From:
Sent: 17, February, 2014 12:39 PM
To: REIT Consultation Paper
Subject: Re: Consultation Paper on Amendments to the Code on Real Estate Investment Trusts

Please Note: These views are my personal views and not the views of my organization. Also, while I am open for SFC to publish my views, please do so in my individual capacity and not as an employee of the company.

Proposal for introducing flexibility in respect of investments in properties under development or engagement in property development activities

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

Response: Yes. The rationale for introducing the flexibility in respect of property development investments is to allow the REITs to acquire income generating assets before they are completed as this would enable REITs to achieve their objectives of providing stable cash-flows in a more capital efficient manner. However, given that this would be a new area of operations for the REIT Managers, the risk of undertaking property development investments should be adequately understood and addressed.

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

Response: Yes. A 10% GAV cap is a reasonable cap. However, for Hong Kong REITs, most of them do not have sufficient granularity of assets, one of the reasons being the high valuation of assets in Hong Kong. Therefore, a 10% GAV cap will limit investments to only smaller properties. This can have 2 consequences:

a) REITs may diversify their asset base with smaller assets being acquired through this route.
b) REITs who only intend to acquire larger assets may be unable to benefit from such a relaxation.

I would recommend building some flexibility in relation to the following situation: REITs may want to re-develop existing assets. The 10% GAV cap should be applied to the quantum of GAV currently under renovation and should exclude any GAV which is earning rental income. This will allow REITs to re-develop larger assets in phases, while meeting the 10% GAV cap.

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

Response: No comments.

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

Response: No comments. Proposal seems appropriate.

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?

Response: No comments.

Proposal for introducing flexibility in respect of investments in financial instruments

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

Response: Yes. I believe that the proposed scope of Relevant Investments and the proposed Maximum Cap are very broad. A 25% of allocation to Relevant Investments can change the stable nature of the REITs distributable income and can also cause a reasonable amount of fluctuation in the net asset value of the REIT. This will create two concerns:

a) For lenders providing financing to REITs, the risk will increase as 25% of the valuation of the REIT will be subject to the mark to market movement of an investment portfolio which may not be linked to real estate and will make the credit evaluation difficult.
b) For investors, they would consider the REITs with investment portfolio allocation as riskier than those that just own real estate assets. This is because an investment portfolio can see wide fluctuation in market values and can also become illiquid.

Based on the above, two comments:

1. Scope of Relevant Investments: I believe that the scope if relatively broad which can potentially result in investments which are not liquid and may also cause fluctuation in cash-flows and valuation for the REIT. I believe that the investments should be restricted to listed and liquid securities. Further, our experience during the global financial crises suggests that markets can freeze up and make an otherwise liquid position as an illiquid position. Therefore the definition of relevant investments should be regularly reviewed for changing market conditions and updated. A potential solution is to provide objective benchmarks on liquidity parameters based on which a particular investment becomes eligible (for example, total investment by REIT not be more than a certain maximum number of trading days based on the average daily trading volume). The objective is to minimize investments into illiquid assets.

2. Proposed Maximum Cap: If the objective of this proposal is to provide flexibility to REITs to utilize their spare cash recourses more effectively, I believe the limit can be set to a lower level, say 15% of GAV, including any development project investment of upto 10% of GAV. This limit is reasonable as even regulations require REITs to distribute at least 90% of the income to unitholders on a regular basis. Assuming that REITs retain 10% of their income and assuming the total distributable income is around 4-5% of GAV, the typical cash and bank balances with REITs should not be more than 1-2% of GAV (assuming they retain roughly 1-2 years of undistributed income with them at any time). While the cap may be more restrictive than other jurisdictions, believe this would meet the objectives of the REITs while addressing concerns of investors and lenders.

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

Response: No Comments

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