

REAL ESTATE INVESTMENT TRUSTS: IS THE PHILIPPINES READY FOR IT?

REIT Trends in Asia

The Asian REIT market has been growing exponentially since it was first introduced in the region in 2001. From merely \$2 billion, the Asian REIT market capitalization has grown to a whopping \$65 billion as of December 2009.

The financial and credit crises that swept the global economy slowed down the growth of the Asian REIT market. In the first half of 2008, Asian REIT market capitalization suffered its biggest fall ever. The industry's market capitalization shrank by almost one-third to \$48 billion as its prices fell and new listings dried up. Nonetheless, Asian REITs rebounded strongly in 2009, rising by more than 34% as stock markets in Asia improved and credit became available following government capital injections in the banking system.

Japan pioneered the introduction of REITs in Asia in 2001, which was shortly followed by South Korea on the same year. In 2002, Singapore enacted its REIT legislation, which was then followed by Hong Kong, Taiwan, Thailand and Malaysia the following year.

In Thailand and South Korea, the Asian financial crisis in 1997 served as impetus for the development of property funds. Originally, property funds in Thailand were intended as vehicle to encourage the acquisition of distressed properties in the aftermath of the crisis but it is now used to raise funds from the public. In South Korea, REITs were initially used to promote investment in real estate owned by corporations and financial institutions in need of restructuring.

Box 1. What is REIT?

Real estate investment trust (REIT) is a company that owns and manages investment grade and income producing real estate properties such as office buildings, residential buildings, shopping malls, tourism-related facilities, healthcare facilities, industrial facilities and infrastructure.

Returns from REITs are primarily derived from two sources – dividend yield and share price appreciation. Most REITs are listed and traded in the stock exchange.

There are three basic types of REITs.

- Equity REITs, where majority of REITs fall, own and operate income producing properties. Their revenues are principally derived from properties' rents.
- Mortgage REITs directly lends money to real estate developers and operators. They can also indirectly extend credit through the acquisition of existing mortgages or mortgage-backed securities. They earn their income from the interest of their mortgage loans.
- Hybrid REITs combines the strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

There are 118 listed REITs operating in seven Asian countries. Japan has the most number of listed REITs (J-REIT) and accounts for 45% of Asian REIT market capitalization at \$29.5 billion. Since 2001, the J-REIT market experienced dramatic growth but tumbled during the credit crisis as financing for real estate companies have become limited. Nonetheless, the J-REIT market slowly recovered in 2009 as the Japanese government introduced safety nets to ensure that J-REIT firms were able to secure adequate funding. Some of these government interventions include the creation of \$3.1-

\$5.2 billion public/private sector joint fund to provide J-REITs with financing and the injection of additional funding into Development Bank of Japan to increase its lending capacity.

Table 1. Asian REITs in Asia as of December 2009

Country	No. of Listed REITS	REIT Market Capitalization (US\$ million)
Japan	41	29,473
Singapore	21	20,617
Hong Kong	7	9,521
South Korea	3	132
Taiwan	8	1,800
Thailand	26	1,972
Malaysia	12	1,540

Source: CBRE

Singapore has the second largest REIT market (S-Reits) in Asia with 21 listed REITs and a market capitalization of \$20.6 billion. The S-REIT market continues to diversify as its asset holdings expanded to service apartments, healthcare facilities and hotels. Supported by the relaxation of government policies on REITs, Singapore also positions itself to be the regional hub for cross border REITs.

Hong Kong is the third largest REIT market (H-REIT) in Asia with \$9.5 billion in market capitalization.

The Philippines Real Estate Industry

The success of the REIT industry in Asia has prompted other Asian countries such as China and India to consider introducing REITs in their markets. The same initiative has also taken place in the Philippines.

In 2007, Sen. Edgardo Angara filed Senate Bill No. 63 or the act providing for the regulatory framework for Real Estate Investment Trust. After two years of deliberation, the Congressional bicameral conference committee finally approved last September 2009 the consolidated bill. In December 17, the bill lapsed into law as Republic Act No. 9856 or the Real Estate Investment Trust Act of 2009 in accordance to the 1987 Constitution when the president did not sign or vetoed the bill within 30 days from receipt of the enrolled bill. The implementation of the REIT Law is expected to promote the development of the Philippines real estate sector.

The Philippines real estate sector has experienced a revival in recent years driven by the inflow of OFW remittances, the growth of the BPO sector and high government spending to upgrade the infrastructure facilities in the country. Thus for the last four years investments in construction grew almost 30%. Likewise, construction output as measured by gross value added (GVA) expanded dramatically to almost 40% to P69.5 billion from P50.3 billion in 2006.

Table 2. Construction Investments

	2006	2007	2008	2009
Construction Investment	94.2	112.4	117.5	122.1
GVA	50.3	60.9	65.7	69.5

Source: NSCB; *In Billion PhP, in constant prices

Loans of universal and commercial banks to the real estate sector have remained robust in the last three years. In 2009, real estate loans reached P275 billion, up by 10% from P250.7 billion reported last year. Commercial loans, which comprised almost three fourths of the total loan, jumped 13% while residential loans grew measly at 1%.

Table 3. Real Estate Loans of Universal and Commercial Banks

	2007	2008	2009
Residential	-	71.6	72.6
Commercial	-	179.1	203.1
Total	197.7	250.7	275.7

Source: BSP; *In Billion PhP

In the Philippine Stock Exchange (PSE), there are 33 listed property companies with combined market capitalization of P487 billion as of October 2009.

The REIT Act of 2009

Here are the salient features of the REIT Act of 2009:

Registration and Listing

A REIT must be organized as a Philippine corporation and be listed at the Philippines Stock Exchange (PSE).

Public Ownership

Upon and after listing, a REIT must have at least 1,000 public shareholders, each owning at least 50 shares of any class and aggregately must own at least one-third of the outstanding capital stock of the REIT.

Minimum Paid-up Capital

A REIT must have a minimum paid-up capital of P300 million.

Foreign Equity Ownership

A REIT that owns land in the Philippines must comply with the foreign ownership limitation imposed by the Constitution.

Box 2: What are the advantages of REITs?

Here are some of the advantages from REITs to developers, investors and the general economy.

- Reliable income streams – REITs own tangible assets and earn rents from tenants that often sign leases.
- Diversification – REITs portfolio are comprised of various properties in various locations reducing risk and volatility of investments.
- Competitive return – In 2009, the average dividend yield of Asian REITs ranged from 4.1-9.3%, which are higher than the interest rates given to traditional investment vehicles such as savings and time deposits. With prevailing low interest rates in the country, REIT could be an attractive alternative investment instrument for investors.
- Tax Benefits – Ordinarily, REITs legal framework offers tax benefits to sponsors in exchange for attaining certain conditions such as how income are distributed and the type of properties held.
- Free up capital – REITs help property developers to redeploy their capital investment in other forms of opportunities. It also allows them to hold their investments in a liquid form.
- Economic growth – The growth of REIT industry is expected to stimulate the economy as the real estate sector is closely linked to three other sectors, namely construction, services and consumer sectors.
- Encourage savings – REITs also enable small-time investors to participate in the real estate market. Small time investors do not need to generate large amount of money to invest in the real estate sector to generate the same return given to large investors.

Dividend Distribution

A REIT must distribute annually at least 90% of its distributable income as dividends. Distributable income is defined as net income as adjusted for unrealized gains and losses/expenses and impairment losses and other items in accordance with internationally accepted accounting standards. It excludes proceeds from the sale of the REIT's assets that are re-invested in the REIT within one year from the date of the sale.

Aggregate Leverage Limit

A REIT is only allowed to borrow or deferred payment up to 35% of its deposited property.

Allowable Investments

A REIT may only invest in the following types of assets:

- real estate located in the Philippines and other real estate-related assets,
- managed funds, debt securities and listed shares issued by local or foreign non-property corporations,
- government securities issued on behalf of the Philippine government or governments of other countries as well as securities issued by multilateral organizations, and
- cash and cash equivalents.

Nevertheless, a REIT may invest outside the Philippines provided that its total investments do not exceed 40% of the REIT's deposited property and that it has obtained the special authority from the Securities and Exchange Commission.

Box 3: What are the disadvantages of REITs?

- Revenue losses – The REIT Law offers various tax incentives to operators. Thus the government stands to lose billions of pesos in foregone revenues from tax collection. The Department of Finance (DoF) projected that once the law is fully implemented, the government will lose around P2.7 billion in tax revenues.
- Uncertain dividend yield - Dividend returns from REITs is not guaranteed as it is subject to the rise and fall of rental income.
- Slower growth of return – REITs are required to pay 90% of its distributable income as dividends. Thus, REITs have fewer resources to re-invest in the business, which hampers the long-term growth of the company.

Investment Restrictions

REIT investments are subject to the following conditions:

- A REIT may invest no more than 5% of its investible funds in synthetic investment products and only upon the approval of appropriate regulatory agency.
- At least 75% of the deposited property of the REIT must be invested in income-generating real estate.
- A REIT cannot undertake property development activities unless it intends to hold the developed property upon completion. The total contract value of property development activities undertaken and investments in uncompleted property development cannot exceed 10% of its deposited property.
- Not more than 15% of investible funds of the REIT may be invested in any one issuer's securities or any one managed fund, except with respect to government securities where the limit is 25%.
- When investing in real estate as a joint owner, the REIT should make such investment by acquiring shares or interests in an unlisted special purpose vehicle constituted to hold/own the real estate and the REIT should have freedom to dispose of such investment. The joint venture agreement, memorandum and articles of association or other constitutive document of the special purpose vehicle should provide for a minimum percentage of distributable profits that will be distributed, and grant the REIT veto rights over key operational issues of the special purpose vehicle.

Valuation

REIT assets must be fully valued at least once a year by an independent appraisal company.

Fund Manager and Property Manager

Both the fund manager and the property manager must be (1) independent from the REIT and its sponsors and promoters; (2) must have independent directors; (3) must comply with the corporate governance requirements including the "fit and proper" rule; and (4) must not have conflict of interest.

Fund / Property Management Fees

Fund and property management fees should not exceed 1% of the net asset value of the asset under management.

Tax Incentives

The REIT Act provides various tax incentives to firms.

- REIT is exempted from the minimum corporate income tax of 2% of gross income,
- income payments to a REIT will be subject to a lower creditable withholding tax of 1%,
- Sale and transfer of assets to REITs shall be subject to only 50% of the applicable DST,
- Dividends paid by REITs will be subject to a final tax of 10%, subject to certain exemptions.
- Dividends distributed by a REIT from its distributable income between the close of a taxable year and the last day of the fifth month following the close of the taxable year shall be considered as paid on the last day of such taxable year.

Is the Philippines ready for REIT?

Property developers are optimistic that the passage of the REIT law will spur the growth of the real estate sector in the country. To date, 29 real estate firms have expressed interest to raise fresh capital thru REITs, which include seasoned property developers such as Ayala Land and SM Prime Holdings. Recently, Ayala and SM announced their company’s respective plans to raise \$300 million from local and foreign investors thru REITs to finance their expansion projects.

While issuers like property developers are eager to sell REITs to take advantage of its tax benefits, demand for the securities may not be as robust as many anticipated. According to Mr. Renan Paglin, FMIC REIT Consultant, REITs are more sophisticated investment products in comparison to bonds, which make it difficult for retail investors to immediately appreciate its real benefits. Similar to bonds, REITs provide a regular and high income stream to investors but the income is not guaranteed as in a regular real estate investment. In addition, because REITs are required to distribute 90% of its income as dividends, only a small portion of their profits are reinvested in the business, which may negatively affect the company’s long-term income

growth. To attract investors in REITs, therefore, the market should be sufficiently educated on their features and the benefits investors can derive from them.

Box 4: REITs vs. Other Real Estate Investments

For a better understanding of REITs, we summarized some of their key features vis-à-vis direct property ownership and listed real estate company.

	REIT	Direct Property Ownership	Real Estate Company Equity
Type of Investment	Shares of corporations owning rental properties	Investment in real estate	Shares of a listed company owning real estate and other businesses
Payout	Majority of income is distributed	Majority of income paid to owners	Discretionary dividends paid to investors
Investment strategy	Focused activity	Focused activity	Investment choices determined by company board
Liquidity	Liquid	Illiquid	Liquid
Diversity	Diversified	Concentrated	Diversified
Risk	Perceived low risk	Perceived high risk	Perceived high risk

He also noted that REIT is not a substitute for traditional real estate investment because they satisfy two different needs of the investors. REIT is a stock market investment, investors own shares of stocks and have no direct participation in the decision-making process of the company. Conversely, traditional real estate investors have direct ownership and/or management of tangible

real estate properties. The investors for REITs would most likely be the current investors in the stock market and its market size will be based on the market capitalization of securitized real estate companies. Given the corporate tax exemption, the implementation of REIT may increase the market capitalization of real estate companies by at least 30%.

Furthermore, Mr. Paglin noted that there is still a shortage of REIT-able properties in the Philippines. Shopping malls are the only properties in the country that can provide REITs with stable rental income. However, given the country's rising population and increasing consumption spending driven by OFW remittances, demand for retail stores is projected to further strengthen and therefore a plus for the development of REITs in the country. The only drawback in this sector is that there are only a handful of mall developers that have the right skills to operate successful malls. These include established brand names such as SM Prime Holdings, Robinsons Land Corporation and Ayala Corporation.

Aside from malls, other rentable properties like office buildings and industrial facilities can qualify as REITs. For the past decade, there has been a surge in the demand for office buildings driven primarily by the exponential growth of the country's BPO sector. This trend is likely to continue as global companies continue to seek ways to cut their costs to recover from the financial crisis. Meanwhile, demand for industrial facilities has remained subdued due to poor performance of the country's industrial sector.

Thus, while the tax incentives for developers, the increasing demand for shopping malls, and the stronger consumer spending will likely contribute to the success of REITs in the Philippines, the slow growth of long-term savings and capital accumulation in the Philippines may hinder the growth of REITs in the country. An ADB report cited that the saving pattern of Filipino households have deteriorated over the years because of the impact of the growing young population on the economy. From a high of 9.8% of GDP a decade ago, savings rate has dropped considerably to 2.4%. On another ADB report entitled "Remittance and Household Behavior in the Philippines," it reveals that allocation of household income to savings of OFW families are deteriorating regardless of quintile income groups. Thus, this poses a challenge for those prospective REIT issuers, will there be enough demand for this new instrument?

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