Research Paper

On

Real Estate Investment Trust

December, 2005

Prepared By: KASB Securities Limited

Preamble

Real Estate Investment Trust (REIT) is a security that sells like a stock and invests in real estate directly or indirectly. Consequently, there are different type of REITs; such as Equity REITS and Mortgage REITs. The Equity REITs invest in and own properties, and their revenue is linked to the rent. On the other hand Mortgage REITs deal in investment and ownership of property mortgages and their revenue is primarily linked to the interest they earn on the mortgage loans.

Real Estate Investments historically have been done through bilateral agreements or through investment schemes launched by developers

In Pakistan, historically real estate investments have been done through bilateral transactions or through investments in schemes launched by various developers. Both investment methods have their shortcomings given that bilateral transaction requires larger capital size whereas investment in developer schemes is a significantly less regulated sector. Hence, the participation of the general public has been on the lower side resulting in a fragile and instable real estate market in Pakistan.

Benefits of REITs

A typical REIT offers a number of advantages to investors:

1. It allows accessible indirect investment in real estate. Participants can invest in a professionally managed portfolio of real estate that is held in tax transparent structures. This serves to open up real estate investment to the small investor who otherwise could not have had this investment opportunity;

REIT allows indirect investment in real estate for small investors who otherwise could have not had this opportunity

2. It enables participants to broaden their investment portfolio and diversify risk;
3. It is typically tax transparent. There is only one level of taxation. The REIT does not pay tax on its profits thereby maximizing dividends to shareholders who then pay their tax on their dividends and on profits made when they sell their shares. Typically a US REIT will pay back at least 90 per cent of its profits to its shareholders and in many cases even more than that, with some REITs distributing all their profits to their shareholders. REITs can also serve to eliminate some of the tax and other difficult experienced by institutional investors, such as pension funds and foreign inventors, if they invest more directly in real estate;

REIT is one of the vehicles that have single taxation

4. It provides ease of liquidation of assets into cash primarily because of their being traded on a stock exchange;
5. It offers historically low volatility. REITs tend to be stable, and therefore, offer an attractive return for investors;

REITS offer low volatility and ease of liquidity

Study of regional countries from Middle East and Far East shows that formalized structures have evolved that allow raising money from the general public in order to invest in real estate opportunities adding them to the real estate market.

Comparison to other Modes of Real Estate Investment

Table 1: Characteristics of Various Investments in Real Estate

	REITS	Direct Property Ownership	Real Estate Company Equity	Corporate Property Bonds
Type of Investment	Units in a listed trust/share of corporation owning	Investment in physical real estate	Shares of a listed company owning real estate and other	Debt issued by the underlying real estate company

	real estate properties		businesses	
Payout	Majority of taxable income paid to unit holders	Majority of income paid to owner	Discretionary dividends to shareholders	Fixed payout
Investment Strategy	Focused Activity	Focused Activity	Investment choices determined by the company board	Investment choices determined by the company
Liquidity	Liquid investment	Illiquid investment	Liquid investment	Low liquidity Investment
Diversity	Diversified portfolio	Concentration risk	Diversified portfolio	Concentration risk
Risk	Perceived low risk	Perceived high risk	Perceived high risk	Perceived low risk
Gearing	Gearing is limited by regulations	High gearing between 70% to 80%	Moderate gearing level between 60% to 70%	Moderate gearing level
Source: KASB Analysis				

From the comparison above, its clear that REITs are more effective and efficient vehicle for investment in real estate.

REIT International Comparison

This section examines the characteristics of REITs currently operating in the Australia, Singapore, and Hong Kong and how can Pakistan learn from their experience.

Table 2: REIT Regulations and Structure in Australia, Hong Kong, and Singapore

	Australia	Hong Kong	Singapore
Legal Form	Resident/non-resident (public) unit trust. No minimum capital requirements exist;	Unit Trust domiciled in Hong Kong, no minimum capital requirements;	Trust or Corporation;
Listing Requirements	No restrictions;	No restrictions;	At least 500 shareholders;
Investments/Activities	Investment in land for deriving rent. Public Unit Trusts that carry on trading business, are not accorded 'flow through' treatment;	Investment in Hong Kong real estate only; Assets should be income generating; REIT required to hold the property for at least two years;	At least 70% of the funds should be invested in real estate and real estate related assets;
Leverage	Unlimited, subject to thin capitalization rules;	Aggregate borrowing shall not at any time exceed 35% of the total gross asset value;	Total borrowings should not exceed 35% of deposited property;

Profit Distribution Obligations • Operating Income • Capital Gains on disposed investments • Timing	• Distribution of 100% of trust's income; • Distribution of 100% of realized capital gains; • distribution must occur annually;	• Distribution of 90% of audited annual net income; • 90% of audited annual net income after tax (the trustee may determine if any of the amount of the gain may form part of net income); • Annual distributions;	• Distribution of 90% of taxable income; • No requirement; • Semi-annually (in practice)
Tax Treatment • Income • Capital Gain • Withholding	• Not taxable, provided unit holders are entitled to trust's income; • Tax treatment is similar to that of ordinary income. 50% CGT discount may be available; • Dividend and interest paid to non-resident unit holders is subject to withholding tax as dividends and interests;	• REIT is subjected to property tax for property held directly, dividend income from SPVs is tax exempt from profits tax; • No capital gain tax; • None;	• Not taxable at trustee level to the extent of taxable income distributed; • No capital gains tax; • 70% on distributions to non-qualifying unit holders, e.g. non-resident corporate unit holders;
Conversion to REIT Status	N/A;	There is no specific transition regulation in Hong Kong governing the transformation of a corporation to a REIT;	No special tax rules for transition of property from a normally taxable entity to an SREIT. The transferor is subject to normal tax treatment on gains realized;
Registration Duties	No duty on capital distributions;	Transfers to REIT are subject to stamp duty at 3.75% for purchases exceeding HK$ 6.7 m;	No capital duty on capital contributions into an SREIT. However, an SREIT has to pay stamp duty at 3%;

Source: EPRA Global Survey

Real Estate Opportunities in Pakistan

Cursory analysis of the real estate market in Pakistan shows the following trends:

1. It is estimated that Pakistan has a shortfall of 6 million homes estimated as of end of June 2005. On an annual basis, the construction industry needs to produce 570,000 housing units against the

actual supply of 300,000 units resulting in an annual shortfall of 270,000 units and with time this backlog is increasing;

2. The prices of real estate have increased significantly during the last few years resulting in higher ratio of urban property prices to purchasing power regionally barring examples of densely populated cities like Bombay, Hong Kong etc;
3. The rental yield of 3.5% to 5.0% is amongst the lowest in the World. This is a result of the prevailing joint family system which results in lower number of first house buyers per annum and large (6.6x) number of dwellers per house.

Issues Hindering Growth of Organized Structures for Real Estate Investment

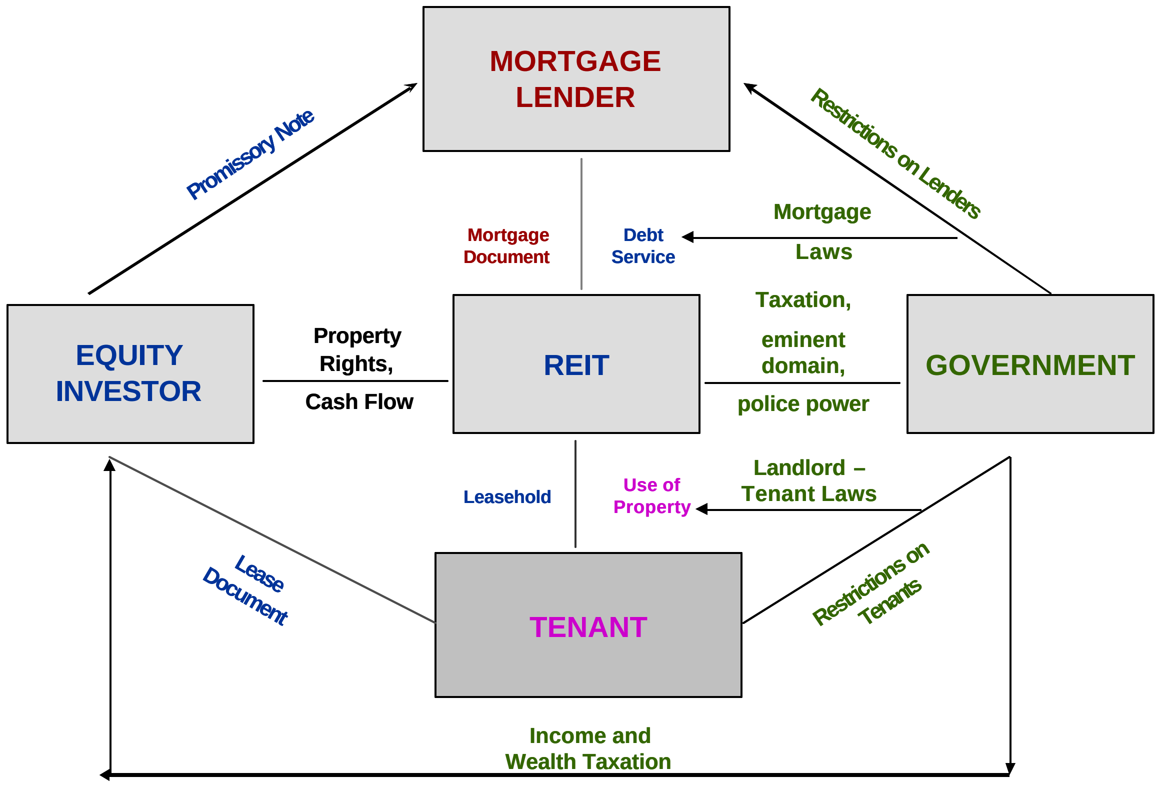
The following are the critical bottle necks which are hindering the growth of organized real estate sector in Pakistan:

1. High rate of incidence of registration charges;
2. Significant portion of the real estate market is undocumented;
3. Historically the rules and regulations have had a tilt towards the tenant as compared to the owners, however, the condition is getting slightly better;
4. Weak foreclosure laws;
5. Rental yield is very low and currently is negative in real terms;
6. Although Modarabas in Pakistan have been used for real estate investments, the structure is not very conducive for all business transactions;
7. Land records are not properly maintained as a result of which there are instances of multiple ownership of the same establishment;

Typical Real Estate Investment Trust Structure

The following figure represents a typical REIT structure. The parties to the transaction are typically REIT Management Company, tenant, and equity investor. However, government exerts significant control in providing an environment that is conducive for a REIT to operate.

Operating Environment for a REIT



Source: PWC

Benefits of Investment Scheme Structure (AMC) Structure w.r.t. REIT

As stated earlier though the Modaraba structure allows the management company to invest in real estate development projects, however, the structure is not viable in traditional business environment, and is only suited for Islamic transaction. On the contrary, existing AMC structure can be used with significant modifications to investment restrictions. In the following section we present an overview of benefits of using AMC Structure for a REIT.

Transparent Taxation

Investment in REIT is one of the investments that does not face a double taxation issue. In addition to this, under the Income Tax Ordinance, the income of a mutual fund or an investment company registered under the NBFC Rules 2003, or a unit trust scheme constituted by an assets management company registered under Assets Management Companies Rules, 1995, is **not** taxable if not less than ninety percent of its accounting income of that year, as reduced by capital gains whether realized or unrealized, is distributed amongst the unit or certificate holders or shareholders as the case may be. In the case dividend income is received by a public company or an insurance company, 5% of the gross amount of the dividend; or in any other case, 10% of the gross amount of the dividend. Therefore the AMC structure will be optimal in terms of tax transparency.

Repatriation

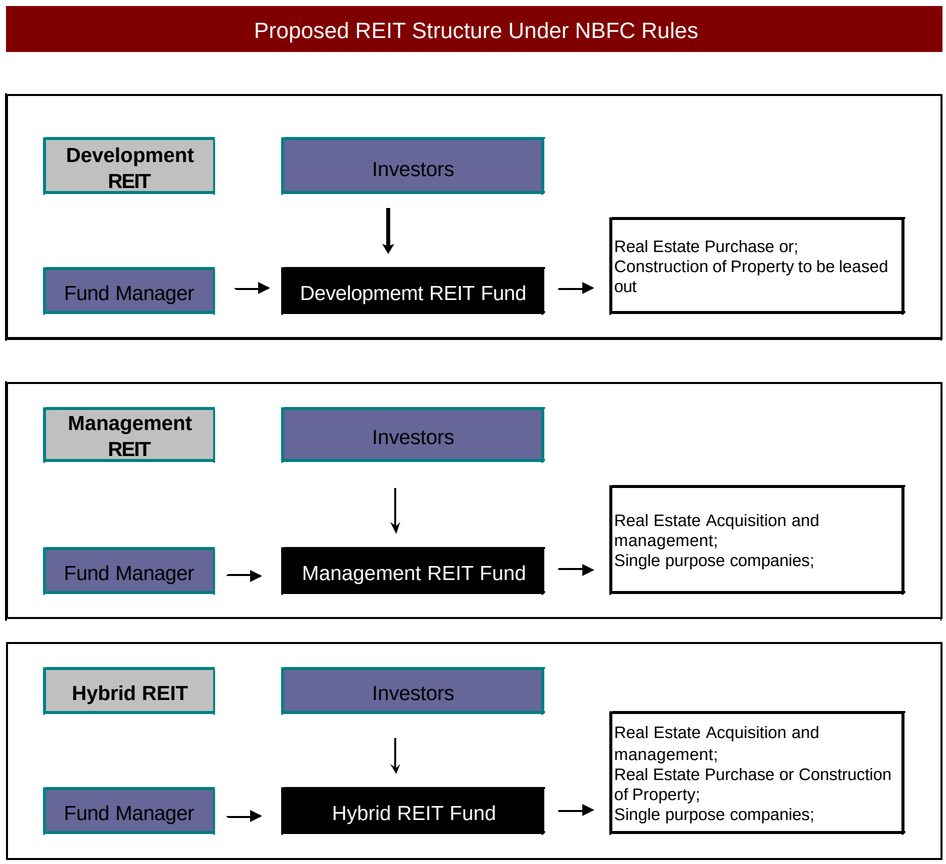
There are no restrictions or repatriation issues for foreign investors as long as they invest in securities whether listed or unlisted. The money can be routed through SCRA channel.

Optimal Structure for Pakistan

The optimal structure REIT is the one that allows tax transparency, transfer of capital in and out of the country for investment, and operational efficiencies. The AMC Structure is the only vehicle that suits the definition. However, two kinds of license shall be required for effective and efficient functioning of REITs in Pakistan:

1. Development REIT;
2. Management REIT, and;
3. Hybrid REIT

The following figure represents the proposed structure of the two types of REITs in Pakistan.

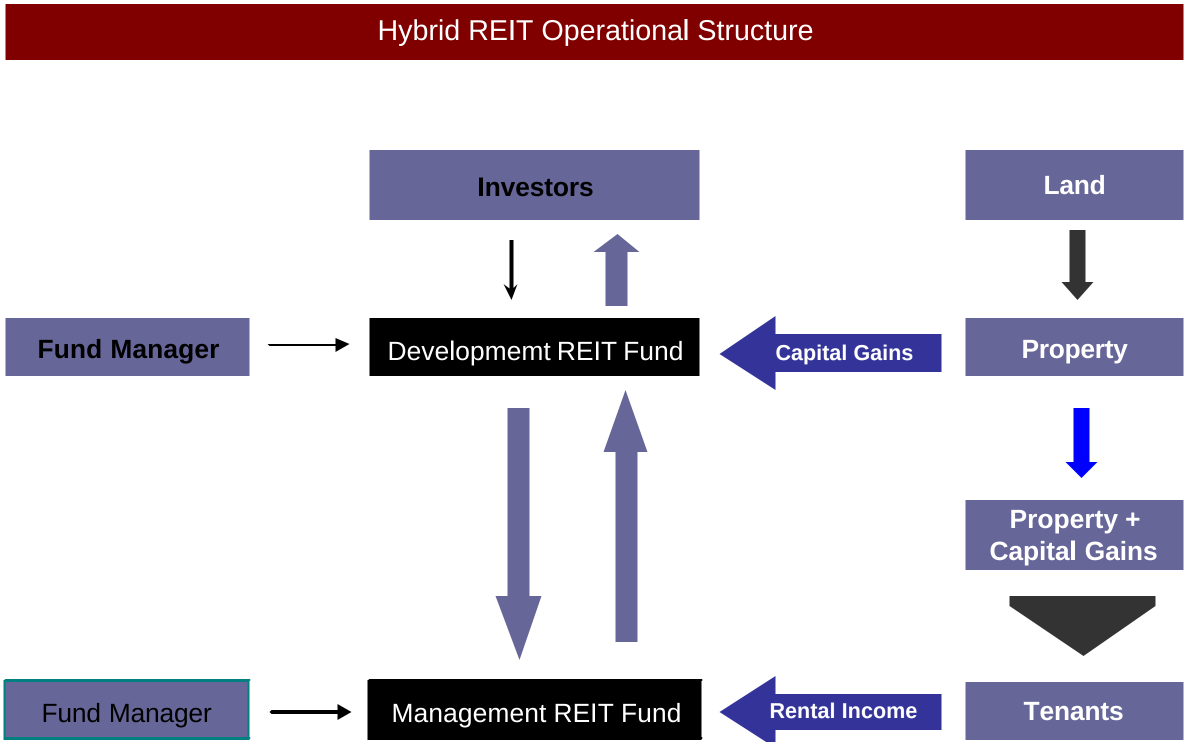


The Development REIT will typically concentrate on real estate acquisition for purchase or construction. After the development is finished, the development REIT will sell the property to either Management REIT or Hybrid REIT or to other interested parties and capitalize the capital gains for the investors. It may then start off another project in due course.

The management REIT will concentrate on concentrate on the management and maintenance of property, and the returns will be in form of rentals. This type of investment will be suited

and will acquired from Development REIT or property acquired through sale and lease back agreements.

The following figure we present the operational structure of a hybrid REIT.



Investors who are willing to revoke rights to their property to obtain benefits from leasing structures may enter into sale and lease back agreements, with Management and Hybrid REITs, which would then be similar to a paghri structure prevailing in Pakistan. Therefore it can be used to abolish the "Paghri" system which would then improve the rental yields. Additional information on sale and lease back agreements can be found in Annexure I.

Recommendations

Although the AMC Structure is tax transparent, however, would require modifications to be conducive for both types of REITs to work. These modifications are:

Investment Restrictions

NBFC Rules need modification for investment

- Under the NBFC Rules 2003, Investment Schemes in Pakistan are not allowed to invest in real estate. However, the REITs should be allowed to investment Real estate, Single-purpose companies, Real estate-related assets, Liquid assets, Non-real estate-related assets, Asset-backed securities. However, development REITS should not be allowed to invest in other development REITS and maintenance REITs. Similarly Maintenance REITS should not be allowed to invest in other maintenance REITs and development REITs;
- Under the NBFC Rules 2003, the Investment in any company shall not exceed ten percent of paid up capital of the company, or ten percent of the net assets of the fund. Exposure limits need a redefinition for a REIT;

Leverage

REITs should be allowed to borrow

- Under the NBFC Rules 2003, the funds may not borrow themselves for. An exemption to this effect is also required;

Capital Gains Tax

- Currently only the capital gains on listed equity are tax free. However, the capital gains on property/land sold to a REIT should also be tax free.

Capital Gains to be abolished for real estate trading and investment

Pension Fund Investment Restrictions

- Under the new Voluntary Pension Rules, Pension Funds are not allowed to invest in anything other than capital markets. However, given the low volatility of real estate investment, the pension funds should be allowed to invest in REITs with minimal quantitative restrictions;

Pension Funds should be allowed to invest in REITs

Tenancy Laws

- The tenancy laws need to be classified as Criminal Law, and not Family Law to allow efficient execution for the property formed under REIT structure. The procedure for eviction of tenants needs to be improved so that there is an incentive to build properties for rental purposes. Moreover, separate courts need to be established to settle the disputes efficiently;

Tenancy Laws to be redefined and strengthened

Transaction Costs

- The transaction costs including registration fee and mutation charges are approximately 6-7%. In addition, the transfer fee is charged separately by various authorities. However, the regional comparison showed that transaction costs are approximately 3-4%. Therefore total transaction costs in Pakistan should also be reduced to 3%.

Transaction Costs to be reduced

Land Record System

- In Pakistan land records are maintained by district administration for deciding ownership and boundaries of land or property. The process of defining and determining land in favor of an owner is called registry of land. Municipal Corporation also uses the ownership information for tax collection. All land disputes come under the charge of Tahsildar, Naib Tahsildar, and Patwari. These officials assist Collector in resolving land disputes. Land records maintained on paper or cloth has preservation, updating and retrieval problems. Computerization is natural solution for all these problems. The government of India has already taken initiatives to computerize land records in the country and has successfully implemented it in the state of Karnataka. Though the process is painful, but will result in single window solution to all land related problems.

Land record system should be computerized

Un-official Pricing

- Buyers of property from REITs should not be asked source of income to avoid problems related with official and unofficial pricing.

Summary of Recommendations:

Modifications(s) to NBFC Rules

- REITs listed under NBFC should be allowed to invest in real estate development and acquisition;
- Exposure limits need redefinition with respect to a REIT;
- REITs should be allowed to borrow;

Modifications(s) to Income Tax Ordinance

- Gains from sale proceeds of land and/or building to a REIT should be tax free;
- REITs should be granted a status of investment scheme formed under NBFC Rules as a result of which the it would be tax exempt;

Modifications(s) to Voluntary Pension Rules

- Under Voluntary Pension Rules, pension funds should be allowed to invest in REITs;

Other Modifications(s)

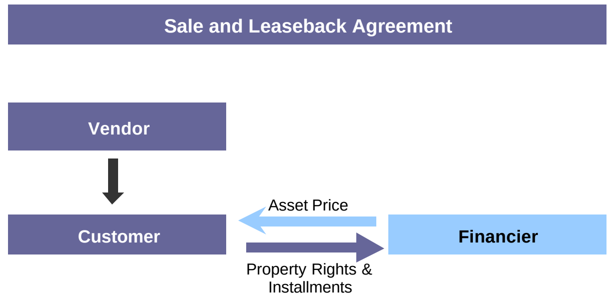
- The Land Record System should be computerized;
- Tenancy Laws should be strengthened and should be classified as criminal law for settlement of disputes efficiently for property formed under REIT structure;
- Transaction costs should be reduced;
- Buyers of property from REITs should not be asked source of income;

Conclusion

The previous sections have discussed the modifications to regulations to provide a framework that allows investment in real estate. However, the markets will not function smoothly unless the rental yields improve, tenancy laws are strengthened, official and unofficial pricing issue is settled, paghri system is abolished, and the time consumed in legal proceedings is reduced.

Annexure I

Alternate Solution: Sale and Leaseback by Banks and Leasing Companies



Sale and leaseback is an arrangement in which one party sells a property to a buyer and the buyer immediately leases the property back to the seller. This arrangement allows the initial buyer to make full use of the asset while not having capital tied up in the asset. Leasebacks operate in finance lease structure and may provide tax shield.

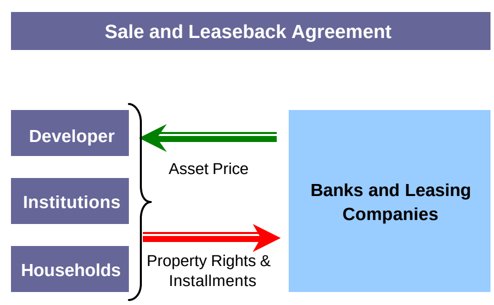
It is apparent from the proposed recommendations that it will take some time before REITs can actually operate in Pakistan. However, this should not hinder skilled investors such as banking and non-banking financing who would like to take real estate exposure. Therefore an alternate solution is the sale and leaseback agreement between the Lessee and Lessor, where the underlying is a property or land.

The key advantages to the sale and lease back agreement are:

1. Negates the need to raise potentially more expensive capital in the marketplace to finance expansion etc.
2. Leasing normally represents 100% financing whereas a mortgage company will not provide more than say two-thirds of the value of a project.

There are certain disadvantages to this arrangement:

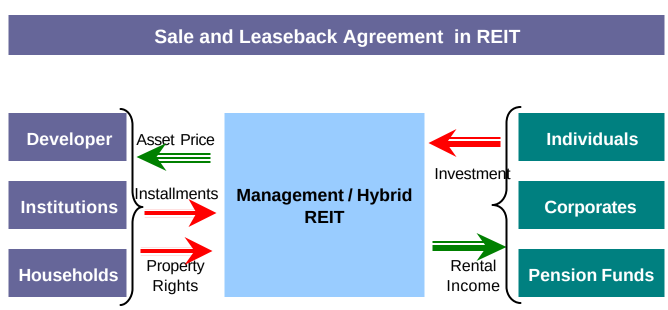
1. Lessee acts much as the owner of the property rather than as a tenant paying for all repairs, maintenance, insurance and property taxes during the currency of the lease.
2. Improvements to the property and any increase in land value inure to the benefit of the landlord at the expiration of the lease.



The sale and leaseback agreement is also available in Islamic Financing Modes and is known as "Ijarah". In this case, the term 'Ijarah' is analogous to the English term 'leasing'. Here the lessor is called 'Mu'jir', the lessee is called 'musta'jir' and the rent payable to the lesser is called 'ujrah'. Since the sale and leaseback agreements can be structured in an Islamic mode, the appeal of such products will be higher.

Therefore the sale and leaseback agreements would allow banking and leasing companies to write real estate leases and therefore sale and leasebacks should be authorized.

Another advantage of sale and leaseback is that it can also be used both in Management and Hybrid REIT model. The figure represents how sale and leaseback agreements would operate in REITs.



1. The investors in hybrid/development REIT will get low risk rental yield.
2. The lessee will capitalize the capital gains that he would obtain on selling his property, and as a result this will be a structure similar to paghri system whereby a rental will be paid by the lessee to the lessor.

This alternate solution to real estate investments will provide a way to obtain exposure in real estate, thus improving the number of products available for investment. This would also aid the future development of REIT market.

Proposed Changes

- Banks and leasing companies should be allowed to write leases for property;
- Land/property sold under sale and leaseback agreements should be tax free;

Annexure II

Proposed Rules and Regulations for REITS

The following is a basic framework that is adopted from the Rules and Regulations present in Turkey and Malaysia.

Authorized Investments

A real estate investment trust may invest in any of the following:

1. Real estate;
2. Single-purpose companies;
3. Real estate-related assets;
4. Liquid assets;
5. Non-real estate-related assets; and
6. Asset-backed securities;

Moreover, REIT can be established;

1. for a limited time to undertake a certain project,
2. for a limited or unlimited time to invest in certain areas, and
3. for a limited or unlimited time without any limitation of purpose;

The investments can only be made in Pakistan.

Conditions for Establishment

Companies can be established by immediate establishment. Furthermore, existing companies can turn into real estate investment companies by amending their Articles of Association in accordance with the procedures of this Law. In order that the transformation of institutions or companies to real estate investment companies can be approved by the Commission:

1. Companies should be established as NBFC or Public Unquoted Company with registered capital,
2. Companies should be established to offer the shares representing at least 49% of the issued capital to public within the period and principles determined by this law,
3. The initial capital should not be less than PKR 1 billion,
4. At least 25% of the shares representing initial capital should be issued for cash,
5. The phrase "Real Estate Investment Company" should be included in the commercial title,
6. Should have applied to the Commission for providing asset management service; mentioned in sub-paragraph; and
7. The Articles of Association should be in conformity with the provisions of the Law.

Investment Focus

A **Development REIT** must comply with the following requirements:

1. At least 70% of the fund's total assets shall be invested in real estate purchase or construction of real property to be leased out;
2. The remaining 30% of the fund's total assets may be invested in other assets such as liquid assets; real estate related assets, non-real estate-related assets or asset-backed securities;

A **Management REIT** must comply with the following requirements:

1. At least 70% of the fund's total assets shall be invested in real estate acquisition and management;
2. At least 30% of the fund's total assets must be invested in liquid assets, real estate related assets, non-real estate related assets, and asset backed securities;

The Investment Focus for both Management and Development REIT should be different for open-ended and closed-ended funds to incorporate redemptions.

Investments in Real Estate

Acquisition of Real Estate

1. Acquisition of a real estate must include the ownership of all rights, interests and benefits related to the ownership of the real estate;
2. Unless otherwise approved by the SC, the real estate proposed to be acquired by the fund shall be specifically identified and has a good track record and/or good prospects of future net rental income of reasonable levels. They shall be chosen from those which have been shown by studies to be competitive and located within good catchments areas;

A fund may acquire buildings which are not fully tenanted. Strong justifications must be provided and the SC must be satisfied of the following:

1. There is good potential to secure tenants;
2. Any costs to be incurred to enhance the appeal of the building (such as the costs of the refurbishment) would not materially affect the yield to the unit holders of the fund; and
3. The acquisition would be able to yield a reasonable return within a reasonable period of time.
4. The real estate proposed to be acquired shall be wholly acquired. However, where this is not possible, the fund shall at least acquire a major portion of the real estate and must be able to exercise all rights and interests over the real estate without any hindrance whatsoever;
5. Where a leasehold property is acquired, the management company must ensure that the consent of the relevant authority to transfer the lease has been obtained before the fund's prospectus is registered with the SC (or where it is an excluded offer, the information memorandum is deposited with the SC), or prior to the acquisition of the leasehold property (in the case of an existing fund); and
6. The lease must be a registered lease.
7. Unless otherwise approved by the SC, all real estates shall be free from all encumbrances at the time of acquisition, except for charges entered by financial institutions, trustees and Management Company in relation to the loan facilities extended; and
8. The real estates acquired shall also be insured for their full replacement value, including loss of rental, where appropriate, with insurance companies approved by the trustee.

A management real estate investment trust may enter into an arrangement or agreement at any stage in the development of a real estate, to purchase the real estate upon its completion, where the real estate is viewed as a viable investment, provided the following criteria are satisfied:

1. The returns from the fund's existing investments shall be sufficient to ensure that there is no substantial dilution to the fund's earnings per unit during the construction period;
2. The purchase agreement is made subject to the completion of the building with proper cover for construction risks. The fund shall be able to withdraw from the agreement if the transaction is no longer in the interests of unit holders, for example if the construction of the building cannot be completed;

3. The development/construction of the real estate must be carried out on terms which are the best available for the fund and which are no less favorable to the fund than an arm's length transaction between independent parties; and
4. The prospects for the real estate upon completion can be reasonably expected to be favorable.

Revaluation of Real Estate

The trustee shall cause a revaluation of real estate directly held by the fund, or indirectly via the holding of the equity of a single-purpose company, to be carried out in the following manner:

1. for listed funds, at least once in every three years from the last valuation date and for unlisted funds, at least once in every 18 months from the last valuation date;
2. with additional revaluation in the interim period where the trustee, on its own accord and where it deems fit, require the conduct of a valuation of the real estates belonging to the fund; or on the recommendation of the management company; or if the auditor is of the view that the carrying values of the revalued real estate differ materially from the market value;
3. Such revaluation must be approved by the SC before being incorporated into the accounts of the fund;
4. Notwithstanding, this does not preclude provisioning in accounts of the fund for diminution in value of real estates as may be recommended by auditors in compliance with approved accounting standards;
5. Where the SC has revised the valuation, the management company shall incorporate the valuation specified by the SC into the fund's accounts;
6. Where the revaluation surplus is to be utilized for the issuance of bonus units, only up to 90% of such revaluation surplus may be capitalized into bonus units;

Valuation of Real Estate-related Assets and Non-real estate-related Assets

For the purpose of determining the fund's net asset value, the valuation of the assets and liabilities of the fund's investments in real estate-related assets and non-real estate-related assets (where applicable) shall be based upon a process which is consistently applied, and which leads to valuations that are objective and independently verifiable.

REIT Management Company

Real Estate Investment Trust ("REIT") in its working replicates the working of a closed-end fund. The concept of REIT can be used both for real estate development as well as real estate management projects. The key guidelines pertaining to REIT are as follows:

1. The application to set-up a REIT management company will be put forward to SECP;
2. The promoters of the REIT Management Company shall not dispose of their shares for a minimum period of three years and will hold at least 20% of the issued capital of the REIT Management Company;
3. Minimum paid-up requirement for the REIT Management Company is PkR 30 million;
4. During the validity of this permission, the promoters of the REIT management company shall get the REIT management company incorporated as a public limited company under the Ordinance;
5. Upon public listing, REIT management company will make an application to SECP for grant of license for establishing a REIT Scheme and carrying on the business of providing REIT management services;
6. REIT Management Company will have on its board of directors at all times at least one person with senior management level experience of at least five years in the financial sector and employ

at least two persons in senior management positions each of whom will have at least 5 years' experience in managing collective investment schemes;

7. REIT Management Company should be assigned a credit rating which shall not be lower than a minimum investment grade, and such credit rating shall be updated at least once every financial year;
8. Investments out of REIT Funds shall only be made in assets in Pakistan with 80% of the funds invested in real estate and 20% in financial assets;
9. Not less than 90% of the annual audited accounting income arising out of a scheme shall be distributed to unit holders;
10. Any real estate acquired shall be held for a period of at least two years;
11. The REIT Fund shall have a minimum proposed capital of PkR 150 million;
12. The units of the REIT Fund shall be held by 100 or more persons for all years of operations and not more than 50% of the units may be held by five or fewer persons;
13. The investment policy of REIT scheme should state allocations amongst (1) yielding assets, (2) real estate to be acquired, held and resold; and (3) real estate to be acquired, developed and resold;
14. The investment policy of REIT scheme should also specify whether the REIT Scheme is to exist for a definite or indefinite period ;
15. The REIT funds shall not invest in more than five real estate projects;
16. The REIT management company shall be entitled to be paid annually a remuneration not exceeding 3% of the average net asset value over the preceding year;