Potential and Prospects of Islamic Real Estate Investment Trusts

Arshad Zaman

Outline:
1. Global Survey
2. Conventional REITs
3. Islamic REITs (I-REITs)
4. Prospects for I-REITs
5. Conclusion
1. Global Survey

1.1 What is a REIT?

A REIT is a:
- Pooled-investment vehicle (partnership, trust, company, &c.) that invests in RE equity and/or mortgages, and meets
- Special regulatory and operational requirements, so as to obtain
- Special tax treatment (mainly: pass-through taxation)
1.2 REITs have many names

- REIT (US, Hong Kong, Korea, Singapore)
- Listed Property Trust (LPT) (Australia)
- Japanese REIT (J-REIT)
- Real Estate Property Trust (REIT) (Malaysia)
- Property Unit Trust (PUT) (South Africa)
- Real Estate Investment Fund (REIF) (Italy, Spain)
- Real Estate Mutual Fund (REMF) (Greece)
- Mutual Fund Trusts (Canada)
- Proposed: UK-REIT, EU-REIT

1.3 Key Countries & Regions

**North America**
- USA, Canada (USAC)

**Austral-Africa**
- Australia, New Zealand, S. Africa (ANSA)

**Asia**
- Japan, Hong Kong, Singapore, South Korea, Malaysia (ASIA)

**Europe**
- France, Netherlands, Belgium (EFNB)

Reclassification of countries covered by Ernst & Young, Global REIT Report 2006, Oct 2006
1.4 Number by Regions

Number of REITs by Major Regions (30 Jun 2006)

- USA (253)
  - Canada (33)
- Australia (58)
  - New Zealand (6)
  - South Africa (7)
- Japan (38)
  - Hong Kong (4)
  - Singapore (11)
  - South Korea (11)
  - Malaysia (11)
- France (30)
  - Netherlands (9)
  - Belgium (13)

Source: Estimates based on Ernst & Young Data

1.5 Market Capitalization

Total Market Capitalization (US$ million)

- USAC: 417,843
- ANSA: 62,785
- ASIA: 46,037
- EFNB: 81,933

Average REIT Capitalization (US$ million)

- USAC: 1,742
- ANSA: 1,364
- ASIA: 924
- EFNB: 1,900

Source: Estimates based on Ernst & Young Data
1.6 Market Depth & Turnover

<table>
<thead>
<tr>
<th>Yearly Value of Volume Traded (US$ million)</th>
<th>Annual Volume Traded (as x Market Capitalization)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USAC: 499,750</td>
<td>USAC 1.2</td>
</tr>
<tr>
<td>ANSA: 59,485</td>
<td>ANSA 0.73</td>
</tr>
<tr>
<td>ASIA: 33,855</td>
<td>ASIA 0.74</td>
</tr>
<tr>
<td>EFNB: 23,855</td>
<td>EFNB 0.38</td>
</tr>
</tbody>
</table>

Source: Estimates based on Ernst & Young Data

1.7 Returns & Yields

<table>
<thead>
<tr>
<th>Total (Capital &amp; Income) Rates of Return &amp; Dividend Yield (to 30 Jun 2006)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASIA</td>
</tr>
<tr>
<td>35</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>25</td>
</tr>
<tr>
<td>20</td>
</tr>
<tr>
<td>15</td>
</tr>
<tr>
<td>10</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>-5</td>
</tr>
</tbody>
</table>

Source: Estimates based on Ernst & Young Data
1.8 Price Premiums & Volatility

<table>
<thead>
<tr>
<th>Premium of Market Price to Net Assets (%)</th>
<th>Beta Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFNB</td>
<td>0.541</td>
</tr>
<tr>
<td>ASIA</td>
<td>0.468</td>
</tr>
<tr>
<td>ANSA</td>
<td>0.591</td>
</tr>
<tr>
<td>USAC</td>
<td>0.815</td>
</tr>
</tbody>
</table>

Source: Estimates based on Ernst & Young Data

2. Conventional REITs

1. Global Survey
2. Conventional REITs
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4. Prospects for I-REITs in Asia
5. Conclusion
2.1 Short History: USA

- Early 1800s Real Estate Trusts (ownership)
- Real Estate Syndicates
- 1960 REITs introduced
- **1976 Tax Reform Act**
- 1981 Economic Recovery Tax Act
- **1986 Tax Reform Act**
- Early 1990s: RE market crash
- 1992 Umbrella Partnership REIT (UPREITs)
- 1992-98 US REITs surged from $8.7b to $105.2b (11% to 44% of global listed property market)

2.2 Real Estate Syndicate

- Promoters select property
- Estimate “cash yield after tax”
- Syndicate manager acquires property on price and terms yielding target investor returns, making a 5-10% deposit
- Promoter organizes syndicate
- Markets participation shares & recoups most of cash invested
2.3 Syndicate Forms

- Mostly LPs with sponsors as GPs
- But also: corporation, general partnership, tenants-in-common, & hybrid forms
- Taxed accordingly
- Regulated under 1933 Securities Act & “Blue Sky” Laws: (1) Anti-Fraud, (2) Security Registration, (3) Broker-Dealer Registration

2.4 Syndicator’s Profits

- Brokerage fee from seller
- Profit on transfer of property (or assignment of executory sales contract) to Syndicate
- Promotional underwriting discounts and commissions
- Legal fees, retainer (if attorney)
- Revenue share as operating tenant or holder of participating share
- Rights to (disproportionate) share of gains from re-sale or re-finance
2.5 Types of REITs

- Equity REITs
- Mortgage REITs
- Hybrid REITs

2.6 REITs & Mutual Funds

<table>
<thead>
<tr>
<th>REITs</th>
<th>Mutual Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closed-end</td>
<td>Open-end</td>
</tr>
<tr>
<td>Illiquid</td>
<td>Liquid (NAV)</td>
</tr>
<tr>
<td>Valuation is problematic</td>
<td>Valuation at market</td>
</tr>
<tr>
<td>Related-party transactions</td>
<td>Related-party transactions</td>
</tr>
<tr>
<td>common</td>
<td>not allowed</td>
</tr>
</tbody>
</table>
2.7 Organizational Structure

Generally meet four tests:
1. Organization: widely-held trust
2. Assets:
   a) Mainly in real estate,
   b) Diversified portfolio of securities
3. Distribution: Conduit – “Pass through” at least 95% to shareholders
4. (Gross) Income:
   1. Over 90% from its investments (incl. RE)
   2. Over 75% from passive RE investments
   3. Under 30% from short-term capital gains on stock and securities, and real property held for less than 4 years

2.8 Tax Treatment

- Trusts (Business Trusts) eligible for “conduit” tax treatment
- 1936 Extended to corporate mutual funds
- 1976 Extended to corporate-form REITs (like regulated investment companies)
- Must be “passive investment” (not “active business”)
2.9 Valuation Issues

- EPS and P/E Ratios make little sense for REITs

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>540</td>
<td>430</td>
<td>2.2</td>
</tr>
<tr>
<td>Plus: Depreciation</td>
<td>440</td>
<td>420</td>
<td></td>
</tr>
<tr>
<td>Gain on Property Sales</td>
<td>(300)</td>
<td>(100)</td>
<td></td>
</tr>
<tr>
<td><strong>Funds From Operations</strong></td>
<td>680</td>
<td>750</td>
<td>-9.3</td>
</tr>
<tr>
<td>Minus: Capital Expenditures</td>
<td>(180)</td>
<td>(150)</td>
<td></td>
</tr>
<tr>
<td>Minus: Other Amortizations</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td><strong>Adjusted FFO</strong></td>
<td>500</td>
<td>600</td>
<td>-16.6</td>
</tr>
</tbody>
</table>

2.10 Pitfalls of RE Investment

- Oversupply & Under-occupancy
- Obsolescence
- Undesirable location
- Management
- Financing
- Risks peculiar to Syndication:
  - Illiquidity of investment interests
  - Lack of investor control
  - Changing “tax shelter” rules
3. Islamic REITs

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3.1 Shari‘ah Requirements

Basic Requirements:
- Honesty and fair dealing
- Avoiding potential disputes
- Strictly avoiding “prohibited gain” (riba)
- Fulfilling higher goals (or “the spirit”) of the shari‘ah
3.2 Riba of Hadith

Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand; but if the kinds differ, trade as you like, as long as it is hand to hand. [Muslim, et al.]

The Economic Context

- MONEY Bi-metallic commodity money, initially by weight (gold dinar, silver dirham – much later: copper or nickel fulus)
- TRANSACTIONS Sale, self-liquidating long distance trade, agriculture, livestock, food processing, and handicraft
3.4 Dinars & Dirhams

3.5 Loan versus Credit

- **CREDIT** Transfer of ownership and risk of loss of a property, against future obligation to return *money* counter-value
- **LOAN** Transfer of ownership and risk of loss of a property, against future obligation to return *similar* counter-value
- **RENTAL** Transfer of “use” of a property against claim to “rent”
3.6 *Riba* 1

- In a loan: any excess on the original capital is *riba*
- In a sale on credit: any excess on the original price is *riba*
- In an exchange of any one "money" or "near-money" food staple with itself:
  - Any deferred transaction is *riba*
  - Any quality premium in spot transactions is *riba*

3.7 *Riba* 2

- *Riba* is "prohibited gain" – All gain is prohibited, (mainly) if:
  - Received in pre-agreed exchange without a tangible *counter-value*; or when
  - Received in a transaction in which the *risk of loss* of the underlying asset is not borne by the recipient of the gain
- Sale of financial assets is prohibited.
... in one easy lesson:

A market in Financial Assets (or Asset Backed Securities) is **not** permitted.

A market in **Tangible** Asset Backed Securities is **permitted**

- So *the solution* is: (i) to “staple” the claim to financial assets to a claim to an underlying tangible asset; and (ii) to ensure that *ownership* and *risk of loss* are kept together.

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**3.9 Stapled securities**

Yield returns ("gains") that might not be classified as *riba* but as:

- Rents, where underlying assets can be construed as having been leased; or as
- Profits, where goods are bought and sold, directly or indirectly; or as
- Wages, where services are provided as part of the transaction
2.10 Successful I-RE Models

- Lease, with buy-out agreement
- Joint purchase, lease, with buy-out agreement ("Declining balance partnership")
- Securitization
- Cost-plus sale
- Contract to manufacture (by fixed date, against future payment)

3.11 I-REIT Manager Setup

Board of Directors

Shari‘ah Advisory Board

CEO

Finance
- Raising equity & "debt"

Investment Management
- Identify & evaluate new investment opportunities

Asset Management
- Oversee management of existing portfolio

Compliance/Accounting
- Ensure Compliance
- Accounting

Investor Relations
- Liaise with investors

Arshad Zaman
3.1.2 REIT Manager Income

1. Recurring Management Fee
2. Performance-based Fee
3. Transaction Fees
   > Acquisition/Disposal Fee
   > If profit is forecast:
     > Expected incremental income
     > Expected incremental management & performance fee

4. Prospects for I-REITs

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4.1 Asia has a big share
...in global listed property market

Listed Property Equity Market Capitalization by Region (US$ bil.)

- North America
- Europe
- Asia Pacific

Source: S&P/Citigroup BMI Property Index (data through Jan. 1, 2006)

4.2 REITs Market: Rapid Growth

Asia Pacific Listed Property Equity Market Capitalization (US$ bil.)


Source: S&P/Citigroup BMI Property Index (data through Jan. 1, 2006)
4.3 Absolute & Risk Adjusted Returns

Sources: S&P/Case-Schiller REIT Index, Bloomberg (Merrill Lynch Global Government Bond indexes, MSCI Pacific equity index); data as of year-end 2005

4.4 Investment Rates

Source: ADB, Asian Development Outlook 2006 Update
4.5 World Economy Prospects

<table>
<thead>
<tr>
<th>Indicators</th>
<th>2006</th>
<th>2007</th>
<th>2008-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth: Industrial Countries</td>
<td>3.1</td>
<td>2.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Rest of the World</td>
<td>7.3</td>
<td>7.2</td>
<td>6.7</td>
</tr>
<tr>
<td>Prices: Manufactures</td>
<td>2.2</td>
<td>2.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Oil</td>
<td>29.7</td>
<td>9.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Non-Fuel Primary Com.</td>
<td>22.1</td>
<td>-4.8</td>
<td>-6.1</td>
</tr>
<tr>
<td>Inflation: Industrial Countries</td>
<td>2.6</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Rest of the World</td>
<td>5.2</td>
<td>5.0</td>
<td>4.2</td>
</tr>
<tr>
<td>Int. Rates (%): Real 6m LIBOR</td>
<td>2.4</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>World Real LT-LT</td>
<td>1.8</td>
<td>2.7</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook, Sep 2006

4.5 Regional Growth Prospects

<table>
<thead>
<tr>
<th>Real Economic Growth</th>
<th>2006</th>
<th>2007</th>
<th>2008-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Rest of the World&quot;</td>
<td>7.3</td>
<td>7.2</td>
<td>6.7</td>
</tr>
<tr>
<td>Africa</td>
<td>5.4</td>
<td>5.9</td>
<td>5.1</td>
</tr>
<tr>
<td>Central &amp; Eastern Europe</td>
<td>5.3</td>
<td>5.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Central Asia (CIS)</td>
<td>6.8</td>
<td>6.5</td>
<td>5.7</td>
</tr>
<tr>
<td>Developing Asia</td>
<td>8.7</td>
<td>8.6</td>
<td>8.0</td>
</tr>
<tr>
<td>Middle East</td>
<td>5.8</td>
<td>5.4</td>
<td>5.4</td>
</tr>
<tr>
<td>Western Hemisphere</td>
<td>4.8</td>
<td>4.2</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook, Sep 2006
4.7 Investment Prospects

<table>
<thead>
<tr>
<th>Investment/GDP Ratios</th>
<th>2006</th>
<th>2007</th>
<th>2008-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Rest of the World”</td>
<td>27.3</td>
<td>28.2</td>
<td>29.8</td>
</tr>
<tr>
<td>Africa</td>
<td>21.8</td>
<td>22.1</td>
<td>22.9</td>
</tr>
<tr>
<td>Central &amp; Eastern Europe</td>
<td>24.9</td>
<td>25.6</td>
<td>26.6</td>
</tr>
<tr>
<td>Central Asia (CIS)</td>
<td>20.5</td>
<td>20.8</td>
<td>22.5</td>
</tr>
<tr>
<td>Developing Asia</td>
<td>36.3</td>
<td>37.9</td>
<td>39.5</td>
</tr>
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<td>Middle East</td>
<td>23.1</td>
<td>23.6</td>
<td>25.6</td>
</tr>
<tr>
<td>Western Hemisphere</td>
<td>20.7</td>
<td>21.1</td>
<td>21.3</td>
</tr>
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Source: IMF, World Economic Outlook, Sep 2006

5. Conclusion

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5.1 Success Drivers in Malaysia

- Liberal Shari`ah Permissibility
- Pro-active government support
- Relatively developed legal framework
- Relatively developed capital markets
- Healthy construction sector
- Sizeable private investor base

5.2 I-REITs Strategy

- Need for demand-, rather than supply-induced, innovation
- Tapping “contractual savings” (insurance and pension funds)
- Islamicity premium needs to be reduced
- Fiduciary responsibilities of and standards for Shariah Boards
5.3 Standards Needed

- Licensing REITs Managers (like CFAs for securities)
- Licensing certified appraisers
- Defining “interested parties” (sponsor, manager, adviser, director, major unit-holder)
- Disclosure requirements
- Trustee role (due diligence, custody, clear title, reporting)

5.4 I-REITs: First Steps

Starting Right:
- Announce intent in budget
- Prepare a substantive paper, and circulate to industry for comments
- Revise and circulate paper and comments to general public, along with draft law
5.5 Opportunities: Pre-Identification

Country-specific review of:
- Structure and growth of construction sector investment
- Foreign investment (in and out)
- Investor sentiment
- Regulatory regime
- Business organization law
- Property transactions, rent control laws (statute and case law)
- Judicial process (institutions of dispute resolution)

5.6 Opportunities: Conventional

Identify scope for secure, better-than-benchmark returns in specific sectors:
- Commercial property
- Plantations, residential, Hospitals, logistics, Warehouses, etc
5.7 Opportunities: Innovative

Explore scope in specific unconventional sectors:
- Agriculture (like plantations in Malaysia)
- Factories, warehouses, etc.
- Residential co-operatives and condominiums
- Pension funds

Thank You