



Policy Advisory

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INTRODUCING REAL ESTATE INVESTMENT TRUSTS: PROSPECTS FOR THE PHILIPPINES

**Congressional Planning and Budget Department
House of Representatives**

Executive Summary

Real estate investment trusts (REITs) are companies that own and operate income-producing real estate which are granted tax exemptions by the government but are required to pay out a substantial part of their net taxable income as dividends to shareholders. Robust growth of the real estate industry in recent years has prompted the introduction of REITs in several Asian countries such as Japan, Singapore, Hong Kong and Thailand, among others.

In the Philippines, legislative measures seeking to introduce REITs are currently being deliberated upon in the Senate and the House of Representatives. There are a number of issues that should be considered particularly in addressing the needs of operators, promoting investor protection and ensuring a strong regulatory framework for the industry.

It is very important to promote a level playing field among operators and investors and, at the same time, ensure that the government is not adversely affected by the proposed liberal tax incentives. Moreover, the introduction of REITs should not create opportunities for tax arbitrage. Thus, REITs legislation should be without or with minimal preferential tax treatments and limited to a specific period, leaving the market to decide where to invest.

Timing is also a crucial factor in the introduction of a new investment instrument. A possible moderation of the real estate sector and the economy as well as the contagion effects of the US sub-prime crisis could have unfavorable impact on the timing of the introduction of REITs in the country.

Other possible issues that should be taken into consideration are the effects of financial engineering, adverse taxation developments, low yields, regulatory process, poor understanding of REITs and the cost of bringing REITs to market.

Introducing Real Estate Investment Trusts: Prospects for the Philippines

By Rosemarie R. Sawali and Elsie C. Gutierrez

Background

Real estate investment trusts (REITs) are companies that own and operate income-producing real estate which are granted tax exemptions by the government but are required to pay out a substantial part of their net taxable income as dividends to shareholders. REITs were first introduced in the United States in the 1960s to enable the investing public to benefit from investments in large-scale real estate enterprises. Since its introduction, the US REITs industry has grown significantly from only 53 publicly-traded REITs with a market capitalization of \$712 million in 1974 to almost 200 publicly-traded companies with a market capitalization of over \$300 billion to date. (*Box 1 provides basic details about REITs.*)

In Asia, robust growth of the real estate industry in recent years has also prompted the introduction of REITs in a number of countries. Japan pioneered the introduction of REITs in Asia in 2001, shortly followed by South Korea in the same year. In 2002, Singapore enacted its REITs legislation, followed by Hong Kong and Taiwan the following year. Both Malaysia and Thailand also have their version of REITs which were established in 2003.

The success of REITs has also prompted other countries to follow suit. India and China, where growth prospects for the property market are seen as strongest, are considering introducing REITs in their markets. At present, real estate companies in these countries seek listing in established REITs markets such as Singapore and Hong Kong.

In the Philippines, legislative measures seeking to introduce REITs are already being deliberated upon in the Senate and the House of Representatives. In view of the need to craft a law that would promote the development of REITs in the country, this paper seeks to surface issues that should be considered particularly in addressing the needs of operators, promoting investor protection and ensuring a strong regulatory framework for the industry.

Box 1. Fundamentals of REITs

Properties/assets kept by a REIT

Office (office buildings); Residential (condominiums, townhouses, apartments); Retail (shopping centers and outlet centers); Tourism-related facilities (hotels, resort facilities, restaurants, golf courses); Healthcare (hospitals, nursing homes, retirement homes, drugstores); Industrial (warehouses, R&D centers, flattened ramp-up and stock-up factories, multi-tenanted business parks facilities); Infrastructure (expressways, railways, ports, power plants).

Kinds of REITs

- 1. Equity REITs** own and operate income-producing real estate. Equity REITs increasingly have become primarily real estate operating companies that engage in a wide range of real estate activities, including leasing, development of real property and tenant services. One major distinction between REITs and other real estate companies is that a REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than to resell them once they are developed.
- 2. Mortgage REITs** lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage-backed securities. Today's mortgage REITs generally extend mortgage credit only on existing properties. Many modern mortgage REITs also manage their interest rate risk using securitized mortgage investments and dynamic hedging techniques.
- 3. Hybrid REITs** both own properties and make loans to real estate owners and operators.

Investors in REITs

Both retail and institutional investors such as investment funds, corporate treasury, hedge funds, insurance companies, pension funds and private banks.

Source: Compiled from the various reference materials.

Advantages of REITs

The spectacular growth of REITs in a number of countries can be attributed to their attractiveness as alternative investment instrument. REITs offer a number of benefits to investors and real estate developers including the general economy.

Free up capital. REITs provide real estate developers the opportunity to free up capital that can be invested in other profitable ventures. This, in turn, stimulates more investment spending for infrastructure development which creates job opportunities. The faster turnover of capital also contributes to improving capital market efficiency in the country.

Investment diversification. REITs can be another investment option for investors. A REIT portfolio in itself already provides significant investment diversification as it may include different kinds of properties in various locations including investment in overseas markets. As an attractive investment instrument, REITs can encourage the inflow of new local and foreign investments, thereby promoting the creation of new jobs and supporting economic growth in the long run.

Liquidity. REITs provide investors the opportunity to invest in real estate without the problem of illiquidity. REITs effectively convert a generally illiquid asset like real estate into units of stocks that are bought and sold. This is similar to shares of stock which can easily be transferred and liquidated as opposed to holding real estate properties which are difficult and take longer to sell and transfer.

Competitive yield. Average dividend yield of Asian listed REITs as of June 2007 is 5.5%, notably higher than the interest rates on savings and time deposits in the country. In the US, REITs have performed better compared to other major market benchmarks. Investments in REITs are also deemed as a good hedge against inflation as the value of properties and the underlying rental income are periodically adjusted to reflect the overall price level in the economy (Li, 2006). Another advantage is that investors get periodic stream of income as REITs are required to distribute at least 90% of their income as dividends.

Tax exempt. A large portion of the income of most REITs is exempt from corporate taxes as long as it is distributed as dividends to shareholders. Exemption from various transaction taxes such as capital gains tax, documentary

stamp tax (DST), among others are also granted to REITs. In effect, these tax incentives translate to higher income for investors.

Small investor participation. REITs enable small investors to invest in large-scale real estate ventures, through stock purchases, that would otherwise be reserved for bigger investors. Investors no longer need to go through the traditional method of directly buying and selling real estate properties themselves and dealing with the administrative and commercial problems.

Disadvantages of REITs

Revenue losses. The government stands to lose revenues from the liberal tax incentives granted to REITs companies and their investors.

Uncertain dividend yield. While REITs are considered as profitable investment, dividend yield is not guaranteed as in any stock investment. Investors are exposed to the rise and fall of rental incomes which affect dividend payout to shareholders.

Slower growth of return. Even though the rate of return of REITs investments is higher than stocks, they tend to grow at a slower rate because of the 90% dividend paid to shareholders. There is less money to be reinvested by the company. This restriction, together with limitation on borrowing, which tends to hamper the growth potential of investments is a deterrent to some investors.

Used as a vehicle to dispose second-class assets. Analysts are concerned that real estate developers/holding companies may use REITs as channels to dispose their poor and non-performing assets. This can possibly happen when REITs are created as spin-offs from parent companies. However, the likelihood of this happening is a little bit far-off as property developers should also recognize that putting second class assets in REITs may discourage investors.

Equity issue. While it is open to retail investors, large institutional investors stand to gain more from favorable tax treatments because of their bigger investments. Being a new instrument, it may also take a while before retail investors profit from REITs as they still need to study well the intricacies of REITs before they can invest.

Increase in contagion risk. Atchison (2008) cited the prospective increase in contagion risk resulting from higher capital flows between countries. This happens when the vulnerability of a country to financial crisis increases reflecting a dependence on capital inflows which arises when a country has a high and persistent current account deficit and minimal foreign exchange reserves.

REITs vs. Property Companies

To gain a better understanding of REITs, it is worthwhile to compare them with existing listed property companies in the stock exchange. Table 1 shows that REITs have different risk profile as compared with property companies. The nature of operation of REITs is more conservative compared with property companies as evident in the allowed scope of investment activities.

Table 1
REITs vs. Property Companies

	Asian REITs	Property Companies
Structure	Authorised Trusts	Registered companies
Property Types	Income-generating properties	No restriction
Dividend Payout	90% minimum payout	No restriction
Gearing	Restricted	No restriction
Taxation	Tax transparency	Possible double taxation
Main Regulator	Regulators	Stock Exchange
Track Record	No requirement for assets	Normally Required
Valuation Base	Projected equity dividend yield	Projected NAV
	↓	↓
	<i>Very transparent and lower risk profile</i>	<i>Higher uncertainty and risk profile</i>

Source: Presentation of Mr. Edmund Ho during the REITs Conference held on 6 October 2006.

Atchison (2008) believed that REITs would normally have a lower cost of capital as compared with property companies as the former have limited real estate development activities as provided by law. On the other hand, property companies which have no borrowing limits tend to have higher cost of capital

particularly when their exposure to loans is high. Atchison also noted that property companies display greater variability of profit due to the uncertainty of construction costs, time frame, financing costs, among others. Moreover, the borrowing limits set on REITs, to some extent, lessen company risk.¹

Furthermore, Ho (2006) reckoned that REITs are very transparent and have lower risk profile while property companies have higher uncertainty and risk profile. Given the differences between REITs and listed property companies, there is a possibility that current investors in listed properties might shift to REITs and, in the process, new capital generated for infrastructure development may be limited.

REITs in Asia

REITs market in Asia steadily grew since 2001. As of end-June 2007, total number of listed REITs in Asia reached 105 with total market capitalization of US\$ 82.3 billion. Japan, which was first to introduce REITs in Asia, remains the largest REIT market. It consists of 41 listed REITs with a market capitalization of US\$ 49.1 billion, and accounted for 60% of the total. Large foreign investors such as CapitaLand, GE Real Estate and Morgan Stanley continue to be active in the market. Growing interest in the medical property shows bright prospect for Japanese REITs.

Singapore is the next second largest REITs market in Asia both in terms of number of listed REITs and capitalization. This market continues to diversify with several expansions in asset holdings such as serviced apartments, healthcare facilities and hotels. The country is positioning itself as a regional hub for cross-border REITs with its forthcoming relaxation of government regulations on REITs. Prospect for REITs in Singapore continues to be positive as it is expected that the number of listed REITs in the country could reach 30 by the end of this year.

Hong Kong is the third largest market with a capitalization of US\$8.7 billion. The average dividend yield of Hong Kong is slightly better compared to Singapore. Prospect of the REITs market in Hong Kong is supported by Chinese REIT listings. China has yet to establish the framework that will govern the regulation of REITs.

¹ It should be noted, however, that a limitation on borrowing is a double-edged thing. While it lessens company risk, it also restricts growth and profitability. Please see pages 13-14.

Table 2
Asian Listed REITs/Property Funds
As of End - June 2007

Country	Number of Listed REITs	Capitalization		Ave. Dividend Yield (%)
		(US\$B)	% Share	
Japan	41	49.1	59.7	3.7
Singapore	16	19.2	23.3	4.3
Hong Kong	7	8.7	10.6	7.2
South Korea	6	0.6	0.7	6.8
Taiwan	8	1.9	2.3	3.5
Thailand	14	1.3	1.6	7.4
Malaysia	13	1.5	1.8	5.7
Total	105	82.3	100.0	Average: 5.5

Source: CB Richard Ellis Research based on company announcements and prospectus

Malaysia revised its guidelines in REITs in 2005 to provide a regulatory framework that would protect the interests of investors and facilitate the development of REITs. As of end June 2007, Malaysia has recorded 13 listed REITs with a total capitalization of US\$ 1.5 billion. The country also issued guidelines on the first Islamic REITs. This basically provides Syariah² guidance on the investment and business activities of Islamic REITs to facilitate further development of new Islamic capital market products. It is expected that Islamic REITs will become the new growth area of Malaysian REITs given the growing interest in Islamic Financial Products in the region.

In Thailand, REITs are referred to as property funds. While the number of listed property funds is the third largest in the region, it has only US\$1.3 billion in market capitalization. However, Thailand property funds recorded the highest average dividend yield of 7.4%, almost two percentage points higher than the average dividend yield of seven countries. Fund managers cite that capital restrictions on property funds have hampered the inflow of investments in Thailand. The central bank of Thailand - Bank of Thailand – imposed a reserve requirement on foreign inflows which requires investors to deposit 30% of any investment over US\$20,000 with the bank at no interest. This rule which

² Under Shariah Islamic law, making money from money, such as charging interest, is usury and therefore not permitted. Wealth should be generated only through legitimate trade and investment in assets. But investment in companies involved with alcohol, gambling, tobacco and pornography is strictly off limits. http://www.muslimsuk.com/shariah_law.asp

effectively tied up capital and decreased returns was recently lifted in March this year.

Legislation

Existing REITs legislation are important source of information in crafting a law that could meet domestic requirements. *Annex 1* shows the key features of REITs legislation in selected Asian countries including the US which pioneered the introduction of REITs. In summary, the key features of REITs legislation in various countries are not very different from each other. Having had the longest experience with REITs, the US legislation has liberal features. For instance, there is no limit in the amount REITs can borrow (gearing limit), probably to give the company more room for expansion as most of its income is distributed as dividends. Moreover, US REITs are not strictly required to be listed in the stock exchange. In terms of management, mature REITs markets such as the US tend to be either internally- or externally-managed while emerging markets such as Singapore and Hong Kong tend to be externally managed.³

Prospects for the Philippines

The success of the introduction and future development of REITs in the country is affected by a number of factors. One factor is the current situation and prospects of the country's economy and the real estate industry in particular. Other factors include key features of the legislation and demand determinants, among others.

Real Estate Industry

Real estate development in the country has been flourishing in recent years. Total investments in construction activities have reached P109 billion in real terms in 2007, representing a robust 18% growth over 2006. Private investments which accounted for 62.4%, on the average, of the total construction investments for the period 2003 to 2007 grew 10.2% last year. Public construction investments, on the other hand, expanded by 30.8% last year as the government fulfilled its commitment to upgrade infrastructure facilities throughout the country.

³ An internally-managed REIT hires its own employees to handle all of its operations while an externally-managed REITs employs a separate business entity – investment manager, bank, insurance company – to supervise the operations in exchange for an advisory fee. Source: Li, Qingru. *Primer on REITs*.

Meanwhile, construction output as measured by gross value-added amounted to P58.8 billion in 2007, representing a 19.5% growth from the previous year.

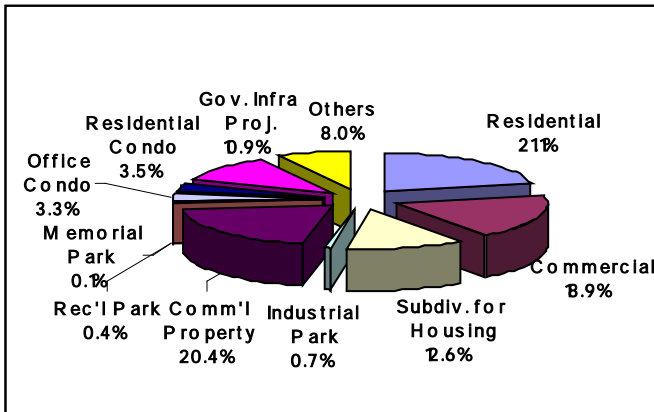
Table 3
Selected Construction Industry Indicators
In Billion Pesos

	2003	2004	2005	2006	2007
Public Investments	35.0	35.0	28.3	35.3	46.1
Private Investments	57.1	59.9	59.2	57	62.8
Total Investments	92.1	94.9	87.5	92.3	109.0
Gross Value-Added	45.6	49.0	45.9	49.2	58.8

Source: National Statistical Coordination Board (NSCB)

Other real estate indicators also show robust industry performance. Loans by commercial banks to the real estate sector have generally been on the uptrend for the period 2003 to 2007, reaching P192.1 billion as of end-December 2007. However, total loans outstanding marginally declined by 2.3% in 2007. Acquisition and development of commercial property-related loans comprised the bulk of real estate loans and together accounted for 39.3% of the total loans. On the other hand, acquisition of residential property including individual units and land consisted 21.1% of the total loans to the real estate sector.

Chart 1
Commercial Banks' Loans Outstanding to the Real Estate Sector



Source: Bangko Sentral ng Pilipinas (BSP)

Another indicator of the real estate sector is the performance of listed property companies with the Philippine Stock Exchange (PSE). As to date, there are 42 property companies listed with the PSE. Annual value turnover of the property sector reached P270.6 billion in 2007 or almost 200% more than the P90.4 billion in 2006. Total earnings of listed property companies reached P26.6 billion in 2007, 41.4% growth over the 2006 earnings.⁴

Key Features of REITs Legislation

Key features of established REITs codes/legislation in selected countries in Asia were examined in evaluating the proposed REITs legislation in the country. *Annex 2* shows the objectives and salient features of the proposed REITs bill of Hon. Juan Edgardo M. Angara at the House of Representatives.

Structure. A REIT can be established as a trust, a corporation or both. A number of countries such as Australia, Hong Kong and Singapore have established REITs as trusts. In the US, REITs are established either as a trust or as a corporation.⁵

According to the Trust Officers Association of the Philippines (TOAP), a corporation has a separate juridical personality and has a Board of Directors who is both responsible and liable for the actions of the corporations.⁶ A corporation must be registered with the Securities and Exchange Commission which prescribes certain requirements prior to the approval of the registration and is governed by the Corporation Code of the Philippines. On the other hand, a trust has no separate juridical personality but it is a distinct and accepted legal vehicle. It is governed by the General Banking Law of 2000 and the Manual of Regulation for Banks and other regulations/rules issued by the BSP. It has a Trust Committee which oversees the operation and which directly reports to the Board of Director of the bank/trust entity.

The proposed bill supports the establishment of a REIT in a corporate form. Under existing Philippine laws, REITs can initially take the corporate form as a law

⁴ Lee, Lovely Nica P. "Listed firms report higher 2007 earnings"

⁵ FAQs of the National Association of Real Estate Investment Trusts. <http://phx.corporate-ir.net/phoenix.zhtml?c=88051&p=irol-faq>

⁶ Position Paper of the TOAP on HB 148.

that will govern a trust form has yet to be enacted.⁷ The BSP argues that the policy objectives of the bill do not limit REITs to the corporate form.⁸ The TOAP also believes that providing investors with two competing forms or options will bring out the best in product categories which will benefit investors.⁹

Investment Requirements. These can include specification on the minimum number of investors or a percentage limit to the number of shares owned to avoid possible control of one or a few investors. The proposed bill contains similar provision requiring that the holdings of the top 10 largest shareholders shall not exceed an amount equivalent to 10% of the REIT's *net asset value* (NAV).¹⁰

A requirement that a single property should not exceed a defined proportion of the total value of the property assets can also be considered.¹¹ This provision could lead to further diversification of investments.

In Malaysia, an initial minimum asset size of a REIT is required at RM100 million (US\$ 30.35 million at US\$3.274/RM 1). For subsequent funds launched and managed, the minimum size of the fund shall be RM25 million (US\$7.64 million). The proposed bill does not contain a provision on the required minimum asset size of a REIT but provides for a minimum paid-up capital stock of P10 million (US\$220,000).

Development Activities. The Singapore model is acknowledged, among others, for its provision of allowing REITs to engage in development activities. The proposed bill allows up to 10% of the *Deposited Property*¹² to be invested in uncompleted property development. There might be a need to reconsider the share allowed for development activities to be able to help in infrastructure development in the country.

⁷ A Collective Investment Schemes Law seeks to establish a comprehensive regulatory framework for all forms of CIS, e.g., mutual funds and unit investment trust funds (UITFs), to eliminate existing differences in regulatory treatment.

⁸ The BSP also believes that issues concerning the trust form such as nationality requirements for purposes of owning land can be easily addressed. *BSP Position Paper on Real Estate Investment Trust submitted to the House Committee on Economic Affairs.*

⁹ Tancongco, Federico P. and Stella A. Sampayan. Coming soon: REITs

¹⁰ *Net Asset Value* refers to the difference between the total assets and the total liabilities.

¹¹ UK Real Estate Investment Trusts: a discussion paper.

¹² *Deposited Property* refers to the value of the REIT's total assets based on latest valuation.

Foreign investor participation. The extent of foreign investor participation in REITs should be consistent with the provisions in the Foreign Investments Act of 1991. The law provides that foreigners, both individuals and corporation, are prohibited from directly owning land in the Philippines but may own up to 40% of a corporation that owns land or fully own a condominium unit in a building provided that only a maximum of 40% of the condominium units of the building can be owned by foreigners.

Overseas investments. Most REITs in Asia are allowed to invest in overseas properties. In the case of Hong Kong, its Securities and Futures Commission (SFC) required REITs to have a *focused approach*, i.e., it should only invest in real estate in the country. The SFC, however, believes that this geographical restriction could be removed in the future as the REITs market becomes more developed.

The proposed law in the country allows a REIT to invest in foreign assets as long as it complies with all the applicable laws and requirements in the foreign country such as ownership restrictions and the requisites of having good and valid title to the real estate. Initially, it may be worthwhile to adopt a focused approach as the one in Hong Kong to promote the development of the local REIT industry.

Taxes. The current bill which proposes for generous tax incentives runs counter to the current policy of the government to rationalize fiscal incentives. It is also not supportive of the plan to balance the budget by 2009. The Department of Finance (DoF) has already enunciated its reservations on most of the proposed tax incentives. *Table 4* shows rates of various taxes affecting REITs transactions, most of which is exempted on the proposed bill. The DoF asserts that the proposed bill should not create more opportunities for tax arbitrage among capital market players and stands pat that taxation should be kept as neutral as possible to ensure a level playing field among players in an industry or among similar industries.

With respect to the documentary stamp tax (DST), the DoF cited that this was already revamped in 2003 to remove differences in rates for similar types of financial instruments. The DoF also argued that transactions of REITs should be subject to the stock transaction tax and the value-added tax.

Table 4
Comparative Tax Treatment of Listed Properties and Proposed REITs

	Listed Properties	Proposed Philippine REITs/*
Corporate Tax	35% of net income (starting 2009, this will be reduced to 30% as provided by RA9737)	Exempted
Capital Gains Tax	6% on gross selling price or fair market value, whichever is higher	Exempted
Dividends Tax	Tax free for domestic/resident foreign corporations; 10% for individuals; 15% for non-resident foreign corporation	Exempted
Value-Added Tax	12% on gross selling price and gross receipts for sale of all goods, properties and services	Exempted
Documentary Stamp Tax	Varies	Exempted
Stock Transaction Tax	0.5% on gross selling price for sale, barter, exchange, or other disposition of shares through the stock exchange	Same

/ Based on HB 1448 as of 14 May 2008 by Hon. Juan Edgardo M. Angara*

Sources: Isla Lipana & Co. / PricewaterhouseCoopers, "How to Invest in the Philippines, A Business Guide" and National Internal Revenue Code of 1997, Amended July 26, 2004 as shown in Rufino (2006)

Another contentious issue is the proposed exemption of overseas Filipino workers (OFWs) from the dividend tax since the policy is that there should be no tax exemptions on passive earnings. The principle is that of neutrality, i.e. there should be no preferential treatment to specific sector such as OFWs. As REITs are no different from mutual funds since both pool capital from investors, alternative investment vehicles should be made to compete on the basis of merits inherent in their structure and let the market determine where resources should flow.

Borrowings. Putting a limitation on the amount REITs can borrow has both advantages and disadvantages. Risks can be minimized when the cost of capital is

high making REITs more resilient in cases of economic downturns. However, the ability to expand the business is affected given that nearly all the income of REITs is required to be distributed as dividends to shareholders. Profitability and growth potential of the company are restricted which can have adverse effects on investment decisions.

The borrowing limit of REITs in most Asian countries is about 35% of their total assets. The proposed measure also states that total borrowings and deferred payments of a REIT should not exceed 35% of its *Deposited Property*. Moody's Asia Pacific Ltd. believes that market forces should determine the maximum debt ratio. It argues that borrowing restrictions will slow property acquisitions and the growth of assets. However, it also notes that there will not be as much of an impact in the long-term because REITs can increase their revenue through renovations and rental increase. In the US, Australia and Japan, there is no limit to the borrowings of REITs.

Dividend payout. Most REITs in Asia are required to declare a significant portion of their net income as dividends to shareholders, averaging over 90% of the total. The proposed law in the country also provides that at least 90% of net income (loss) before extraordinary item, depreciation and amortization (NIDA) shall be distributed as dividends to shareholders. While this is very beneficial to investors in the short-term, it has serious repercussions in the long-term as limited retained earnings coupled with borrowing restrictions limits growth and profitability of the company. Moreover, this can possibly raise problems on cash management as REITs may not be able to meet unexpected expenditure requirements.

REITs managers. Specific qualifications are required of REIT managers. In Australia and Hong Kong, REIT managers are licensed. Singapore is also considering to require REIT managers to be licensed. Commissions of managers in Singapore are in terms of unit stocks, which cannot be sold within a period of one year to make them more prudent in their transactions. This feature can also be considered for adoption in the Philippines as the proposed law is not very clear on the commission of a REIT manager.

Investor protection. Small investors are encouraged to participate in REITs as investing in real estate has been made easier through ownership of stocks. In contrast to institutional investors, small investors do not have adequate knowledge and means to make a careful analysis of their investment options. Thus, it is important that the proposed law contains provisions such as strict

disclosure and reporting requirements of REITs to protect the interests of investors.

Factors Affecting Demand

Recent developments such as the US sub-prime mortgage crisis and the general outlook of the economy affect investor demand. Other factors that may contribute to acceptance of REITs include interest rates movement, investor readiness and global trends such as urbanization and ageing demographics.

US sub-prime mortgage crisis. The US sub-prime mortgage crisis is an ongoing economic problem as shown through liquidity issues in the global banking system due to foreclosures which accelerated in the US in late 2006 and triggered a global financial crisis during 2007 and 2008.¹³

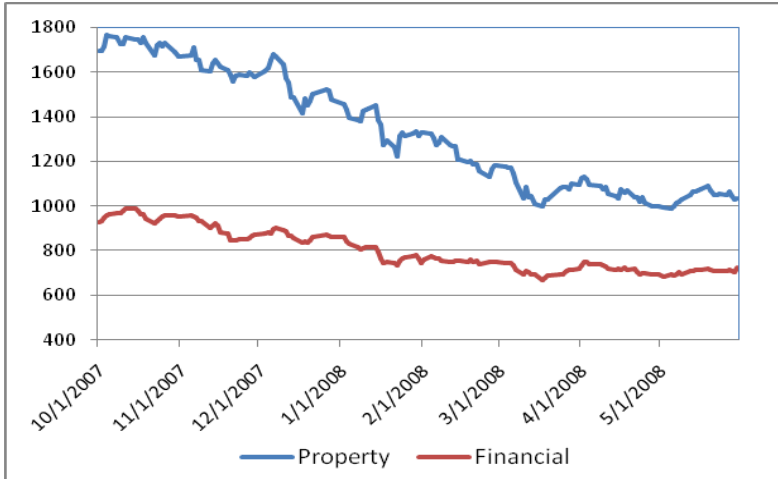
The possible direct impact on the REITs sector is that earnings reported can be adversely affected by defaults on mortgages they issue and retain. REITs value their mortgage assets (receivables) based on estimates of collection. Bad debts could result to rapid or unexpected changes in mortgage asset valuation which can lead to volatility in earnings and stock prices. The share prices of REITs may fall simply as a result of negative sentiment about the property sector even if actual property prices hold steady. In other words, despite the fact that the asset is the same, the psychology means that share prices have fallen. *(Please refer to Annex 3 for more discussion of the sub-prime mortgage crisis and its impact on existing REITs.)*

The US sub-prime crisis was really bad news for the Philippine stock market. Starting October 2007, prices of Philippine property and financial stocks have fallen steadily up to the present. Property shares have fallen by 658.96 basis points while financial stock prices declined by 207.53 basis points. For small investors (especially if the intended parties are OFWs) whose primary concern is

¹³ http://en.wikipedia.org/wiki/Subprime_mortgage_crisis. Furthermore, a New York Times article described the crisis as a “global financial turmoil that can be felt in all corners of the world, unsettling hedge funds, banks and stock markets as far away as Australia, Thailand and Germany.” Several financial institutions around the world were affected because they purchased bonds, or risk related to bonds, backed by bad home loans.
http://www.nytimes.com/2007/08/31/business/worldbusiness/31derivatives.html?_r=1&oref=slogin

liquidity, tying up their hard-earned money in REITs may not be an attractive option at the moment.

Chart 2
Index of Philippine Property and Financial Stocks
October 2007-May 2008



Source: www.pse.com.ph

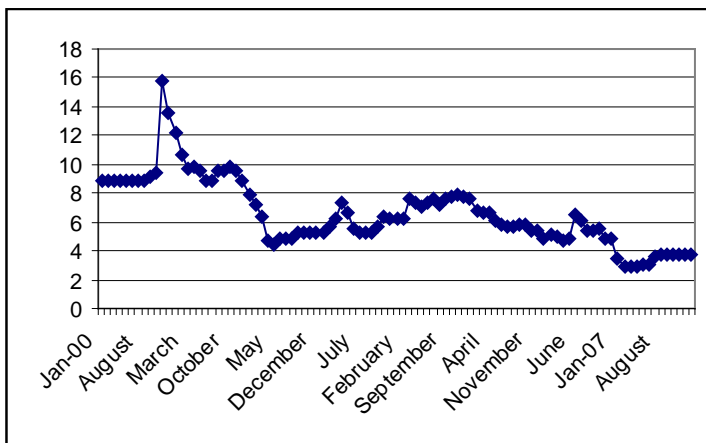
Economic outlook. Demand for office space and other real estate properties is largely affected by the level of economic activities. Businesses are encouraged to expand their operations when economic prospects are optimistic, which translates into more revenues for REITs through the increase in number of tenants. Based on official targets, the country is expected to post a slower GDP growth of 5.7%-6.6% in 2008 from 7.2% last year. Soaring prices of gasoline and basic commodities such as rice which resulted in two-digit inflation (12.2% as of July 2008) will temper consumer spending. An expected slowdown in the world economy will also soften demand for exports.

Notwithstanding recent negative developments in the local and global economy, both local and foreign investors continue to be upbeat on the real estate sector in the country. According to an executive of CB Richard Ellis Group Philippine Office, a property consulting and research firm, foreign investors are looking at the positive effects of the stable Philippine peso, increasing tourist arrivals, the BPO

boom and the positive effects of the OFW remittances.¹⁴ Moreover, local property developers such as Ayala Land Inc. and SM Investments Corp. still see many opportunities for expansion and even new projects.¹⁵ However, one possible factor that may dampen their optimism is the increasing price of construction materials such as steel and cement.

Interest rates. The cost of money affects the decision of businesses whether to lease or build their own facilities. A low interest rate generally encourages businesses to build their own facilities as the cost of money is affordable. On the other hand, a high interest rate makes renting of facilities more attractive as the high cost of money is a deterrent to constructing own facilities. It is important to note, however, that other factors such as availability of equity and the general economic and political situation also affect the decision to engage in building activities.

Chart 3
Philippine T-bill Rates, Jan 2000-Jan 2008



Source: BSP

Although the real estate sector may be negatively affected by the slowly rising interest rates due primarily to inflation, this might be mitigated by the continuous growth of the business process outsourcing (BPO) industry which sees growth

¹⁴ Rimando, Lala, "RP is 'hottest real estate market in Southeast Asia' – consultant"

¹⁵ Madrilejos-Reyes, Honey, "Bullish SM Group still in expansion mode" and "ALI ignores crisis, eyes projects"

because of the entry of new investors and new projects. The industry has already outlined initiatives to capture 10% of the global market, which is expected to balloon to US\$130 billion by 2010.¹⁶ Promotion of the country as a destination for medical tourism and retirement may also boost real estate activities.

Investor readiness. Being a new investment instrument, it is important that prospective investors be informed of the advantages as well as the disadvantages of REITs to enable them to make an educated decision. This is particularly important for small investors as they generally do not have sufficient information as well as tools and skills to evaluate new investment instruments. It should also be taken into consideration that less than one percent of the total population invests at the stock exchange.¹⁷

In light of the collapse of the pre-need industry and the issues which beleaguered the unit investment trust fund (UITF)¹⁸, it is very important to improve investor confidence. Investor education, therefore, will become very important once a REIT legislation is in place.

Global Trends. Li (2006) mentioned urbanization and ageing demographics as two other possible factors that may affect the demand for REITs. He argued that urbanization which is a natural consequence of economic growth will make Asian countries such as the Philippines with the greatest potential for real estate because the growth in wealth and real estate space tend to cluster in or near urban centers. On the other hand, changes in demographics have a significant impact on capital allocation decisions. For instance, high dividend yielding investments which the real estate offers will lead investors to increase their exposure in this sector.

¹⁶ Sto. Domingo, Bernadette S., "BPO firms face China threat, MBC told; industry disagrees"

¹⁷ Lim, Francis E. as quoted by Rufino (2006)

¹⁸ UITF is an open-ended trust fund denominated in peso, or any acceptable currency which pools together the funds of various investors, for investment in various instruments such as government securities, bonds, commercial papers, deposit products and other similar instruments. There was a massive withdrawal of investments in May 2006 UITF when the central bank hinted of possible increase in interest rates. <http://www.pnb.com.ph/content/view/176/211/>

Conclusion/Recommendation

In crafting the enabling legislation to promote REITs in the country, it is important to foster a level playing field and, at the same time, achieve a balance that addresses both the objectives of the government (revenue collection) and the property developers and investors (profit). The introduction of a new financial instrument such as REITs should not create opportunities for tax arbitrage. To prevent this from happening, the direction of legislation should be to introduce REITs without or with minimal preferential tax treatments and limited to a specific period, leaving the market to decide where to invest.

Timing is a crucial factor when it comes to succeeding in the capital market. A possible moderation of the real estate sector and the economy as well as the contagion effects of the US sub-prime crisis could adversely impact on the timing of the introduction of REITs in the country, thereby possibly affecting plans for initial public offerings. The slow start of the German REITs, introduced in March 2007, and the slowing down of other REITs markets in the world can be traced to negative developments in the stock markets.

There are other possible risks to the future of REITs that should be taken into consideration. Property professionals surveyed by Latham Consulting (2007) identified effects of financial engineering, adverse taxation developments, low yields, regulatory process, poor understanding of REITs and the cost of bringing REITs to market as important issues to consider.

Apart from the abovementioned concerns, it is also imperative to ensure a strong regulatory framework for the industry.

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Annex 1
Comparison of Key Structural Features of Selected REITs Markets

Features	USA	Singapore	Hong Kong	Malaysia
Structure				
Form	Corporate or Trust	Trust	Trust	Trust
Listed/Unlisted	Both	Listed	Listed	Both
Management				
Internal or External	Either	External	Either	External
Scope of Investment Activities				
Real Estate Investments	75%+	70%+	100%	50-75%
Overseas Investments	Ok	Ok	Ok	Ok but approvals required
Development	Ok	20% of total assets	Prohibited	Ok (limit to 30% of equity)
Gearing Limit	None	35% of total assets but for companies with an A rating, may be >35%	45% of total assets	35% of the NAV of the fund
Dividend Payout	90%+ of taxable income excluding capital gains (undistributed amounts are subject to corporate tax)	At least 90 of income must be distributed annually (undistributed earnings is taxed at 20%)	90%+ of net income after tax	No restrictions (undistributed earnings is taxed at 28%)
Tax Considerations				
At Trust Level	Subject to corporate tax on amounts retained or not distributed. Subject to 4% excise tax on certain undistributed amounts	Individual: Tax Free; Local Institution: Tax Free; Foreign Institution: 10%	Individual: Tax Free; Local Institution: Tax Free; Foreign Institution: 10%	Individual: Tax Free; Local Institution: Tax Free; Foreign Institution: Corporation Tax
At Recipient Level	Income tax rates are applied.	Individual Level: Tax Free; Local Institution: 20%; Foreign Institution: 10% for 5 years	Individual Level: Net of above; Local Institution: Net of above; Foreign Institution: Net of above	Individual: Marginal Tax; Local Institution: Corporation Tax; Foreign Institution: Corporation Tax
On Foreign Investors	30% withholding tax on foreign distributions (reduced rates may apply under specific	20% withholding on foreign distributions. This is reduced to 10% for distributions	Income generated from foreign securities is subject to 20% withholding tax	Distributions to non-resident unit holders are subject to 28% withholding tax

	tax treaties)	made during the period 18 Feb 2005 – 17 Feb 2010	upon repatriation	
Others		Stamp duty at approximately 3% for acquisition of properties; Remission of stamp duty is granted for transfer of properties located in Singapore by a company or an individual to a REIT listed or to be listed on the Singapore Exchange for the period 18 Feb 2005 – 17 Feb 2010; No stamp duty on transfer of units.		Stamp duty: exemption for instruments of transfer relating to properties disposed to approved REITs; Capital gains: exemption for properties disposed to approved REITs; Gains from disposal of properties by REIT may be subject to Real Property Gains Tax at 5%-30% rates if held for <5 years.

Sources: *Global REIT Comparison*, UBS

For data on tax considerations, *International Tax Treatment of REITs* by Ernst & Young, presented in Rufino (2006).

Annex 2
Proposed REITs Legislation in the Philippines
As of 14 May 2008

House Bill No. 148

The Real Estate Investment Trust Act of 2007
Introduced by Hon. Juan Edgardo M. Angara

General Objective

To promote the development of the capital market by providing an enabling regulatory environment and legal framework for real estate investment trusts.

Specific Objective

To provide small and large investors alike with the opportunity to participate directly in the ownership and financing of large-scale real estate projects at affordable rates of investment, without the disadvantages of illiquidity, high transaction and management costs, as compared to traditional private real estate ownership.

Salient Features

1. REITs shall be established as a stock corporation established in accordance with the Corporation Code of the Philippines and the rules and regulation promulgated by the Securities and Exchange Commission.
2. At least 90% of net income (loss) before extraordinary item, depreciation and amortization (NIDA) shall be distributed as dividends to shareholders.
3. Allowable investments: real estate and other related assets; debt securities and listed shares; government securities; and cash and cash equivalent items.
4. At least 75% of the Deposited Property of the REITs must consist of income-producing real estate located in the Philippines.
5. Total contract value of property development activities and investments in uncompleted property developments should not exceed 10% of the Deposited Property.
6. A REIT may invest in local or foreign assets, subject to the terms of its articles of incorporation.
7. Total borrowings and deferred payments of a REIT should not exceed 35% of its Deposited Property. However, for REITs with a credit rating of "A" or higher, it may exceed 35% but not more than 60% of its Deposited Property.
8. Holdings of the top 10 largest shareholders shall not exceed an amount equivalent to 10% of the REIT's *net asset value*.
9. A REIT manager who is appointed in accordance with SEC rules and regulations is responsible in managing the assets of the REIT. Commissions and fees must be reasonable and no higher than market rates.
10. Tax incentives: (i) REITs shall be exempt from income tax; (ii) Sale and transfer of assets to REITs shall be exempt from capital gains tax, DST, creditable withholding income tax and value-added tax; and (iii) Dividends paid by REITs shall be exempt from income tax.

Annex 3

US Sub-Prime Mortgage Crisis

The US sub-prime mortgage crisis began with the bursting of the US housing "bubble" and high default rates on "sub-prime" and other adjustable rate mortgages (ARM) made to higher risk borrowers with lower income or lesser credit history. However, when housing prices dropped moderately in 2006-2007, access to refinancing became difficult such that defaults and foreclosure activity increased as ARM interest rates reset higher. In 2007, nearly 1.3 million US housing properties or an increase of 79%, were subject to foreclosure activity. As of December 22, 2007, the Economist estimated sub-prime defaults would reach a level between US \$200-300 billion.

The mortgage lenders that retained credit risk were the first to be affected, as borrowers became unable or unwilling to make payments. Major banks and other financial institutions around the world have reported losses of approximately US \$379 billion as of May 21, 2008. Because of securitization, many mortgage lenders had passed the rights to the mortgage payments and related credit/default risk to third-party investors via mortgage-backed securities (MBS)* and collateralized debt obligations (CDO)**. Corporate, individual and institutional investors holding MBS or CDO faced significant losses, as the value of the underlying mortgage assets declined. Stock markets in many countries declined significantly.

In addition, REITs have business models with significant reliance on the ability to regularly secure new financing through CDO or commercial paper issuance secured by mortgages. Investors have become reluctant to fund such investments and are demanding higher interest rates. Such lenders are at increased risk of significant reductions in book value owing to asset sales at unfavorable prices and could result to eventual bankruptcy.

On the part of the investors and corporations who have purchased MBS or CDO as investments from REITs, they are affected by the lower earnings and uncertainty regarding the valuation of mortgage assets and related payment collection and may incur related losses.

Impact of the Crisis

On US REITs. According to industry analysts, many banks, mortgage lenders, REITs and hedge funds suffered significant losses as a result of mortgage payment defaults or mortgage asset devaluation. As of May 21, 2008 financial institutions had recognized subprime-related losses and write-downs exceeding US\$379 billion.

On other REITs. After a year of REIT legislation in Germany in March 2007, there is only one REIT company that has been listed in the German stock exchange. Analysts maintained that REIT introduction in Germany came at possibly the worst time when negative developments in the stock exchange climate have been experienced as with rising interest rates and the general concern that share prices in the 3-year boom had reached their peaks. As proof, the GPR General Germany Total Return Index (measures the performance of the top German real estate shares) showed that prices of real estate stocks declined by more than 33% in mid-November from February 2007. Theoretically, the sub-prime crisis usually only affects the financial institutions and money market funds in Germany. However, market analysts contend that with talk of a real estate crisis even in the news, the fear and uncertainty was transferred to all indirect real estate investments.

Similarly, investment banks in Singapore predicted that the Singapore real estate investment trust market is expected to face waning investor appetite and a short supply of potential acquisitions for 2008. They cited that Singapore REITs have taken a beating in the first four months of 2008 as large chunks of capital fled Asia on the back of the US sub-prime crisis with many REITs trading now at about 20% below their June or July 2007 peaks.

*/MBS are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. (US Securities and Exchange Commission)

**/CDO is an investment-grade security backed by a pool of bonds, loans and other assets. (www.investopedia.com)

Source: Compiled from the various cited reference materials on US sub-prime mortgage crisis.