to tax treatment, all current S-REITs are listed | Yes |
| Geographic Restrictions | No | No | No | No |
| Percent of Real Estate Asset | At least 70% | Only allowed to invest in income-generating real estate | At least 75% invested in income-producing real estate | At least 75% invested in income-producing real estate |
| Real Estate Development | Restricted | No | <10% | <10% |
| Gearing Restrictions | No | <45% | <35% | <35% and <60% for investment grade credit rating |
| Dividend Payout Ratio | ≥90% | ≥90% | ≥90% | ≥90% |

Source: EIC analysis based on data from CFA Institute and European Public Real Estate Association

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Figure 3: Examples of REIT management compensation in foreign markets

| | Nippon Building Fund Inc (Japan) | Champion REIT (Hong Kong) | Capita Commercial Trust (Singapore) |
|-----------------------------------|--|---|--|
| Base fee | 2.50% per year based on rental income | 12% of net property income (NPI) per year as long as NPI each half year is at least HK\$200 million | 0.1% per year of the value of the deposited property |
| Performance fee | 3% per year on profit | None | 5.25% per year of net income |
| Acquisition fee | Variable depending on acquisition price; maximum of 0.5% | Up to 1% of the acquisition price | 1% of the acquisition price of property acquired |
| Disposal or Divestment fee | None | Up to 0.5% of the sale price | 0.5% of the sale price of the property divested |

Source: EIC analysis based on data from CFA Institute

Figure 4: Comparison of REITs in Japan, Hong Kong, and Singapore

| | Japan | Hong Kong | Singapore |
|--|-------|-----------|-----------|
| Cap Rate | 2.4% | 2.8% | 3.9% |
| Dividend Yield | 4.1% | 5.5% | 6.4% |
| Debt-to-Total-Capital ratio | 48.4% | 26.3% | 34.9% |
| Monthly Return Standard Deviation | 21.2% | 16.8% | 18.5% |

Remark: $\text{Cap Rate} = \text{Operating Income} / \text{Total Capital}$

Cap Rate, Dividend Yield and Debt-to-Total-Capital ratio is as of 06/06/2014

Monthly return Standard Deviation are calculated from TSE REIT Index, FTSE Strait Times Real Estate Index and Hang Seng REIT Index during 01/2009 – 05/2014

Source: EIC analysis based on data from Bloomberg

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Figure 5: Explanation of how higher leveraged REIT will have higher price volatility

- Compare REIT A and REIT B. Assume both REITs have annual net operating income of Bt 100 mn. REIT A has no debt, while REIT B has Bt 200 mn debt.
- Both REITs have similar asset quality and income growth rate. Assume the same cap rate for both REITs at 10%.⁶
- Asset value of each REIT can be computed as net operating income divided by cap rate or = Bt 100 mn / 10% = Bt 1 bn.
- As REIT A has no debt, equity value of REIT A should be Bt 1 bn. Since REIT B has Bt 200 mn debt, its equity value should be Bt 800 mn.
- Suppose both REITs' incomes are lower. Assume net operating income decrease by 20% from Bt 100 mn to Bt 80 mn. Fair asset value of each REIT should decrease to Bt 80 mn / 10% = Bt 800 mn.
- As REIT A has no debt, new equity value should be Bt 800 mn or decrease by 20%. For REIT B, which has Bt 200 mn debt, new equity value should be Bt 600 mn or decrease by 25%.
- This scenario analysis shows that when two similar REITs experience the same percentage of lower net operating income, REIT with higher debt-to-capital will have larger decline in equity value. In other words, for REITs that have similar assets, the one with higher leverage will have higher price volatility.

| | REIT A | REIT B | | REIT A | REIT B | Remark |
|---------------------------|--------|--------|---|--------|--------|---|
| Net Operating Income | 100 | 100 | ⇒ | 80 | 80 | |
| Cap rate | 10% | 10% | | 10% | 10% | |
| Asset Value | 1,000 | 1,000 | | 800 | 800 | Asset value = Net operating income / Cap rate |
| Debt | 0 | 200 | | 0 | 200 | |
| Equity Value | 1,000 | 800 | | 800 | 600 | Equity value = Asset value – Debt |
| Equity value decreased by | | | | 20% | 25% | |

Source: EIC analysis based on data from Alpen Capital and Pew Research Center

Figure 6: Type, quantity, and size of REITs in Japan, Hong Kong, and Singapore

| | Japan | Hong Kong | Singapore |
|---------------------------|-------|-----------|-----------|
| Hotel & Resort REITs | 2 | 2 | 4 |
| Retail REITs | 4 | 3 | 7 |
| Office REITs | 12 | 3 | 5 |
| Diversified REITs | 14 | 3 | 3 |
| Industrial REITs | 4 | 0 | 7 |
| Residential REITs | 9 | 0 | 2 |
| Health Care REITs | 0 | 0 | 2 |
| Total REITs | 45 | 11 | 30 |
| Total Market Cap (USD bn) | 79.8 | 23.8 | 48.2 |

Remark: Market Cap is as of 06/06/2014

Source: EIC analysis based on data from Bloomberg

⁶ Cap rate can be implied as the cost of capital less income growth rate. According to Modigliani-Miller Proposition 1, for non-taxable entity like REIT, the cost of capital cannot be reduced by debt financing. Therefore, for two REITs that have similar asset type and income growth rate, cap rate should be the same.

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Figure 7: The 5 largest REITs in Japan, Hong Kong, and Singapore by Market Cap

| Country | REIT Name | Market Cap (USD mn) | Number of Properties | Property Type | Dividend Yield |
|-----------|-------------------|---------------------|----------------------|-------------------|----------------|
| Japan | NIPPON BUILDING | 8,175 | 71 | Office REITs | 2.9 |
| | JAPAN REAL ESTAT | 7,025 | 64 | Office REITs | 2.7 |
| | JAPAN RETAIL FUND | 5,006 | 76 | Retail REITs | 3.6 |
| | UNITED URBAN | 3,714 | 97 | Diversified REITs | 3.5 |
| | NIPPON PROLOGIS | 3,424 | 20 | Industrial REITs | 2.5 |
| Singapore | CAPITAMALL TRUST | 5,622 | 14 | Retail REITs | 5.1 |
| | ASCENDAS REAL ES | 4,668 | 105 | Industrial REITs | 5.8 |
| | CAPITACOMMERCIAL | 3,851 | 10 | Office REITs | 5.0 |
| | SUNTEC REIT | 3,554 | 10 | Diversified REITs | 5.2 |
| | KEPPEL REIT | 2,855 | 10 | Office REITs | 6.2 |
| Hong Kong | LINK REIT | 12,236 | 182 | Retail REITs | 3.8 |
| | HUI XIAN REIT | 2,827 | N/A | Diversified REITs | 7.2 |
| | CHAMPION REIT | 2,749 | 2 | Office REITs | 5.7 |
| | FORTUNE REIT | 1,622 | 17 | Retail REITs | 5.3 |
| | YUEXIU REAL ESTA | 1,318 | 6 | Retail REITs | 7.3 |

Source: EIC analysis based on data from Bloomberg

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