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RICS Asia

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The Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

By email: reitsconsultation@sfc.hk

Dear Sir,

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

The Securities and Futures Commission ("SFC") launched a consultation paper on amendments to the Code on Real Estate Investment Trusts ("REITs") on 27th January 2014 and invites market participants and interested parties to submit comments on the proposals by 26th February 2014.

RICS HK would like to submit the comments as follows [in line with the specific questions raised in the consultation paper]:

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

- REIT has grown in popularity and size in many overseas markets. But after over 10 years of the launch of the REIT market in Hong Kong, only 10 REITs are currently listed here, substantially lagging the growth of other REIT markets in the region.

- Given the restrictiveness of the current REIT regulations, 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.

- 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. Hong Kong must strengthen its position and increase its competitiveness to capture the potential growth of REIT market.

- Hong Kong should enhance its REIT regulations to align itself with market changes and international norms, thereby securing its role as a centre for REIT listings.

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- 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.
- Currently, Hong Kong has one of the most stringent investment limitations among regional and international REIT markets and is lagging behind other regional markets in terms of the number of listed REITs, size of the REIT market (except Malaysia) and diversity of asset types and geography.

  - Asian pension funds are increasing their real estate allocations which will become a significant stimulus for the REIT market in Asia:

    - Real estate has been an important asset for pension funds in many countries because of the investment characteristics of high quality, income-producing real estate and its low risk and portfolio diversification benefits.
    - Pension funds in Asia are expected to increase their assets to over US$4.3 trillion by 2020. In particular, significant growth is expected in the developing pension fund systems in China.
    - Domestic REITs and international REITs are among the top three types of real estate investments considered suitable for pension funds.

      Source: "The Significance of Real Estate in Asian Pension Funds", APREA (2010)

  - Hong Kong must seize the opportunity as the preferred listing venue for REITs:

    - Hong Kong stands as the best-positioned market to tap into the substantial potential of REIT listings for Chinese and regional assets.
    - As Hong Kong develops its REIT market, more investment analysts and property specialists will be required to cover the stocks. Brokerage service will also benefit from the increase in trading.
    - Asset management market will also develop, leading to more opportunities for fund managers and professionals.
    - 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.

  - 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.
    - The current REIT Code denies investors the choice as it restricts Hong Kong REITs from undertaking any property development activities.
    - 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. More specifically:

1. It would allow better integration with the infrastructure, e.g. connections to planned footbridges or mass transit systems to serve the community better and to add value to the asset;
2. It would produce less material wastage and achieve higher efficiency during construction since the REITs could tailor-make their own assets to suit their particular operational structures and business targets;
3. It might lower fundamental cost on land acquisition, design development and overall construction compared to purchasing a built-asset at a higher price; and
4. It would offer a more sustainable solution than a major overhaul of the existing property and alleviate unnecessary disturbances to the existing tenants, users and public.

- 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.

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

- The relaxation of development activities from 10% NAV to 10% GAV shall allow greater flexibility for REIT to acquire land when it is cheap and to actively consider re-development potential of their currently en-bloc properties or redevelopment of any industrial buildings into commercial properties. This shall deliver highest and best uses property value to the REIT investors in the long run, which in line with IFR13. Besides, there is a likelihood that the market value of the entire investment portfolio of any REIT to augment in its market value with the encouragement of development activities for REIT.

- REIT Managers could have a better redevelopment plan with greater flexibility and scope of redevelopment plan in property cycle that favours holding of the investment, and allow the choice of better timing to execute the redevelopment activities when the property cycle is in down turn where and when cost of redevelopment could be lower.

- 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% of GAV is in line with market practice in other overseas REIT regimes.

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, with the support of independent professional experts such as members of RICS, of the total cost for each property development project.

- 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.

- The cost of construction shall include site formation, foundation, basement, the building structure, and fit-out cost covering building services from vacant site if it is new development. The professional fee engaging the consultants to carry out the design, submission and supervision of construction works should also be calculated in the Property Development Costs.

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 periodic updates to inform the market and unitholders of any subsequent increases to the Property Development Cost.

- Half yearly reporting is minimum and necessary to tie in interim result announcement of REITs. Quarterly reporting is preferable for development projects due to the variables involved.

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?

- 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.

- In addition, REIT managers owe a fiduciary duty to unitholders to ensure property development investments and related activities:

    - Must be made solely in the best interests of unitholders;
    - Should not result in a material change in the overall risk profile of the scheme;

- Management company should have the requisite resources, competence, expertise, effective internal controls and risk management system for conducting such investments or activities.

- Whenever there is material information regarding property development investment and other related activities that are substantial to investors or potential investors, such as exceeding the budget or surge in the development cost, substantial delay upon completion, etc., the REITs managers should disclose such information in a timely manner.

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 (Hong Kong and overseas listed securities, unlisted debt securities, government and other public securities, and local or overseas property funds) and Maximum Cap (not exceeding 25% of the gross asset value of the REIT) are appropriate thresholds and in line with comparable regional regimes such as Singapore and Malaysia.

- The relaxation of investment of financial resources in various securities and vehicles as suggested in the consultation paper enables REIT managers to finance at the time when the funding needs is low, but be able to park the funding into various securities and enable the REIT to have flexibility to evaluate and to acquire investment properties during both the good time and bad time of the property cycle. In contrast, the previous restriction which limits REIT in growing the portfolio in view of the limitation in financial instrument should have been removed in this proposal. This shall mean that future increase in portfolio sizes of REIT is more readily, fund raising activities is feasible when the cost of funding is low in global market and any mis-match in timing of funding and identification of target acquisition could be addressed by this measure.

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.

Other observations:

Clause 16 last sentence

- Suggested to add "such as member of RICS" to the last sentence.

Clause 17

- RICS with members worldwide are qualified to undertake valuations not only for Hong Kong properties but also for overseas properties. REITs may also have overseas property investments which require local valuers to perform property valuations. Thus members of RICS should also be included in this paragraph.

- For overseas properties, valuers with recognised professional qualification, sufficient market knowledge and the asset type, should be engaged to perform property valuations according to the standards compliant to IVSC. In case the local valuation standards do not comply with IVSC, the RICS Red Book should be adopted.

- For valuation of properties under-development, report of quantity surveyor should be used for cost estimation.

Conclusion

- "RICS Hong Kong in principle supports the SFC's proposal on the relaxation measures of the REIT Code.

- The current market capitalization of the HK REITs market is around US$20 billion, which is six times larger than the first listing of Hong Kong REITs and this figure is continuing to rise. To stay competitive in the market, formulating current regulations for Hong Kong REITs by introducing the flexibility of investment in property development and financial instrument is welcomed.

- REITs is an investment tool to generate stable income for investors. Focus should not only be put on enhancing market development and competitiveness, it is also crucial to ensure that investor's interest is well protected.

- RICS Hong Kong considered that the relaxation of the two core areas: 1. Investment in Land and Development Activities 2. Financial Instrument, Cash Management and Treasury Activities should further promote the REIT market and Hong Kong as a Capital Formation Center and Asset Management Center for the Asia-Pacific Region.

- Further consideration of tax incentive might also be beneficial in long run to attract more Mainland developers and commercial property owners to list in Hong Kong. This should increase business transaction, and shall be beneficial to surveyors, bankers, accountants, lawyers, fund managers and investors in REIT.

- RICS Hong Kong strongly supports the initiatives of the SFC to further develop the REIT platform to enlarge the Asset under Management of REITs to be listed in Hong Kong Exchange.

Please feel free to contact RICS HK should further information or clarification is required.