Consultation on Amendments to The REIT Code proposed by the Securities and Futures Commission

Submission by
The Link Management Limited,
manager of The Link REIT
Dated : 26 February 2014

Contents

SUBMISSIONS BY THE LINK REIT ON THE MARKET CONSULTATION BY THE SECURITIES AND FUTURES COMMISSION

A. General

The Link Management Limited (***The Link***), *as manager of The Link Real Estate Investment Trust* (***The Link REIT***), welcomes the proposals by the Securities and Futures Commission (the ***SFC***) in its consultation paper dated 27 January 2014 (the ***Consultation Paper***) to update the Hong Kong Code on Real Estate Investment Trusts (the ***REIT Code***). The Link supports the proposals in the Consultation Paper for changes to the REIT Code which will have positive impact on the development of the Hong Kong real estate investment trust (***REIT***) market and the future of our financial and capital markets as the whole. It is hoped that the SFC will advocate further reforms to put the Hong Kong REITs market at par with its global peers.

B. Summary of response to the questions raised in the Consultation Paper

Questions in the Consultation Paper	Response
1. Flexibility for REITs to undertake property development activities?	• Agree.
2. Is the 10% GAV Cap on property development activities appropriate?	• Agree with suggestions.
3. Calculation on property development cost	• Agree with suggestions.
4. Frequency of periodic update.	• Agree with suggestions.
5. Is any further safeguard needed on property development activities?	• SFC proposed safeguards are adequate.
6. Is the scope of the Relevant Investments appropriate?	• Agree with suggestions.
7. Is any further safeguard needed on Relevant Investment?	• SFC proposed safeguards are adequate.

C. Specific deliberation on Question 1 to 7 of the Consultation Paper

QUESTION 1: DO YOU CONSIDER THAT FLEXIBILITY IN RESPECT OF PROPERTY DEVELOPMENT INVESTMENTS AND RELATED ACTIVITIES SHOULD BE INTRODUCED FOR REITS?

1.1 REITs listed in Hong Kong should be allowed to undertake property development investments and related activities. The Link supports the rationale detailed in paragraph 11 of the Consultation Paper.

In particular, relaxation on property development investments and related activities provides benefits to unitholders with (i) greater investment opportunities for individual REITs to acquire properties at an early stage with lower entry cost, (ii) opportunities to redevelop existing properties where the financial benefit of re-development outweighs the maintenance cost of any aging property, and (iii) better control over designing and building a property that fits the REIT's individual investment strategy. This will further enhance the development of the REIT market and the returns to REIT investors.

1.2 The relaxation will address the current anomaly that REITs listed overseas can acquire land and develop properties in Hong Kong but REITs listed in Hong Kong itself are prohibited to do so.

1.3 A thriving REIT market benefits a wide spectrum of industry stakeholders, brings more demand for listing, financing and other capital market activities, and enhances the practice of the financial services and real estate industries.

1.4 Paragraph 12 of the Consultation Paper cited some of the concerns relating to the proposed relaxation. The (below-mentioned) GAV cap already serves the purpose of limiting impact of any perceived risks. The issue of capabilities and expertise is no different from how REIT managers currently differ in their set up, from being internally managed versus external managed, and from having certain management functions in-house versus outsourced. Some REITs (such as The Link) have built up expertise and experience in property development through working on complicated asset enhancement projects by their project and development team. Other developer-sponsored REITs can draw on the resources and expertise of their parent groups. Ultimately, it should be investors' decision on which REIT they prefer to invest and in doing so, they will consider how the REIT managers are set up to manage the REITs as part of the evaluation for their investment decision.

1.5 There appears to be considerable misunderstanding that engagement in "build and hold" investments would amount to significant change to REIT's profile as a primarily recurrent income generating vehicle.

(a) Firstly, this "build-and-hold" feature distinctly sets REITs apart from property developers. REITs are currently required to "buy" existing income generating properties and "hold" for a minimum period of two years. The Consultation Paper already proposes that REITs should participate in build-to-hold projects with a requirement to hold the property after completion for a specified minimum period of two years (consistent with the requirement for acquisitions). By merely participating in the project cycle early, the REIT will potentially lower its cost of acquisition/entry.

(b) Secondly, by requiring the REIT to hold the properties for, at the very least, the minimum holding period as proposed by the Consultation Paper, the REIT would not have the volatility of income which is normally associated with property developers as they may encounter varying amounts of properties for sale year by year.

1.6 Furthermore, the proposal allowing REITs to engage in property development is not likely to affect the credit risks for the overall Hong Kong REIT market. The risk profiles of individual REITs depend more on their investment strategies and financial positions, and the risk appetites of their particular unitholders.

The research notes published by the three leading international credit rating agencies, Fitch, Moody's and Standard & Poor's are attached as appendix to this submission.

1.7 In the final analysis, by providing the flexibility so that the market will have REITs with different degrees of participation in property development investments will have the following diversification effects:

(a) possibility of more diverse growth strategies among the REITs, thereby

(b) providing investment choices for investors.

The diversification effects will lead to lowering of systematic risks across the REIT sector.

QUESTION 2: DO YOU CONSIDER THAT THE 10% GAV CAP IS SET AS AN APPROPRIATE THRESHOLD?

2.1 The Link does not believe that it is appropriate to have a limit (or ***cap***) on REITs undertaking property development investments and related activities. If the perceived benefit to preserve the distinct risk profile of REITs as against property development companies is so over-whelming, the proposal in the Consultation Paper has already provided for it by imposing the requirement to hold. If there is a need to strengthen this, The Link would propose extending the holding period post completion such that the REITs cannot dispose any interest in the projects in the first two years and they have to maintain controlling interest at least until the end of five years after completion.

2.2 While the proposed 10% gross assets value (***GAV***) cap on property development investments and related activities is in line with market practice in certain Asian REIT regimes, such as Singapore and Malaysia, other REIT markets such as United States and Australia do not impose any cap on property development investments by REITs. Some of the largest and most notable REITs have a significant portion of development investments. For example, Westfield Group, the largest listed REIT in Australia, had a development pipeline (A$12 billion) which amounted to 33.5% of its total asset (A$35.8 billion) as at 31 December 2012. Unibail–Rodamco, the largest listed REIT in Europe, also had a development pipeline (€6.7 billion) which was 23.7% of its total asset (€29.6 billion) as at 31 December 2012.

2.3 At the minimum, the SFC may consider setting the GAV cap at 25%. There are two advantages for the higher GAV cap. First, small-to-medium REITs will have more flexibility to bid for property development projects if they have a bigger cap to work with. Secondly, a bigger cap raises the competitiveness of the Hong Kong REIT regime over its Asian peers and put Hong Kong closer to or at par among the larger global REIT markets. Otherwise Hong Kong will continue to play catch up over the coming years. Benchmarking Hong Kong market against the largest global markets for IPO has supported Hong Kong to become a leading financial centre in the world. We would encourage the SFC to benchmark Hong Kong with the larger REIT markets in the world, rather than with regional peers, for the development of its REIT market.

2.4 The 25% GAV cap is in line with the Maximum Cap proposed in relation to Relevant Investments. A "one-size-fits-all" cap is easier to administer. If the SFC considers for the time being more appropriate to keep the GAV cap at 10% pending more experience by the REITs, the SFC should set a clear time frame to review the effectiveness of the 10% GAV cap periodically say, every 3 years.

2.5 There are several issues relating to any level of GAV cap which should be clarified.

(a) <u>The end-date</u> When does the development activity end so that the GAV cap can be refreshed for other property development investment projects? The objective yardstick should be the date when the new building becomes legally fit for occupation by the users or tenants. In the Hong Kong context, this will be the date when the Occupation Permit is issued by the Building Department.

(b) <u>Redevelopment of existing properties</u> With the relaxation of the prohibition over REITs' participation in development investments and related activities, paragraph 11(d) of the Consultation Paper cited the opportunity to redevelop existing aging properties of the REITs. Making distinction between asset enhancement and re-development of the same properties is unnecessary. The REIT managers will exercise their judgement in determining the extent of the change to the physical structure of their properties for the benefit of their unitholders. It is more appropriate to exclude redevelopment of existing properties from the GAV cap calculation as such properties are already part of the invested portfolio. Otherwise, the REIT Code has to make it clear how the line should be drawn between substantial asset enhancement and refurbishment versus redevelopment.

QUESTION 3: DO YOU HAVE ANY COMMENTS ON HOW THE PROPERTY DEVELOPMENT COSTS SHOULD BE CALCULATED?

3.1 The SFC may consider adding qualified quantity surveyors as one of the independent experts. Quantity surveyors specialise on costing issues for construction contracts and are qualified and better-placed than valuers or surveyors to opine on costing and cost-overrun matters.

3.2 We support the proposal in the Consultation Paper that the Property Development Costs, as adjusted by any cost escalation, should be used as the numerator of the GAV cap calculation. The whole proposal is premised on the concept of REITs entering the projects at an early state thereby lowering the cost of acquisition, and saving any development margin which would otherwise be paid to a developer for a completed project. If the projects are re-valued before completion, the increase in value of the project will be brought forward prematurely. This is out of line with REIT regulations internationally and carries unintended risks.

3.3 There should be clarification on the determination of management fee for external REIT managers. If development projects are re-valued above cost even before completion of the projects, there may be risks that management fee will be paid pre-maturely to REIT managers adding to the conflict of interest with unitholders.

3.4 We further support that the denominator used in calculating the GAV should be the cost of the development investment projects, plus the value of the rest of the portfolio as included in the valuation report.

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?

4.1 The REIT managers should provide an estimate of the project development cost upfront at the time of acquisition. They should provide periodic updates, by way of semi-annual reporting under the current REIT Code regime, to inform the market and their unitholders of the project progress and changes in the project development cost.

4.2 If the REIT managers consider that no material change on the project development cost has occurred, semi-annual reporting (with a statement of no material change on the estimated project development cost and without the need for any opinion from independent expert) should suffice for the purpose of updating unitholders.

4.3 If there is material change, the REIT manager is already obliged to make timely disclosure under the current price sensitive information disclosure regime.

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?

5.1 The current proposals offers investor sufficient protection associated with participating in development activities by:

(a) imposing a GAV cap (albeit that we disagree with the necessity of such cap as explained above);

(b) providing transparency in disclosure to ensure material information is properly disclosed to the market and unitholders; and

(c) requiring a minimum holding period after completion given REITs' much longer term investment horizon.

QUESTION 6: DO YOU HAVE ANY COMMENTS ON THE PROPOSED SCOPE OF THE RELEVANT INVESTMENTS AND THE PROPOSED MAXIMUM CAP?

6.1 The proposed cap of 25% GAV on Relevant Investment is appropriate. The proposed scope of Relevant Investments is in line with comparable regional regulatory regimes.

6.2 There are however certain clarifications and drafting ambiguities which the SFC should consider.

(a) <u>Unlisted debts/funds</u> The scope of the Relevant Investment under the proposed Clause 7.2B of the REIT Code includes (among others) unlisted debt securities and unlisted property funds. Proviso (ii) requires that they should be "*sufficiently liquid, could be readily acquired/disposed of under normal market conditions* and *has transparent pricing*". Further, Notes (2) to the proposed REIT Code Clause 7.2B requires the REIT manager to update these unlisted debts and unlisted funds "*monthly within five business days of each calendar month end*".

(b) Unlisted debt securities are typically traded over-the-counter and their pricing are based on quotations by dealers. Fund valuation is usually done on a less frequent basis. Given their private/unlisted nature, neither unlisted debt securities nor unlisted/private property fund is likely to meet the requirements of proviso (ii) and Notes (2) to the proposed REIT Code Clause 7.2B. It is suggested that proviso (ii) and Notes (2) to the proposed REIT Code Clause 7.2B should not apply to unlisted debt securities and unlisted property funds. For the purpose of Notes (2) to the proposed REIT Code Clause 7.2B, unlisted debt securities and unlisted property funds can only be reported at the lower of cost or valuation obtained by the REIT managers.

(c) <u>Valuation</u> Periodic updates of the investment portfolio and key information (such as fair value of the aggregate portfolio instead of the full investment portfolio) in the interim and annual reports of the REIT should be sufficient disclosure to investors. Such practice is also in line with overseas markets such as Singapore, Malaysia, Australia and the United States. Reporting at other times may be necessary if there is material change which is already subject to price sensitive information disclosure regime.

(d) <u>An unintended result</u> The reference to "*other miscellaneous non-real estate holdings*" in Note (1) to the proposed REIT Code Clause 7.2B may have unintended consequence. The ambiguity arises because paragraph 36 of the Consultation Paper suggested that "*cash and cash equivalent items, real estate related assets*[16] and *hedging instruments*[17]" are "other miscellaneous holdings". This can be interpreted to include asset items currently arising from normal course of business of a REIT such as cash and cash equivalent, goodwill, property, plant and equivalent, trade and other receivables, deposits and prepayments and also furniture, carpets, furnishing, machinery. It does not seem to be the intention of the proposed amendments to target these normal asset items which the current REIT Code allows. Furthermore, if any of the assets are considered part of the investment properties of the REIT under current accounting standards, they will be dealt with as part of the valuation of the investment properties in the valuation report, rather than being singled out and considered separately.

(e) <u>Hedging instruments</u> Paragraph 36 (footnote 17) of the Consultation Paper suggests that hedging instruments currently used by REITs to protect against currency and interest rate exposure in funding its investment in real estate are included. Hedging instruments used to manage interest rate and currency exposure arising out of normal treasury needs (mitigating financial exposure) should not be counted towards the calculation of the 25% Maximum Cap. These are legitimate treasury tools for REITs already allowed under the current REIT Code. As an illustration, the proposal treats REITs which choose to borrow at floating rate and hedge with interest rate swap differently from REITs which issue fixed rate bonds.

It is therefore suggested that the reference to "*other miscellaneous non-real estate holdings*" in Notes (1) to the proposed REIT Code Clause 7.2B should be deleted or normal asset items and hedging instruments referred to in paragraphs (a) and (b) above be specifically excluded.

(f) Income at all times The proposed REIT Code Clause 7.2B (iii) states that "at least 75% of the gross asset value of a scheme shall be invested in real estate that generates recurrent rental income *at all times*". Some REIT assets may be temporarily out of income because they are under fitting-out and renovations, or subject to rent-free arrangements. Technically, they are not income generating "at all times". It is suggested that the reference to "*at all times*" towards the end of the proposed REIT Code Clause 7.2B (iii) be deleted to avoid any confusion.

QUESTION 7: WHAT OTHER SAFEGUARDS DO YOU CONSIDER APPROPRIATE TO BE PUT IN PLACE CORRESPONDING TO THE PROPOSAL TO ALLOW FOR THE RELEVANT INVESTMENTS?

7.1 It is believed that the safeguards proposed by the SFC in this regard are more than sufficient, as explained above.

Appendix

Reports by Standard & Poor's, Moody's and Fitch

STANDARD & POOR'S
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Sector Review:
A Freer Rein Won't Give Hong Kong's Real Estate Investment Trusts Much More Room To Run

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Table Of Contents

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Sector Review:

A Freer Rein Won't Give Hong Kong's Real Estate Investment Trusts Much More Room To Run

Hong Kong's real estate investment trusts (H-REITs) could soon have more flexibility. The Securities and Futures Commission is proposing to allow the trusts more scope to develop investment properties. That would bring the industry closer to practices in other Asia-Pacific markets, including Singapore. Standard & Poor's Ratings Services believes the proposed changes will have a neutral impact on the credit quality of the sector, but they could benefit individual trusts to varying degrees.

The Securities and Futures Commission published a consultation paper in January 2014 that proposed amendments to the regulatory code on H-REITs. The proposals followed recommendations from the Financial Services Development Council in November last year to spur growth in the Hong Kong REIT sector. The key proposal is to allow trusts to engage in property developments, provided that the aggregate development value doesn't exceed 10% of their gross asset value (see table). The H-REITs would also be permitted to invest in certain liquid financial instruments. The investments would be capped at 25% of the gross asset value when aggregated with total property development activities.

In our view, the proposals would not affect the credit risks for the overall H-REIT market over the next two to three years, which include the possibility of increased leverage and higher volatility. The effect on the risk profiles of individual trusts will depend on their operating strategy and asset size, and the risk appetites of unit holders. The proposed changes are also unlikely to have a material impact on rated large property investment companies in Hong Kong because they aren't covered by the regulatory code.

Overview

- We believe proposed changes to the regulatory code will have a neutral credit impact on Hong Kong's REIT industry.
- Hong Kong is unlikely to close the gap on other rapidly growing markets in the region, given its small size, lack of asset diversity, limited geographical reach, and single-company concentration.
- We expect Hong Kong's biggest trust, The Link REIT, to pursue growth opportunities and improve its asset quality.
- Smaller REITs would still have limited flexibility, partly because of their small scale and the high costs of development in Hong Kong.

Hong Kong Will Likely Still Lag The Growth Of Regional Markets

We don't believe the proposed changes will fully close the gap on other REIT markets in Asia-Pacific. It's unclear if the revised code would encourage property owners to create a trust over its existing corporate structure because of the limited advantages under a REIT structure.

Hong Kong's REIT market hasn't grown at the same pace as other markets largely because its industry code has been more restrictive and there are fewer policy-related incentives, such as tax breaks. Singaporean trusts (S-REITs), for example, are already allowed to invest in vacant land and financial instruments. And like other markets, S-REITs are exempt from tax on rental income (see table). The greater flexibility has led Singapore's market to grow rapidly over the past three to four years, as shown in the trusts' market capitalization, diversity, new listings, and overseas acquisitions.

The Hong Kong REIT market has several challenges, in our view. First, the industry is smaller than other key markets, with fewer assets and less diversity in asset types. The assets of H-REITs tend to be confined to traditional office, retail, and hotel properties. In contrast, REITs in Australia, Singapore, Japan, and Malaysia incorporate asset classes that extend to industrial, logistics, and healthcare.

Second, H-REITs have a limited geographic scope. In recent years, S-REITs have attracted foreign listings and are expanding into high-growth markets, such as China.

Finally, Hong Kong's market capitalization is about half the size of Singapore's, and is concentrated in a single large company: The Link Real Estate Investment Trust (A/Stable/--; cnAA+/--). The Link REIT accounts for about 50% of the total market capitalization of the Hong Kong REIT industry.

Individual Trusts May Benefit To Differing Degrees

Standard & Poor's believes the proposed changes could provide varied growth impetus for individual H-REITs. The benefits are likely to be greater for the Link REIT, which has a gross asset value of US$12.7 billion. The trust would be able to pursue growth strategies, and it would have more flexibility to develop greenfield sites and improve the asset quality of its portfolio. Smaller REITs, such as Yuexiu Real Estate Investment Trust (BBB/Stable/--; cnA/--), would have less flexibility, given their limited asset size, and Hong Kong's high entry prices for land and considerable development costs that would push them over the 10% cap. The gross asset value of most small REITs ranges from US$1 billion to US$8 billion.

We expect some smaller REITs to pursue joint-venture opportunities with developers to fulfill their growth aspirations. However, a trust would need to have majority control over and manage the developments to comply with local regulations. Such restrictions will likely moderate the viability of this investment option. Some REITs could pursue development opportunities with their sponsors to gain exposure to that market and benefit from related experience; REITs with property-related sponsors include Yuexiu.

We would evaluate whether increased exposure to developments would undermine a fund's financial leverage and cause a trust's business risk position to deteriorate through increased volatility in earnings and cash flow. Unit holders that are seeking annuity-type returns may not welcome the volatility in income introduced from development activities.

We believe it's unlikely that property leasing companies would spin off quality assets into trusts, in the absence of greater incentives, such as a preferential tax policy for H-REITs. The Hong Kong property leasing market is mature and dominated by several large property investment holding companies, such as Hongkong Land Holdings Ltd. (A-/Stable/A-2; cnAA/cnA-1), Swire Properties Ltd. (A-/Stable/--; cnAA/--), and Hysan Development Co. Ltd. (BBB+/Stable/--; cnA+/--).

Standard & Poor's uses its criteria for REITs to assess if leasing companies have REIT-like characteristics, with over 70% income generated from property leasing. We assess companies based on their business model, strategy, financial policy, and track record. In our view, the type of corporate structure or the level of regulatory descriptiveness is not a differentiating factor of credit quality.

Looking Further Ahead

The increased flexibility for REITs under the proposed regulatory changes could increase competitiveness in Hong Kong's non-residential property sector, as the trusts step up their pursuit of growth and improve their asset quality. However, we expect this to be a longer-term outcome, given the likely limited impact of the changes. In our view, H-REITs still have a long way to go before they can catch up with their peers.

REIT Regulations

	Hong Kong	Singapore	Australia	Japan	U.S.	Taiwan
Market capitalization estimate	US$22 bil.	US$43 bil.	US$100 bil.	US$72 bil.	US$670 bil.	US$3 bil.
Listing	Required	Not required	Not required	Not required	Not required	Not required
Asset rule	100% real estate (proposed change: min 75% GAV must be from real estate rental)	Min 75% income must be from rental or other specified sources	Can establish corporate structure and staple to the trust such that ineligible trading activities are undertaken	Min 70% of total assets under management in real etate. Min 95% of total assets under management in real estate, real estate-related assets, and liquid assets	Min 95% of earnings and min 75% of assets must be in real estate activities and passive sources such as dividends and interest	Min 75% invested in real estate assets or other assets permitted by the Real Estate Securitization Act
Distribution requirement	Min 90% of net income after tax	Min 90% of taxable income	100% of taxable income from the trust and can retain taxed income from the corporate.	Min 90% of taxable income	Min 90% of taxable income	Min 90% of distributable profits
Property developments	Not permitted (proposed change: max 10% GAV exposure to property development)	Max 10% of total assets	No restriction	Not permitted to conduct ground-up developments.	No restriction	Public REITs limited to urban renewal or public infrastructural projects only, capped at 15% NAV. Private REITs may invest in public and private projects, capped at 40% NAV

REIT Regulations (cont.)

Investment in vacant land	Not permitted (proposed change: permitted if part-and-parcel of property development project)	Permitted if part of property development project	Can invest in land for the purpose of deriving rent.	Not permitted (redevelopment or third-party development is partially allowed, if their impact on portfolio cash flow is limited)	Min 95% of earnings and min 75% of assets must be in real estate activities and passive sources such as dividenda and interest	No restriction
Financial instrument investment	Not permitted (propsed change: permitted subject to max GAV cap of 25% for aggregate exposure of property development and financial investment)	Allowed subject to 25% cap under asset rule.	Allowed	Allowed subject to asset rule	Allowed	No restriction if assets are permitted by the Real Estate Securitization Act
Geographic diversification	Allowed	Allowed	Allowed	Allowed	Allowed	No restriction under Real Estate Securitization Act; subject to approval
Gearing limit	Max 45% of GAV	Max 60% GAV for rated REIT, max 35% for unrated REIT	No restriction	No restriction	No restriction	50% for rating of 'twAA' or above by two credit rating agencies; 35% for rating of 'twA' or above; 25% if lower than 'twA'; 15% if otherwise
Profit tax on rental income	No preferential treatment. Corporate tax rate 16.5%	Profit tax exempt on rental income	Tax pass-through, provided unitholders are entitled to the trusts' income. The stapled corporate pays tax on its profit from trading activities	Distributed dividends are deductible from taxable income	Tax-exempt to the extent distributed	Exempt
Capital gains and dividend tax	No preferential treatment. No capital gains or dividend tax	No tax on capital gains	Exempt provided unitholders are entitled to the Trusts' income	Distributed dividends are deductible from taxable income	Dividends are deductible from taxable income. No refunds of foreign withholding tax	Exempt
Property transaction tax	No preferential treatment. Up to 8.5% stamp duty on transfer of real estate into REIT	2%-3% stamp duty remission on purchase of real estate asset by REIT. No GST on transfer of properties	No stamp duty for listed trust. Up to 6.75% stamp duty for transfer of property/units in unlisted trusts	Reduced acquisition tax and registration, license tax	Property acquisiton and registration tax apply	No preferential treatment
Takeover rules	Not possible unless REIT can obtain 100% acceptance from all unit holders	Possible	Possible	Merger is possible subject to compliance with Investment Trust Law, including a unit holders' super-majority vote.	Possible	Possible with unitholders' majority vote and approval from competent authority

GAV--Gross asset value. Source: Hong Kong Securities and Futures Commission, Hong Kong Financial Services Development Council, European Public Real Estate Association, Standard & Poor's.

Related Criteria And Research

Related criteria

Key Credit Factors For The Real Estate Industry, Nov. 19, 2013

Related research

Asia-Pacific Credit Trends 2014: Real Estate Developers Wrestle with Regulatory Curbs; REITs Hunt for M&As, Oct. 29, 2013

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Hong Kong Real Estate Investment Trusts

Proposed Code Changes Would Raise REITs' Risk Profiles but Support Market Development

REITs would stay disciplined; business growth would remain gradual

Table of Contents:

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» **Investment in property development and financial instruments would raise risk.** Changes proposed by the Hong Kong Securities and Futures Commission for Hong Kong real estate investment trusts (REITs), if implemented, would increase the REITs' execution and financial risk by allowing them to invest in property development and financial instruments. But the heightened risk would be manageable largely because the amount REITs could invest outside of income-generating real estate would be limited, and we believe REITs would remain cautious. Some REITs, such as Yuexiu Real Estate Investment Trust (Baa2 stable), would be unlikely to engage in property development because they can source assets from their sponsors.

» **The changes would also help advance the development of Hong Kong's REIT market,** as the current regulations on Hong Kong's REITs are generally stricter than those in the rest of Asia. Market development in Hong Kong would remain gradual, however, as the proposed changes on their own would be unlikely to spur rapid change in the industry.

» **Large REITs would benefit most from investment in property development.** REITs with larger asset values, such as the Link Real Estate Investment Trust (A2 stable), would benefit most from the proposed changes because they would have more investment options than smaller REITs. Larger REITs are also more likely to leverage on their existing resources and expertise to invest in property development for future business growth. The gross asset values of most Hong Kong-listed REITs are small and the cap on property-development spending would limit their options, especially in developed markets. The REITs could, however, form joint ventures for property development or initiate re-development of their existing assets, which would help to boost their long-term revenue growth.

» **REITs would likely maintain discipline when investing in financial instruments.** The ability to invest in financial instruments would increase the REITs' investment risk. But the impact on the REITs' overall risk profiles would be manageable given the proposed requirement that REITs disclose their investment holdings and the general financial discipline that the rated REITs have adopted.

Investment in property development and financial instruments would raise risk but to a manageable level

Changes the Hong Kong Securities and Futures Commission has proposed for Hong Kong real estate investment trusts (REITs) would, if implemented, increase the trusts' execution and financial risk by allowing them to invest in property development and financial instruments. The current regulations allow the REITs to invest only in real estate that generates rental income. (See Appendix for details of the proposed changes and a comparison of Hong Kong's REIT market to those in Singapore and Australia.)

A REIT's execution risk would rise if it engages in property development because the required expertise is different from property investments, and there will be no cash inflow during the construction period.

But the heightened risk would be manageable largely because the amount REITs could invest outside of income-generating real estate would be limited, and the REITs would likely maintain discipline in their investments.

Although they would have more investment options, we believe the REITs would adhere to their strategy of acquiring assets that generate stable income.

Moreover, given the gradual pace that the REITs would likely undertake if they engage in property development and their general standard of corporate governance on investments, their overall risk profiles would be unlikely to increase materially.

The changes would also help advance the development of Hong Kong's REIT market

Additionally, the changes would advance the development of Hong Kong's REIT market, as the current regulations on Hong Kong's REITs are generally stricter than those in the rest of Asia.

The proposed amendments that the commission circulated in mid-January would allow Hong Kong REITs to undertake property development investments and related activities, subject to a maximum threshold of 10% of the REIT's gross asset value. The amendments would also allow Hong Kong REITs to invest in financial instruments subject to a cap of 25% of the REIT's gross asset value.

These changes would bring the Hong Kong REIT regulations closer to those of Singapore, where the REIT market is larger and more established than in the other Asian countries (excluding Japan). The Hong Kong REITs would also be permitted to acquire land if they can demonstrate that such investment is part-and-parcel of property development activities.

Market development in Hong Kong would remain gradual, however, as the proposed changes on their own would be unlikely to spur rapid change in the industry.

Large REITs would benefit more than small ones from property development

REITs with larger asset values would benefit from the proposed changes because they have more money to invest, which gives them more investment options.

Larger REITs are also more likely to leverage on their existing resources and expertise to invest in property development for future business growth. Many of them rely on asset enhancements, such as renovations and optimization of tenant mix, to support their revenue growth amid the current restrictions on their ability to invest outside of income-generating real estate. But asset enhancement offers less design flexibility than property development and re-development, potentially limiting the maximization of their asset values.

The Link Real Estate Investment Trust (A2 stable), one of the two Hong Kong REITs we rate, would likely benefit if the proposed changes are approved given its large asset size and ability to use its large pool of existing resources, such as market intelligence, established contractor relationships and in-house design capabilities. Unlike some of the other Hong Kong REITs, Link REIT does not have a sponsor to source assets for acquisition. In addition, its leverage is low – 2.6x as measured by adjusted debt/ EBITDA at the end of September 2013. Its high financial flexibility and good access to the capital and bank financing markets would allow Link REIT to raise debt to fund property development opportunities.

However, given its shareholders' recent approval to expand its investment mandates, we will continue to monitor the Link REIT's risk appetite, particularly in relation to any potential property development in mainland China, where it has not invested or developed any properties.

The gross asset values of most Hong Kong-listed REITs are small (see Exhibit 1 for a list of Hong Kong REITs by asset size). The 10% cap would limit their development options, especially in developed markets where land prices are high, such as Hong Kong and top-tier cities in mainland China. The REITs could, however, form joint ventures for property development or initiate re-development of their existing assets. These options would likely increase the REITs' revenue growth over the long term.

EXHIBIT 1

Listed Hong Kong REITs

Name of Listed REIT	Market Cap (USD million) [1]	Total Assets (USD million) [2]
Link REIT (A2 stable)	10,439	13,461
Champion REIT	2,474	7,830
Hui Xian REIT	3,151	6,522
Yuexiu REIT (Baa2 stable)	1,305	4,038
Fortune REIT	1,409	3,053
Regal REIT	861	2,991
Sunlight REIT	589	1,954
Prosperity REIT	404	1,096
RREEF CCT REIT	260	7

[1] As of 7 Feb 2014

[2] As of 30 June 2013, except Link REIT and Fortune REIT are as of 30 Sept 2013

Source: Companies' interim reports

Yuexiu Real Estate Investment Trust (Baa2 stable), the other Hong Kong REIT we rate, would benefit only slightly from the proposed changes because its relatively small asset size would limit its investment options. In addition, engaging in property development would pressure its debt leverage: its adjusted debt/ EBITDA was around 8.7x as of 30 June 2013, the date of its most recent interim filing. The REIT would be unlikely to take on further debt for property development while it is still improving the asset performance of Guangzhou IFC, which it acquired in late 2012.

However, Yuexiu REIT would, to a certain extent, benefit from the increased investment flexibility in the next three to five years. It could, for example, dismantle and rebuild existing properties when they become old. The proposed changes would allow Yuexiu REIT to develop new and small projects in mainland China, where land prices in many cities are much lower than in Hong Kong. But it is unlikely to develop greenfield projects by itself because it can source assets from its sponsor and parent, Yuexiu Property Company Limited (Baa3 stable).

REITs would likely maintain discipline when investing in financial instruments

Under the proposed changes, Hong Kong REITs would also be permitted to invest in financial instruments including listed securities, unlisted debt securities, government and other public securities, and local or overseas property funds. These investments would be subject to a cap of 25% of the REIT's gross asset value, another measure that would bring it closer to the Singapore REIT regulations.

The ability to invest in these instruments would increase the REITs' investment risk, but the impact on the REITs' overall risk profiles would be manageable given the disclosure requirements and the financial discipline that the rated REITs have adopted. The former calls for REITs to publish their full investment portfolios on their Web sites and to update their holdings monthly. The latter is evidenced by the REITs' high distribution payout (at least 90% of annual net income after tax) and the cap on leverage (45% of gross asset value).

Appendix

Background

The Hong Kong Securities and Futures Commission circulated a consultation paper in mid-January on Amendments to the Code on Real Estate Investment Trusts. The commission said it's seeking to strike a balance between facilitating market development and competitiveness, and ensuring the protection of investors' interests and market integrity.

The proposed changes and comparison with the REIT codes in Singapore and Australia, the more developed REIT markets in the region, are summarized below:

	Hong Kong (Before Proposed Change)	Hong Kong (After Proposed Change)	Singapore	Australia
Legal form	Unit trust	-	Collective investment scheme (Unit trust) which invests in a portfolio of income generating real estate assets	Unit trust
% of assets mandatory for real estate investment	100%	At least 75% of the REIT's gross asset value (GAV) shall be invested in real estate that generates recurrent rental income	Minimum 75%	No minimum
Property development	Prohibited	Permitted to undertake property development investments and related activities, subject to a maximum threshold of 10% of the REIT's gross asset value (GAV Cap)	Capped at 10% (including investments in uncompleted projects)	Permitted with no cap on property development investments
Investment in financial instruments	Prohibited	Not more than 25% of total assets may be invested in assets that are non- real estate assets that generate recurring income	Not more than 25% of total assets may be invested in non-real estate assets	Allowed
Borrowing	Shall not exceed 45% of gross asset value	-	Shall not exceed 35%. Limit can increase to 60% if the REIT obtains and discloses a credit rating from Moody's, S&P, or Fitch.	Shall not exceed 75% of gross asset value (60% from 1 July 2014 onwards) under the thin capitalization rules
Distribution policy	Not less than 90% of annual net income after tax	-	Not less than 90% of taxable income	100% of annual net income
Tax	» No special tax treatment » Capital gains or dividends not taxable » Transfer of real estate assets into a REIT subject to stamp duties of up to 8.5%	-	» Not taxable if 90% distribution rule is met » Capital gains not taxable » Purchase of real estate assets subject to 2-3% of stamp duty » No GST on transfer of properties into a REIT	» No tax at trust level » Corporate side of stapled trusts have to pay tax on active income » Taxable income (including capital gains) is included in investor's income for Australian tax » Transfer of real estate assets into a REIT subject to stamp duties of up to 6.75% for unlisted property trusts; some stamp duty benefits for transfers of units in listed trusts

Sources: Hong Kong Securities and Futures Commission, Hong Kong Financial Services Development Council, Monetary Authority of Singapore, Moody's Investors Service

Report Number: 164642

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MOODY'S
INVESTORS SERVICE

FitchRatings

Fitch: HK Code Change Unlikely to Immediately Drive REITs to Development

Endorsement Policy
04 Feb 2014 9:01 PM (EST)

Fitch Ratings-Hong Kong-04 February 2014: Fitch Ratings says today that a proposal to allow Hong Kong (HK) real estate investment trusts (REITs) to develop investment properties is not likely to immediately change the REIT industry. This is because most of the HK REITs would easily breach the regulator's limit on project size if they develop an investment property on their own. Also, the trusts generally prefer to acquire assets with stable cash flows from their sponsors.

The Securities and Futures Commission recently published a consultation paper that proposed to allow HK REITs to redevelop the investment properties in their portfolio or develop an investment property project on vacant land, provided the cost of development does not exceed 10% of a REIT's gross asset value (GAV). This proposed change brings the HK REIT code in line with the practice in Singapore.

Most of the HK REITs are unlikely to be able to build an investment property without exceeding the 10% cap, in view of their size constraints and the high land cost in Hong Kong. Alternative strategies available to smaller REITs to participate in development and remain within the 10% cap - redevelopment of existing assets; development via JVs; and development of assets in China, where land costs are significantly lower - are likely to entail more risk and uncertainty about yields than buying completed projects with stable cash flows from their sponsors. As a result, HK REITs will likely stick to their strategy of acquiring stable assets from their sponsors because this will help the REITs to sustain steady distribution rates.

The exception may be large trusts, like The Link REIT, which had a GAV of HKD104bn at end-September 2013. The Link REIT may be able to immediately take advantage of the proposed rule change to improve its asset yields by redeveloping some of its retail centres that do not have efficient floor layouts while remaining within the 10% cap on project size.

However, over the longer term, Fitch believes that the change could attract more China-based REITs to list in HK. These REITs may be involved in joint development of investment properties in China with their sponsors.

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Additional information is available at www.fitchratings.com.