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Private & Confidential
The Securities and Futures Commission
35/F Cheung Kong Center
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Hong Kong

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By Email (reitsconsultation@sfc.hk)

Dear Sirs

Consultation Paper on Amendments to the Code on Real Estate Investment Trusts

Further to the Consultation Paper on Amendments to the Code on Real Estate Investment Trusts issued by the Securities and Futures Commission ("SFC") dated January 2014, Knight Frank Petty Limited ("Knight Frank" or "We"), submits our written comments on the proposals discussed in this consultation paper.

In general, Knight Frank, welcomes the changes and believes these amendments could bring the Code on Real Estate Investment Trusts more in line with international practice and are an important step towards developing the city as a capital formation centre for Real Estate Investment Trusts ("REITs"). While measures for further developing Hong Kong's REITs industry should be encouraged, striking a balance between expanding the REITs industry and protecting investors' interest should be prioritised, for the long-term, healthy development of the industry.

Our responses to the seven questions are as follows:

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

Knight Frank supports the allowance of more flexibility in respect of property development investment and related activity for REITs. Allowing REITs to carry out limited property development activity is a plus for investors. Hong Kong investment property can transact with low investment yields of below 3%, which are well below REITs dividend yields of 5% to 8%. This makes it difficult for REITs to acquire stabilised assets. By allowing REITs to develop and hold assets, the REIT manager is able to capture development profit, which is passed on to shareholders.

Allowing Hong Kong REITs limited participation in development would allow them to achieve capital growth and put them at the same competitive level as REITs from Singapore and Japan. Hong Kong REITs can only

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acquire investment property already in the market and are forbidden from building their own assets. The capacity to invest early in the project cycle would create pricing advantages and also give REITs control over the final product.

Over time, the functional utility of real estate diminishes and, as it currently stands, REITs cannot redevelop their own property. As such, allowing REITs to undertake limited property development is a very practical and sensible measure that addresses a unique Hong Kong anomaly. The policy direction would also allow REITs to compete head to head with other market players for development opportunities. In a free market environment like Hong Kong, we believe such competition will have a positive impact on the long-term development of the city's real estate market.

Allowing REITs to engage a small part of their business in property development or in buying financial instruments can also provide flexibility and alternatives, should they find it difficult to buy suitable completed projects when property prices are sky-high or when quality property is scarce. Examples overseas prove that this can enhance REIT values while avoiding significant fluctuation of REIT values, as 75% of Gross Asset Value (GAV) is reserved for investment in real estate that generates recurrent rental income at all times.

Question 2: Do you consider that the 10% GAV Cap is set as an appropriate threshold?

Most Hong Kong REITs are unable to invest in property development with GAV below 10%, because of their small scale and the high price of land in Hong Kong. However, it is good to start with a 10% cap as an introduction to the opening up of the market. A gradual relaxation of the cap could be considered at a later stage. Small REITs could participate in property development by redeveloping existing assets, joint ventures and investment in Mainland projects, given the relatively low price of land in Mainland China.

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

We believe that the imposition of a GAV cap on the scale of property development investment could help maintain the nature and objective of REITs, as a recurrent rental-income generating vehicle. The proposed definition of Property Development Cost—land acquisition cost and development / construction cost—is also in line with the international standard adopted by the real estate industry.

Moreover, accepting professional opinion from independent third party such as professional valuer on such matters could maintain fairness in the process of determining an estimate of Property Development Cost and in ensuring compliance of the required GAV cap.

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?

To ensure compliance of the required GAV Cap, Knight Frank believes updates on the status of property development investments and related activity should be regularly undertaken by the REIT managers. In view of current market practise and the availability of relevant information, such as construction costs, we believe development is a suitable option.

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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 investment and related activities?

Knight Frank disagrees with critics who warn that REITs being allowed to invest in development projects will lead to increased investment risk for the sector. The proposal does not allow REITs to develop a property and then immediately sell it. Instead, they need to hold on to the completed property for at least two years. The SFC also requires that REITs prove land is essential for a property investment project before they purchase it.

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

Knight Frank has no comment in this issue.

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

Knight Frank considers that tax incentives and the relaxation of development policy should help Hong Kong's REIT sector capture the next wave of capital inflow from the world's largest real estate investors. Hong Kong's REIT market would benefit from profit-tax exemption, but the government may not be able to grant full exemption, as it would lose a major source of revenue. A more realistic approach would be to reduce the tax rate from the existing 16.5% to, say, 13%–14%. Moreover, tax exemption will stimulate secondary property sales, and the subsequent stamp duties generated should well offset the profit tax lost.

Concluding remarks

Knight Frank believes that the SFC's public consultation sends an encouraging signal, not only to the REIT industry, but also to the overall real estate sector. We support these proposals and believe that if they are fine-tuned and implemented, they will bring Hong Kong's REIT market in line with competing markets. They could also increase employment in the city and assist in growing Hong Kong's economy.

Yours faithfully
For and on behalf of
Knight Frank