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Consultation Paper on Amendments to the Code of Real Estate Investments Trusts from Pegasus Fund Managers Limited

Question 1: Do you consider that flexibility in respect of property development investments and related activities should be introduced for REITs?

Hong Kong is renowned for its real estate expertise and has all the right foundations to grow a REIT market rapidly. However, there have only been 10 REITs since the enactment of the Hong Kong REIT Code in 2003. The development of Hong Kong REITs is relatively slow compared to Singapore who has 30 listings, Malaysia 16 and Japan 43. Singapore's REIT market of US $42.7 billion is second to Japan, which has a market capitalization of US $72.3 billion. Hong Kong comes in third at US $21.6 billion market capitalization. The market is falling behind due to the overly restrictive regulations and lack of incentives. Many property owners and new issuers have either listed their assets abroad where the regulatory regime is less biased against growth, or opted for the convoluted structure of a business trust to avoid the regulatory hurdles associated with the REIT Code. Hong Kong should enhance its REIT regulations to align itself with market changes and international norms, thereby securing its role as a center for REIT listings. The market will continue to lose REIT managers from overseas if the REIT regulations remain unchanged.

Hong Kong must seize the opportunity as the preferred listing venue for REITs by removing the unnecessary regulations. More flexibility to Hong Kong REITs will translate into more variety for investors, who will have the opportunity to choose the right investments according to their own needs and risk appetite. Hong Kong should also consider following other countries footsteps such as US and Australia, who have shown that tax transparency and other regulatory reform can help REIT market to grow rapidly. As the REIT market expands, more jobs will be created. Investment analysts and property specialists would be required to cover the stocks. Brokerage service will also benefit from the increase in trading. With frequent financing and acquisition activities, REITs will increase the demand for services from various experts such as lawyers, accountants, valuers, surveyors and tax advisors. Furthermore, asset management market will develop which will lead to more opportunities for fund managers and professionals. Hong Kong must strengthen its position and increase its competitiveness to capture the potential growth of REIT market.

With an aging population growing in Hong Kong, the Asian pension funds are expected to add further demand to REITs. Asian pension funds are increasing their real estate allocations, which will become a significant stimulus for the REIT market in Asia. The rapid growth of wealth in the region and need for investment products to cater to the growing retirement savings market in Asia will give rise to substantial demand and growth for REITs. In addition, Domestic REITs and international REITs are among the top three types of real estate investments considered most suitable for pension funds. Since the pension funds in Asia are expected to increase their assets to over US $4.3 trillion by 2020, Hong Kong should consider taking advantage of the Mandatory Provident Funds and using it as a source of investment. In many countries real estate has been an important asset for pension funds because of the investment characteristics of high quality, income-producing real estate and its low risk and portfolio diversification benefits. Currently, a maximum of 10 per cent of assets from MPF funds can be invested in REITs in Hong Kong. Since REITs are well suited as a pension fund investment, Hong Kong should consider letting investors freely invest or set a higher cap like Singapore, which has permitted 35 per cent for pension funds. By removing the 10 per cent cap it would allow investors to have the opportunity to obtain higher yield investment stock.

The increased liquidity will also help REIT managers to build portfolio value and acquiring more assets. As a result, Hong Kong will become a more attractive REIT market.

REIT regulations should seek a fine balance between investor protection and choice. Acquisition is currently the only form of inorganic growth stipulated by the REIT code and REITs in Hong Kong is underdeveloped because of the lack of acquisitions. At the end of November 2013, REITs in Hong Kong only accounted for 5 per cent of the total listed real estate market capitalization in Hong Kong compared to over 30 per cent in both Singapore and Japan. Singapore REITs have been very active in acquiring offshore assets to expand their portfolios. By end of November 2013, 16 of the 30 listed REITs in Singapore owned overseas assets whilst only 3 in Hong Kong had assets outside of Hong Kong. Hong Kong is an international market that is also a suitable place for overseas companies to issue REITs. It stands as the best-positioned market to tap into the substantial potential of REIT listings for Chinese and regional assets. It is a small city and its REIT market is therefore destined to depend on cross-border deals such as China. China is predicted to represent almost a third of the world's investable real estate by 2031 and it currently has no REIT market of its own. Therefore, if Hong Kong would like to take part in the growth expected in the Chinese property market then it should make its regulations more attractive for cross-border dealings.

The current regulation does not allow REITs in Hong Kong to pursue any property development activities and also cannot rebuild their own aging properties. Buildings get older and if REITs cannot undertake any upgrading works then they will be compelled to sell the asset at a price that would not reflect the full potential of the asset. The revised rules would allow REITs to invest in vacant land, given that it can be shown to be part of a planned property development project. If REITs were allowed to pursue property development, it would be equivalent to acquiring projects at an earlier stage, designing the assets to suit their specific needs, and achieving better returns on the investments. With more flexibility in their investment scope, REIT investors will have a wider variety of investment products to choose from. Investors can assess their respective risk appetite and choose the appropriate REIT whose business strategy matches their appetite. This choice should be the prerogative of the REIT investor.

QUESTIONS 2: Do you consider that the 10% GAV (Gross Asset Value) Cap is set as an appropriate threshold?

The 10% GAV Cap for REITS to undertake property development investments and related activities is an appropriate threshold to safeguard the overall risk profile of the REIT. The cap at 10 per cent of GAV is in line with market practice in other overseas REIT regimes such as Singapore and Malaysia. In Singapore, REITs can use 10 per cent of their assets to purchase land to build property for investment purposes - this has helped the market to develop much quicker compared to our city. Where as more mature REIT markets such as US and Australia have no cap on property development investments by REITs. Some of the largest and most notable REITs have a significant portion of development investments:

	WESTFIELD GROUP	SIMON PROPERTY GROUP	UNIBAIL-RODAMCO SE
Background	Largest listed REIT in Australia	Largest listed REIT in the United States	Largest listed REIT in Europe
Market cap	A$20.4 billion	U$47.2 billion	€17.4 billion
Development value	A$12 billion	U$6.2 billion	€6.7 billion
Total asset	A$35.8 billion	U$32.6 billion	€29.6 billion
Development as percentage of total asset	34%	19%	23%

Source: Bloomberg as at 29th January 2014; latest annual reports.

This GAV cap could attract more China-based REITs to list in Hong Kong and at the same time maintaining as a safe investment.

QUESTION 3: Do you have any comments on how the Property Development Costs should be calculated?

To keep unitholders informed, REIT managers have the fiduciary duty to provide a fair estimate of the total cost for each property development project. Unitholders need to understand the true economic costs of any acquisition and not be taken in by the initial understated costs. Property Development cost should include the cost of land acquisition (if any), REIT manager's estimates of the development/construction costs and a prudent buffer. Thus, SFC's proposal on the calculation of Property Development Costs is appropriate.

QUESTION 4: Do you have any comments on the frequency of periodic updates that should be provided to unitholders on the status of property development investments and related activities?

REIT managers should provide the estimate upfront at the time of acquisition. REIT managers should also provide in good faith period updates to inform the market and unitholders of any subsequent increases to the Property Development Cost.

QUESTION 5: What additional safeguards do you consider appropriate to ensure there will not be any material change to overall risk profile of a REIT despite the flexibility to engage in a limited extent of property development investments and related activities?

Currently, the code restricts REITs so that managers cannot invest in vacant land or participate in property development. There were concerns that if REIT managers were allowed to broaden the scope of investment, some managers may be tempted to pursue short term or high-risk returns from investments, which may offer higher returns than real estate acquisitions. This would result in REITS becoming a riskier investment. In order to reduce this risk, the proposed 10 per cent GAV Cap provides an appropriate threshold to safeguard the overall risk profile of a REIT. The 10 per cent GAV Cap would also be in line with regional market practices such as Singapore. Furthermore, the two-year minimum holding requirement will allow REITs to mitigate some of the volatility to their earnings given the much longer-term investment horizon.

REIT managers owe a fiduciary duty to unitholders and must ensure that their property development investments and related activities would not result in a material change in the overall risk profile of the scheme. To further mitigate these risks Management Company should have the requisite resources, competence, expertise, effective internal controls and risk management system for conducting such investments or activities. Managers should conduct proper due diligence to ensure all relevant government and regulatory approvals required for property development investments and related activities have been obtained and all applicable laws and regulations are complied with. The REIT managers should also ensure that there are sufficient resources to finance property developments and be aware of the limitations on borrowing under the REIT code.

Managers have a fiduciary duty to ensure that they have the right skills and resources to monitor the relevant investments and associated risks. These safeguards should ensure that there would not be any material change in the overall risk profit of the REIT and have financial transparency. It is vital for managers to not only be real estate specialists with a deep understanding and experience in the market, but they must also be familiar with credit, financial, operational and regulatory as well as real estate and market risks.

QUESTION 6: Do you have any comments on the proposed scope of the Relevant Investments and the proposed Maximum Cap?

The proposed scope of the Relevant Investments and the proposed Maximum Cap ensures transparency of REITs activities. They are appropriate thresholds and in line with comparable regional regimes such as Singapore and Malaysia. The Maximum Cap would also ensure that the REIT profiles remain primarily as a recurrent rental income-generating vehicle.

QUESTION 7: What other safeguards do you consider appropriate to be put in place corresponding to the proposal to allow for the Relevant Investments?

The proposed scope of Relevant investments is appropriate and in line with comparable regional regimes.

CONCLUSION

As Asia's financial hub, Hong Kong has the right platform to grow a successful REIT market. It is evident from the evolution of other jurisdictions that reformed regulations and tax incentives will significantly boost and expand the REIT market. Hong Kong should strive to be like other mature markets such as United States and Australia and eventually have no limitations on REITs property developments. Furthermore, REITs are an attractive income-generating investment that is a great alternative to real estate and bonds. As mentioned previously, the MPF scheme is a significant potential investor pool for Hong Kong REITs. As at 30 June 2013, the aggregate net asset values of all MPF Schemes amounted to HK $452.1 billion, hence, by lifting the 10 per cent cap, it will expand the market significantly. To align us with other markets, in the future we will need to raise the cap to be on par with Singapore (at 35%) or even have no restrictions, like Australia.

To conclude, a good regulatory framework would add value to our investor and attract more listings of overseas assets as Hong Kong REITs. To compete with other regions, Hong Kong will have to exceed these markets by offering more attractive incentives. We believe that allowing greater flexibility to our regulations and providing a 10 per cent GAV will dramatically increase our attractiveness to REIT investors. The GAV cap could even be raised to 15 per cent, which would put us ahead of other regions and be a more appealing option in the REIT market. The 15 per cent cap would still remain as a safe investment for investors because the low cap rate would not be heavily reliant on real estate. If these proposed amendments are implemented then Hong Kong will be able to build a strong foundation to become a global leader in the REITs capital market.