What are the Business and Regulatory Factors for a Successful Philippine REIT Market?

by

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A.B., Management Economics, 2000

Ateneo de Manila University

Submitted to the Department of Architecture
in Partial Fulfillment of the Requirements for the
Degree of Master of Science in Real Estate Development

at the

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ABSTRACT

In an attempt to determine what business and regulatory factors are required for the successful establishment of a Real Estate Investment Trust (REIT) structure in the Philippines, we analyzed the macro and microeconomic factors affecting the Philippines property market. The proposed law governing the REITs in the Philippines was also analyzed and compared with other REIT regulation in Asia.

In the Asian REIT industry, supply and demand issues are inherently important. However, regulations, governing their activities, are also a factor in their growth and success. On the Philippine REIT supply side, the office, retail and hotel sectors offer acquisition potentials for REITs. Key demand drivers for real estate in the Philippines have been the increasing remittances from Overseas Filipino Workers, which have increased consumer spending in residential real estate and consumer goods, prompting rent growth in the retail sector. Another factor is the phenomenal growth of the Business Process Outsourcing industry which is driving both demand for office and residential supply

On the REIT demand side, there is a strong incentive for real estate developers/owners/sponsors to divest their properties into REITs in order to access an alternative and cheaper source of capital caused by the increasing globalization and securitization of real estate. Opportunities to create fee-based businesses through external management contracts with REITs also exist. For potential REIT shareholders, there is clear investor demand for a tax efficient, yield driven investment vehicle such as REITS, which provide, not only higher transparency, professional management, greater liquidity and more stable return, but also diversification for their local and global portfolios. A tax savings analysis was simulated using the current proposed REIT legislation and found that, although REITS provide significant tax benefits to residents and nonresidents, greater tax advantages are created for nonresident investors.

The proposed Philippine REIT legislation is largely in line with international REIT standards. As is the case with other Asian REITs, it appears that Philippine REIT regulation shall be a case of walking-before-running. And as international REIT regulation is continuously evolving and changing, both the Philippine REIT public and private sectors should ensure that local market regulation adapts to the global markets.

Thesis Advisor: Lynn M. Fisher
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LIST OF ABREVIATIONS (In order of appearance in)

1. REIT – Real Estate Investment Trust
2. SPV – Special Purpose Vehicle
3. NPA – Non Performing Assets
4. NPL – Non Performing Loans
5. AMC – Asset Management Companies
6. COE – Certificate of Eligibility
7. REIC – Real Estate Investment Company
8. BIR – Bureau of internal Revenue
9. IAS – International Accounting Standards
10. BSP – Bangko Sentral ng Pilipinas (Central Bank of the Philippines)
11. JREIT – Japan Real Estate Investment Trust
12. SREIT – Singapore Real Estate Investment Trust
13. EMEA – Emerging Europe and Africa
14. TROR – Total Rate of Return
15. UBS – Union Bank of Switzerland
16. KREIT – Korean Real Estate Investment Trust
17. REOC – Real Estate Operating Company
18. NOI – Net Operating Income
19. FAD – Funds Available for Distribution
20. IPO – Initial Public Offering
21. AREIT – Australian Real Estate investment trusts
22. NAREIT – National Association of Real Estate Investment Trusts
23. CPI – Consumer Price Index
24. PAX - Persons
25. SQM – Square Meters
26. GDP – Gross Domestic Product
27. ADB – Asian Development Bank
28. NCR – National Capital Region
29. NSCB – National Statistical Coordination Board (NSCB)
30. MMAP – Money market Association of the Philippines
31. TDO – Total Domestic Output
32. OFW – Overseas Foreign Workers
33. ROE – Return on Equity
34. BPO – business process Outsourcing
35. BPAP – Business Process Association of the Philippines
36. POEA – Philippine Overseas Employment Agency
37. GLA – Gross Leasable Area
38. DOT – Department of Tourism (Philippines)
39. JLL – Jones Lang LaSalle
40. IPD – Investment Property Databank
41. PRICOA – trading name of Prudential Real Estate Investment Management Inc.
42. JPY – Japanese Yen
43. CBRE – Coldwell Banker Richard Ellis
44. TIAA-CREF – Teachers Insurance and Annuity Association – College Retirement Equity Fund
45. RESI –Real Estate Securities Index

46. SSGA – State Street Global Advisors
47. NIRC – national Internal Revenue Code (Philippines)
48. PSE – Philippine Stock Exchange
49. DOF – Department of Finance (Philippines)
50. ECLIPSE – Evolution & Cycle of Listed Property Securities Analysis
51. DST – Documentary Stamp Tax
52. CWT – Creditable Withholding Tax
53. UPREIT- Umbrella Partnership Real Estate Investment trust
54. KRW – South Korean Won
55. RM – Malaysian Ringgit
56. EPRA – European Public Real Estate Association
57. NAV – Net Asset Value
58. S&P – Standard and Poor's
59. FEREIT – Far East Real Estate Investment Trust

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DEDICATION

This thesis is dedicated to three very important people in my life.

To my wife, Aisa, for her support during this extraordinary year, for posing incisive questions and for helping to edit and pull this thesis together.

And

To my Dad and Mom, for inspiring me to be the best person I can become and for their continuous support in all my endeavors.

Chapter 1: INTRODUCTION

I. BACKGROUND

The Asian financial crisis, in 2001, brought about a new generation of real estate vehicles designed to foster restructuring of the real estate markets. The Philippines, a country deeply affected by the crisis passed the Special Purpose Vehicle Law (SPV) in December 2002 (signed in January 2003). Through the SPV law, banks would be able to transfer their non performing assets and loans (NPA & NPLs) to SPVs which were able to dispose the NPLs & NPAs with greater speed and flexibility than banks. SPV's are essentially asset management companies that have expertise in expeditiously solving NPL/NPA problems. Owing to the bureaucratic system of banks, the SPV Law was envisioned to break the inertia and hasten the recovery process of financial institutions after the Asian Financial Crisis. As of May 2008, the NPL/NPA ratios of commercial banks had significantly reduced to pre-Asian crisis levels and SPV Law's life was not extended. On June 30, 2002, of the P520 Billion[1] (approx. US$ 10 Billion) NPA's, P170 Billion was sold to SPV's[2]. This represented 32% of the total NPA portfolio. While the Philippines Central Bank views the SPV law as a success, it should be noted that much of this success was due to the recent and ongoing real estate boom.

While the Philippines used the SPV Law for its Asian crisis woes, other countries, like Japan and Singapore, used Real Estate Investment Trusts (REITs) to restructure their NPA problem. REITs are investment vehicles with a focus in owning income-producing property, such as office, retail and industrial property. While originally planned to be a mere troubleshooting vehicle, the gamble paid off as REITs have seamlessly transitioned to be an enduring financial innovation[3] in these countries' real estate capital markets. In the world of global real estate investment, currently valued at US$10 trillion (source RREEF Research), REITs have become crucially important as a financial innovation. Given the phenomenal growth of REIT markets in countries like Singapore and Japan, it is evident that REITs have opened the door to global real estate investment through the local stock exchanges. Among different real estate vehicles, Asian REIT and REIT-like structures continue to be the most popular due to high yields that they have generated over the past several years.

In the absence of national laws creating REIT and REIT–like product, investors in real estate have been limited to corporations and institutional investors[4]. Individual investors in real estate have mainly been limited to home purchases. Within a REIT structure, investors are given the opportunity to buy and sell units in a REIT, rather than owning the property directly. Developers and sponsors, on the other hand, get to use the investor's capital and acquire, redevelop and manage the properties. The main difference between REITs and typical Real Estate Operating Companies is that REITs qualify as pass-through vehicles and are able to distribute the majority of income cash flows to investors without taxation at the corporate level, as long as certain conditions are met. This tax feature is the most important feature of a REIT. However, this cannot be offered without legislation in place. The Philippines is also on the verge of

---

[1] Total NPA's and NPL's represened 14.9% of the banking system's gross assets of 3.5 trillion.

[2] P100 Billion during the first SPV deadline of April 2005, P70 Billion during the extension of May 2008

[3] According Harvard Business School professor, Peter Tufano, financial innovation serves the six following purposes: 1.To complete the incomplete markets; 2.To address agency concerns and info. asymmetries; 3.To minimize transaction cost; 4.Response to taxes or regulations; 5.Response to globalization and risk

[4] A non-bank person or organization that trades securities in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions.

passing its own REIT legislature (Real Estate investment Company Act 2007). As the SPV Law's intent and use has been surpassed by the market, the Philippines has also realized the need to pass new legislation which fits the current market environment.

Currently, the Asian REIT markets are in competition[5] to achieve growth and investor participation in their respective local exchanges. There are two major factors in this competition. The **first** factor, for different REIT markets, relates to the business side of REITs. As REITs are compared by their Total Rate of Return, this thesis will determine which property segments in the Philippines will be poised to supply growth and provide the highest yields to Philippine REITs. In addition, as the success of the Philippine REIT market is dependent on the success of its players, potential REIT sponsors' and investors' motivations will also be determined and reviewed in order to assess the market demand for the REIT structure in the Philippines. The **second** factor is regulation governing the REIT's structure and activities. Thus, this thesis will review the current proposed law (Real Estate Investment Company Act, May 12, 2008) in the Philippines and compare it to other REIT legislation in Asia.

II. METHODOLOGY

Given that there is no current REIT legislature and market in the Philippines, the author used the May 12, 2008 version of the REIC draft to compare with other Asian REITs. The author relied on interviews with key industry sources and an extensive literature review on the topic and its proposed queries. The interviewees were chosen based on their involvement with the proposed REIC Bill and their expertise on various topics namely:

1. The current supply and demand issues and trends in the office, residential, retail and hotel sectors of the Philippines Property Market
2. Philippines Tax Law (National Internal Revenue Code of 1997) and the Real Estate Investment Company Act's effect on the tax provisions of the code, with regard to different tax classifications.
3. The proposed Real Estate Investment Company Act, its motivations, goals and hurdles.
4. Asian REIT legislature, its history, and its motivations for choosing its different elements and for changing past regulations.
5. The Asian REIT market, its historical performance, current trends and future outlook

The interviewees include representatives of international property consultants, developers and government and regulatory agencies. Information sources on the literature review include articles (web and print), books, investment banks' and REIT consultants' reports, real estate journals and textbooks. The detailed list of all literature and interview sources is made available in the bibliography.

III. RESEARCH PLAN

As the Philippine REIT Law is in the process of being reviewed, this thesis shall carry on from a thesis by Rufino (2006) and determine the business and regulatory factors for a successful Philippine REIT market. Chapter one shall give an in-depth overview of the Asian REIT Market, its history and what relevant

[5] In a thesis by Mullins (2004) on international real estate investments, he found that investments are allocated on a regional basis. Thus, Asian countries will have to compete with each other for a bigger percentage of the total Asia allocation.

trends and governance issues are currently happening in the market. Due to maturity and size of the United States and Australia REIT markets, they shall also be included as points of reference.

Chapter two presents an extensive overview of the Philippines' macroeconomic factors which are affecting the Philippines Real Estate Market. The chapter shall also involve an in-depth analysis of the different real estate segments (office, residential, retail, hotel) including current estimates of available stock and its drivers.

Chapter three explains and differentiates the benefits for adopting the REIT structure for the Philippine REIT owners/sponsors and the different classifications of investors/shareholders (residents and nonresidents) of Philippine REITs.

Chapter four will dissect and explain the elements of the current draft of the REIC Law and attempt to provide justification or provide improvements on them through comparison with other REIT legislation in Asia, including US and Australia, and provide examples of failed REIT structures.

Finally, Chapter five concludes and answers the question at hand: What are the business and regulatory factors for a successful Philippine REIT market? This chapter shall also suggest other recommendations for the REIT Law.

Chapter 2: ASIAN REIT OVERVIEW

The recent phenomenal growth in Asian Real Estate Investment Trusts (REITS) has sparked global interest in the REIT structure. In particular, REIT regulatory factors have been a significant topic as they have been cited by industry observers as the reason why some markets have succeeded while others have floundered. This chapter will look at the origin of the Asian REIT, its recent and current performance and trends. An overview of these regulatory factors shall also be discussed as they will be the focal point of comparing the Philippines Real Estate Investment Company Act with other Asian REIT legislation in Chapter 5.

I. THE ASIAN FINANCIAL CRISIS

In the early stages of the Asian Financial Crisis (1998), the real estate market became highly illiquid and balance sheets were very difficult to restructure. "The central issue which caused such disturbance in the investors' minds was the gap between the immediate liquidation value of a property at a time of great market instability and the perceived range of new equilibrium prices." (Brown, Liu 2001). While holding these assets on the books was not a long term option, asking prices remained unrealistically high as property owners still did not want to recognize their losses. Initial Public Offerings in the public markets were also tried by developers who wanted to liquidate their properties and raise capital at the same time. However, all these were unsuccessful as the real estate markets in Asia were in a virtual standstill.

With credit becoming increasingly inaccessible, Asia focused on three crucial reforms (Brown, Liu 2001)

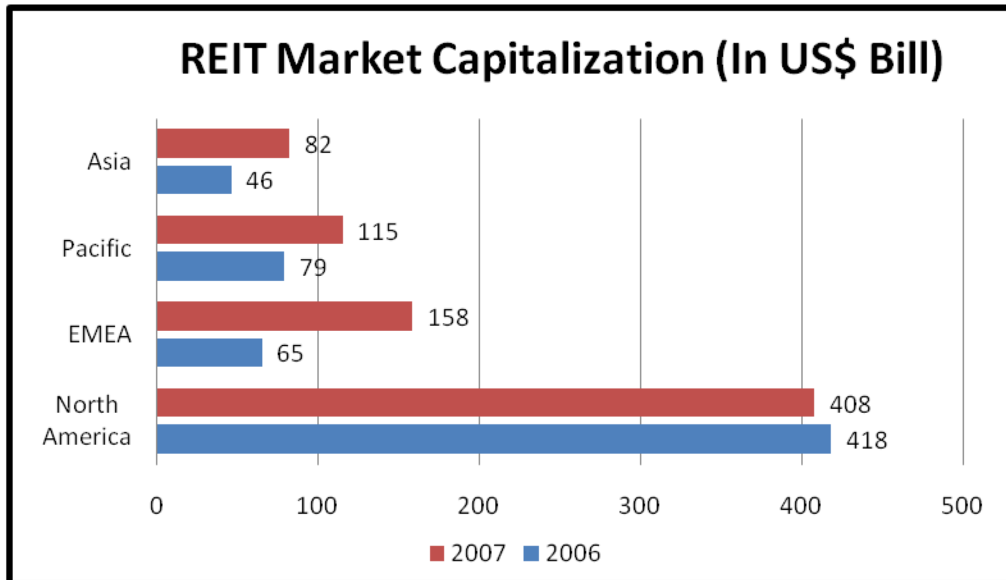
1. Creating improvements in real estate market infrastructure and sector transparency
2. Extensive restructuring of financial institutions
3. Strengthening of capital markets[6]

In 2001, the Real Estate Investment Trust (REIT) structure emerged as the newest public real estate vehicle in Asia. With Japan (JREIT 2001) and Singapore (SREIT 2002) as the market leaders, South Korea, Taiwan, Hong Kong and Malaysia have also launched/re-launched REITS and REIT-like structures. As of October 2007, Ernst and Young[7] reported that Asian REIT market capitalization topped US$80 Billion (vs. US$ 46 Billion in 2006), as depicted in Figure 1. Of the Total Asian REIT Market today, Japan holds a substantial majority at 63%, as shown in Figure 2. Other Asian countries, including the Philippines, are currently in the process of passing their own respective REIT legislature.

[6] This focused on giving incentives for private sector monitoring of financial institutions as well as developing the links between the real estate industry and the capital markets

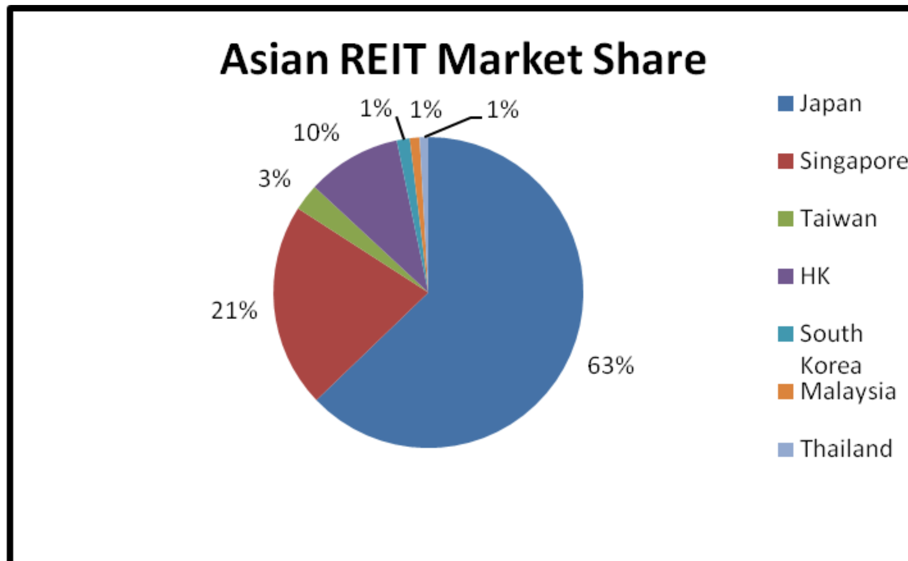
[7] Ernst and Young classifies the global REIT regions as North America, EMEA (Europe, Middle East, Africa), Asia & Pacific

Figure 1: Asian REIT Market Cap 2007



Data Source: Ernst & Young

Figure 2: Asian REIT Market Share 2007



Data Source: Bloomberg and CapitaLand Research

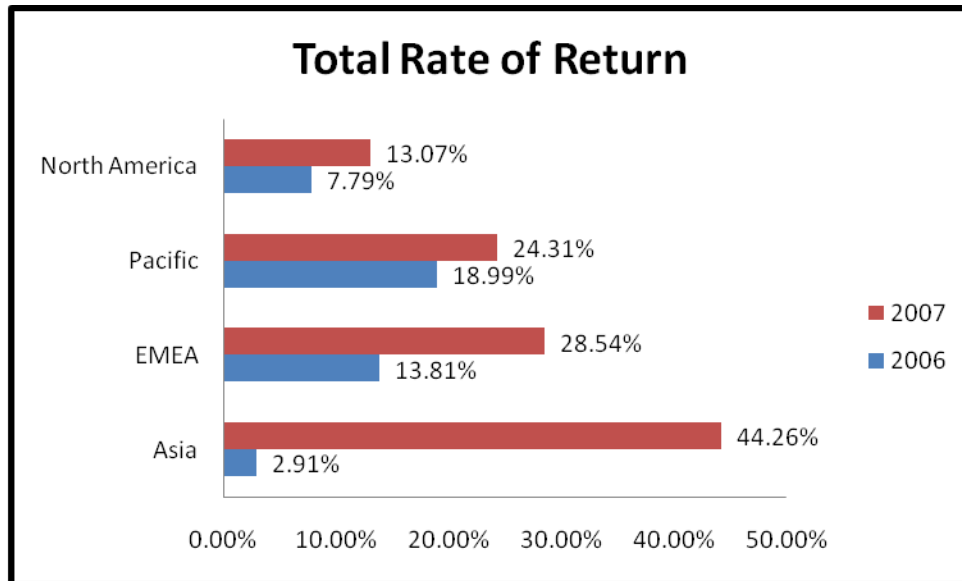
In a recent Market Report across the four REIT regions around the world, Asia has clearly led the pack for total returns over one year in 2007[8]. As shown in Figure 3, Ernst & Young reported an average total rate of return (TROR)[9] of 44.26%, in 2007, for Asia across all five Asian countries[10]. This is highly significant, considering that in the past year, Asia's TROR was only at 3%.

---

[8] The three year return for Asian REITS (up to June 30 2007) is 22.55%

[9] TROR is defined by price appreciation and dividend yield

Figure 3: One year REIT Total Rate of Return (TROR)



Data Source: Ernst and Young: Global REIT Report 2007

II. ASIAN REIT ELEMENTS

Currently, different REIT and REIT-like structures have emerged all across Asia. Several key elements of REIT Regulation have been used by Union Bank of Switzerland (UBS) to compare each country's structure, namely: Management (Internal or External), Gearing (%), Investment in Foreign Assets (%), Real Estate Assets Invested (%), Payout/Dividend Distribution (%), Development Allowed (Yes or No), Tax Transparency(Yes or No), Tax Concession for Investors (Yes or No). Each country has a combination of these different elements to form their own unique REIT structure.[11] These elements basically regulate a REIT's operations and activities (Development Allowed, Gearing, Investments in Foreign Assets, Percentage of Real Estate Assets Invested, and Management) and its responsibilities to its investors (Dividend Policy, Tax Concession for Investors, Tax Transparency). This section shall seek to define explain the relevance of each of these aspects to gain some understanding of why each country chose one element over the other.

A. Internal vs. External Management

Depending on the REIT Legislation, fund and property management can either be external, as shown in Figure, internal or external but allowing for internal management like Australia's stapled REIT

---

[10] Ernst and Young only covered Japan, South Korea, Singapore, Malaysia, and Hong Kong in its report. Other Asia REIT measures are available in Appendix 1.

[11] The United States shall also be included in the comparison as the US REIT Market dominates the Global REIT transactions and market capitalization at US$312 Billion. A comparison of the combinations is available in the Appendix.

structure.[12] It should be noted that the oldest and most mature REIT markets found in the United States (US) and Australia currently allow for internal management. In Asia, only Taiwan, HK and Korea allow for internal management. Historically, internally managed REITs have outperformed externally managed REITS in the US. In a study by Seguin and Capozza (1998), they found that internally managed REIT's outperformed externally managed REIT's by 7% per year. Another finding was that not only did externally managed REIT's have 11% more debt, interest rate was 285 basis points higher on debt negotiated by externally managed reits than internally managed REITs. Regardless of this evidence, Asian REIT regulators' persistent arguments for external management system are the existence of additional risks in internal systems, due to exposure to non-real estate investment risks and the ease of replacing underperforming external managers (Interview with CapitaLand, 2008). They also argue that this risk caused by integrating with other operating business (e.g. stapled security consisting of property development, fund management, property services, etc) might have detrimental effects to a REIT's dividend yield. Another yet more minor consideration was that certain REITs required specialized external services like hotel and health care REITs.

However, with external management, REITs face unique corporate governance challenges that can add to credit risk, according to Moody's Investors Service. Chiefly, the main concern is that the external manager will use its control to further the interests of the management company over those of the REIT's shareholders. "A typical external management agreement grants the external manager a relatively broad level of authority, and does not require the manager to balance its own interests with those of the REIT's shareholders." (Nestoras, 2007). This creates potential conflicts in that external management structures enter into outsourcing agreements with a particular (or preferred) property manager without any regard to performance or cost. Another issue is that since external managers get paid a percentage of acquisition and dispositions cost, this might entice them to enter into non yield-accretive transactions. And with regard to fund governance, "concerns include external management representation on the board limiting board independence, the board surrendering its authority to appoint senior management and determining executive pay, and the structure leading to few, if any independent accounting controls." (Nestoras 2007)

Moody's argues that externally managed REITs can address these concerns. For instance, the external manager can possess substantial equity in the REIT may align itself with the shareholders' interests. Another example, REIT Management contracts can focus on management's performance by providing performance targets and cost benchmarks and tying these up with their fees and yearly retention. The only drawback of this strategy is that, in event of non-retention of managing firm, there will be higher turnover of employees and thus, long learning curve for the new property management staff.

[12] An active business company is "stapled" to a passive property trust under this structure. The advantageous taxation treatment is maintained; however the stapled security can engage in higher-risk/return business activities related to the property industry.

Figure 4: External REIT Mangement Structure

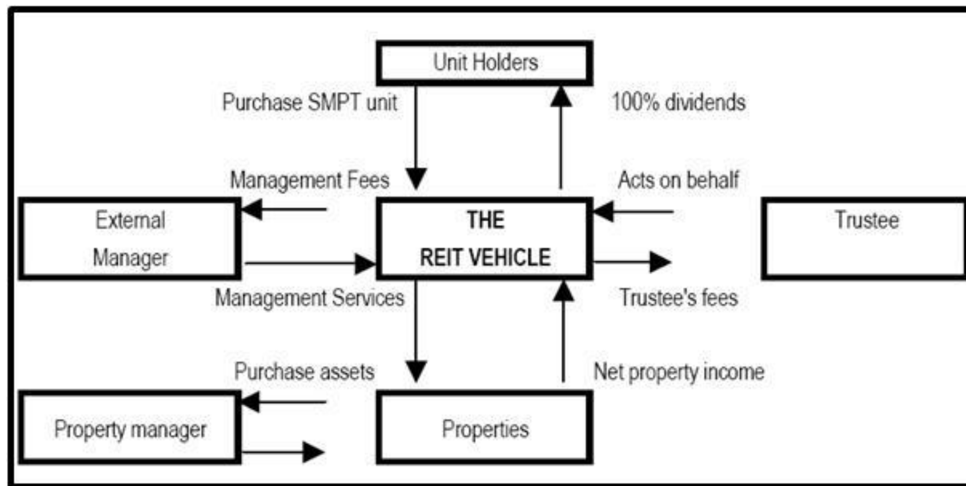


Figure Source: UBS

B. Gearing

Gearing, in REITS, is basically leverage[13]. While Thailand has prohibited gearing, almost all Asian countries have some restriction on the percentage of gearing allowed in REITS. In terms of regulations on gearing limits, "there appears to be a concern that REITs may be exploited by certain sophisticated investors, who may gear up the vehicle and channel interest payments to lenders with tax capacity while allowing capital growth to flow to equity holders" (Hughes 2005). With Real Estate Operating Companies[14] (REOC), gearing is actually beneficial, assuming it creates positively leveraged[15] projects, because interest expense from debt is a tax deductible expense. In effect, this actually provides an income tax shield for the REOC. With REITS, interest expense cannot be used as an income tax shield as income tax levied on the shareholder level. Interest expense effectively reduces Net Operating Income (NOI) and Funds Available for Distribution (FAD) to shareholders.

In mature markets, like the US and Australia, there are no limits on gearing. "In an ideal environment, regulatory restrictions on gearing should not be necessary and that investors should be able to choose the risk-reward parameters that suit their needs." (Fitch 2008)This would create a flexible and adaptive environment for the REIT manager to be able to adapt to the consistently changing public environment. In Asia, REITs have been promoted as dividend vehicles for the public. Therefore, they want to ensure a reasonable level of distributions as over-leveraged REITs tend to have their rental income eroded by interest payments, thereby diluting their distribution to investors.

[13] Leverage is the ratio of a company's total debt to its total assets
[14] Real Estate Operating Companies are basically publicly listed real estate companies that are Non-REITS
[15] A projects is positively leveraged when the Return on Equity exceeds the cost of debt/leverage

C. Investment in Foreign Assets

While the REIT structure was used to spur investments in local real estate, some REIT markets have grown well beyond their local boundaries. In these countries, the need to find alternative markets for growth has become an imperative. Australia, for example, has the strongest REIT market in the Asia Pacific region.[16] Large amount of superannuation[17] money in Australia is continuously looking for new investments and some of the funds in the portfolio need to be allocated in property. Local investment grade property has effectively run out. Thus, Australian REITs have been investing in international properties to gain exposure to foreign property markets. In fact, 43% of property directly held by Australian REITs is located on foreign shores. Evidence of this market trend has been a rise of Australian REIT IPO's on the Australian Stock Exchange that invest solely in the Japanese office (and retail) properties. Another advantage in this strategy is the opportunity for borrowing arbitrage. By leveraging in Japanese currency and lending rates, "AREITs have taken advantage of the spread between interest rates in Japan compared to property yields". (Ernst & Young, 2007). Investing in the Japanese market has produced satisfactory income returns for AREITs compared to dividend yields in its home market. Also, not only has the Australian market grown tremendously in market capitalization and REIT number, but the strength of the market has risen as well. "The average AREIT experienced US$1 billion in trade in its stock in 2006. In 2007, this rose to a depth in trading of US$1.6 billion per REIT". (Ernst & Young, 2007)

Singapore, on the other hand, is another REIT market with investments in foreign assets. In 2006, Singapore real estate giant CapitaLand launched its CapitaRetail China Trust, raising US$150 million in a Singapore public offering. The deal which represented CapitaLand's overall China strategy included seven shopping malls in five Chinese cities. Encouraged by their parent companies' who develop these China projects and then sell these projects to their respective REIT subsidiaries, Singapore REITS soon follow as they bring not only management experience, expertise and international standards, but also, better access to the capital markets for Chinese real estate projects.

The ability to seek alternate property markets and provide its shareholders access to those markets could prove to be an important factor in a REIT management's ability to improve the growth of a REIT. John Welch, head of research at Melbourne's Property Investment Research, points out that "Looking at the graph (see Figure 5) and concentrating on the 'percentage of the global investable universe' bar, one can see that Australia is actually a minnow in terms of size of the property market, being just under 2% of the world total. However, the size of the market is not a factor of the size of the country. It is a factor of the size of the economy" (Newell 2007). This signifies how REIT growth is no longer defined geographically, but rather, economically, in terms of its ability to compete for investment grade assets and find opportunities in other countries and regions.

[16] In Australia, property has 10% of the market capitalization of the stock market, compared to the US' at 3% and HK at 3.7%

[17] An organizational pension program in Australia created by a company for the benefit of its employees

Figure 5: Global Potential for Securitization

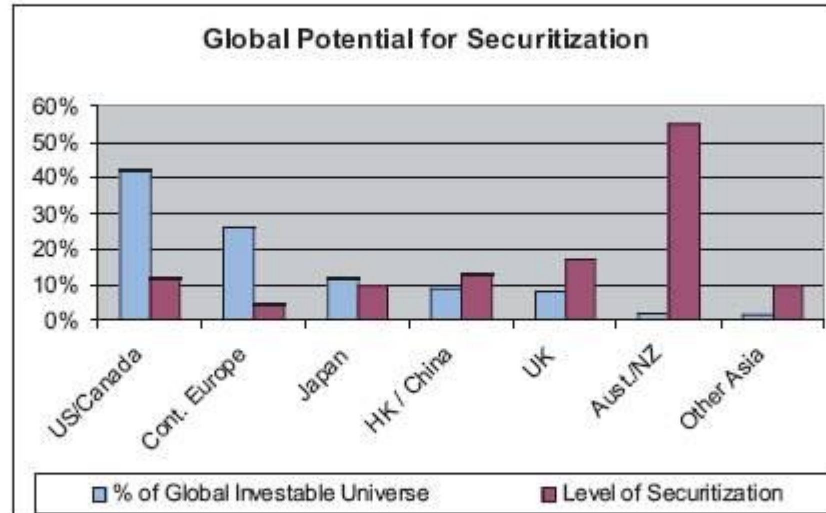


Figure Source: Asian REIT Review 2007 by Richard Newell

D. Dividend Policy

REITs are required to distribute a substantial percentage of their Net Incomes. In Asia, the industry standard has been a minimum of 90% of funds available for distribution/dividends. Dividend Policy in REITs demonstrates merging the real estate and stock market. Private real estate owners expect consistent and competitive income from available real estate cash flows, along with conservative price appreciation from increasing property values. Stock owners, on the other hand, expect minimal dividends. They also expect most of their returns coming from substation capital appreciation produced by reinvesting the company's retained earnings in positive Net Present Value projects.

REITs, first and foremost, are yield driven investment vehicles. Dividend yields remain very important to investors. Most retail investors who invest in REITs do so in the expectation of receiving a dividend yield substantially greater than is available from other common stocks. Regulation will unlikely move from this position and REITs will generally strategize within this given range (90% to 100+%) of dividend distribution requirement, depending on their growth strategy. For growth expecting companies, lower dividend policies will both provide the needed capital for its projects and ease pressure in maintaining high dividend ratios during times of economic recession. That being said, "keeping a dividend as low as legally possible isn't always in the REIT shareholders' best interest. After all, REITs are as much about real estate as they are equities, and many institutions that invest in REITs do so as a proxy for real estate—a hallmark of which is a high level of cash distributions relative to income". (Block 2007)

Accordingly, determining the best dividend policy is more complicated than a simple application of modern corporate finance. A REIT should be able to examine the current opportunities in the market to provide higher yields. At the same time, considering the expectations of shareholders who want consistent dividends, it should mitigate risk when maximizing market opportunities. Being stingy with dividends can be done when there are high yielding accretive acquisitions, development

and share-repurchase opportunities[18]. However, with respect to the typical REIT shareholder who expects high dividend distributions, dividends will be the most effective and expected use of net income and free cash flow.

In real estate recessions, maintaining high dividend yields will be a challenge for REITs. A current trend which has surfaced in Asian REIT markets is financial engineering. Financial engineering is a strategy that can be used by investment bankers to produce a market competitive dividend yield. Its basic mantra is lift dividends now, pay for it later[19]. There are different ways that can be employed to achieve this result, namely:

1. **Interest rate swaps**

   In a swap agreement, a REIT will pay a lump sum upon entering the agreement and a fixed but gradually increasing interest rate to a third party during the course of the agreement. In return, the third party will pay the floating interest rate payments of the REIT to its creditors. The assumption is that as rents start to rise, the REIT will be able to carry the rising interest payments to the third party. The downside is that while the dividend yield increases during the initial years, there will be little growth at the end as the interest's growth, paid to the third party, offsets or even exceed the rise of rental payments. Furthermore, if the REIT funds the initial lump sum, required during the closing of the swap agreement, from the initial investors IPO contributions, in effect, the IPO investors will be funding their own initial dividend yields.[20]

2. **Distribution entitlement waiver**

   In this strategy, the REIT Sponsor, who will retain a substantial share of the REIT, will not accept dividend during the initial years in order to provide the required dividend yield to other investors. However, in a year or two, when the waiver expires and the REIT landlord/contributor/sponsor starts to accept dividends, the shareholders will feel the hit as their shares and the properties' income is diluted. Again, the assumption is that once rents rise, the impact will not affect the yield. However, concerns have also been raised about the prices in which the properties were sold absorbed to the REIT, given the yields foregone by the contributor in the waiver.

3. **Sale leaseback agreements**

   In cases where corporations agree to divest of their non-core real estate assets[21] and the former owner pays an above-market rent commensurate with the REIT's yield, in return for an equally competitive purchase price. The risk to REIT investors is that if a single tenant were to leave, a

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[18] Share repurchase opportunities exist when the current market price per REIT unit is well below the estimated Net Asset Value per REIT unit

[19] When rents are higher, REITs can then recoup its initial yield sacrifices.

[20] Because this sum is a prepayment, it is amortized over the lifetime of the swap for accounting purposes. The charge is carried over the income statement of the REIT but added back to the distributable income because the amortization does not involve any cash outlay. (Whiting, 2007)

[21] An example of this event would be Japan Airlines' sale of their corporate office building

100% occupied property becomes a 100% vacant property. It will be extremely difficult to find a new tenant willing to pay at higher than market rental levels.

In all these financial engineering tactics, the common assumption has been that rents will be higher in the future. This assumption is also the most common criticism of Asian REITs which have employed[22] such financial engineering. Temasek Chief Executive Ho Ching[23] describes these financial tactics as "charades to shore up short term performance indicators, at the expense of long term pain". She also suggested that bad surprises await those unsuspecting individual investors who might not understand financial engineering.

As REITS are still subjected to property and stock market cycles, it is evident that no standard dividend program applies to all REITs. While a consistent dividend policy is always favorable, an intelligent dividend policy should be flexible at the same time focused both on the individual shareholder's interest as well as the risk adjusted return-opportunities that are present in the market. "A well-crafted dividend strategy is a good indicator of a high-quality REIT organization". (Block, 2007)

E. Allowing Development Activities

In mature REIT markets in US and Australia, REITs are active businesses. They own and manage commercial real estate as well as redevelop their properties, develop new projects and engage in fee oriented services such as property and facilities management. All these activities require capital, which may be highly available during boom times. In Asia, REITs have mostly been restricted or prohibited from development. While opportunities and superior returns are present in development, Asian REIT regulators believe that development is too risky and would put the REITs' expected consistent dividends in jeopardy. However, this does not mean that Asian REITs are not pursuing a development strategy in periods of real estate growth. Because traditionally, REIT sponsors and owners and owners are Asian developers, REITS still have access to development strategies just not directly. Rather, developers will proceed with the projects and sell the properties to the REIT upon completion and stabilization. The only consistent concern with this strategy is that, due to the exclusive relationship between the REIT sponsor and the REIT, overvaluation in the purchase price of the property can occur.

This strategy differs for REITs which are not prohibited and restricted from development. In the US, for example, with the recession in 2000 and its aftermath from 2001 through 2004, most real estate sectors started to improve in 2005. "According to NAREIT, the turnaround coincided with very strong real estate prices and low cap rates[24]. REITs didn't want to compete with pension funds for high priced properties producing low returns." This constraint paved the way for US REITS to explore development.

Currently, market effects similar to the 2005 US markets are happening in Asia. As publicly listed REITS continue to rise, increasing property prices and key lending rates are making REIT growth in

[22] Champion REIT, a HK REIT, was one such REIT which analysts believed had overdone the financial engineering.

[23] Madam Ho Ching is also the wife of Singapore Prime Minister Lee Hsien Loong.

[24] Low cap rates would indicate low income yields which would make acquisitions very undesirable.

Asia very unclear and speculative. “Intensifying competition for ever-pricier property is expected to squeeze REIT dividend payouts to investors and spark a consolidation among the nearly 100 REITs in Asia worth a combined $79.6 billion (39.5 billion pounds). REIT managers are finding it harder to compete against private equity players for assets and yet pay ever-higher dividends to investors” (Tong, 2007). It will be interesting to see if the current yield squeeze in the Asian real estate markets will produce the same relaxation of development restrictions

F. Tax Transparency

The most important element of REITs which allow it to achieve such high yields is tax transparency. Tax transparency means that REITs are not levied a corporate income tax. Rather, income tax is “passed through” to the shareholder level, as shown in Figure 6. Most of the mature REIT markets are granted tax exempt status creating tax transparency, provided that they achieve a set of stringent requirements pertaining to security tests[25], asset tests[26] and income tests[27] . Other countries, however, are less proactive with regard to extending tax transparency status in their REIT Legislation. “With exception with countries that have imputed tax systems[28] (such as the UK, Australia and HK), the absence of preferential tax treatment has been cited as the key reason for the slow development of REIT’s in Asia[29] (and Europe)” (Ooi, Newell, & Sing, 2006). The governments’ primary reason for restricting tax transparency is the loss of tax revenue to the countries tax collecting agencies. In any new REIT legislature, proving the explicit benefits of creating a new investment vehicle which will offset the loss in tax revenue has been the major hurdle for granting tax transparency.

The significance of tax transparency (for the REIT shareholder) is explained further in Figure 6. As can be seen, without tax transparency, REITS, in effect will be the same as any listed real estate operating company wherein taxation is applied on the corporate and the shareholder level. With REITs, income tax is levied only once, creating higher dividends for the shareholder.

[25] E.g. In the US, 20% of the value of REIT’s total assets must be less than or equal to securities of 1 or more Taxable REIT Subsidiary (TRS). This is to ensure that the TRS is more of a servicer rather than a profit generator of the REIT.

[26] E.g. In the US, 75% of the value of its total assets are real estate, cash, cash items and gov’t securities

[27] E.g. In the US, 75% of REIT Gross income/taxable year must be derived from real estate sources

[28] Dividend Imputation is a corporate tax system in which some or all of the tax paid by a company may be attributed (or "imputed") to the shareholders by way of a tax credit to reduce the income tax payable on a distribution.

[29] Examples of these cases are available in Appendix 7.

Figure 6: Impact of Tax Pass-through Benefit

Impact of Tax Transparency

Tax Status	Double Taxation System		Imputed Tax System	
	REIT Non-Transparent	REIT Tax Transparent	REIT Non-Transparent	REIT Tax Transparent
Operating income	100	100	100	100
Corporate tax @ 22%	−22	0	−22	0
After tax income	78	100	78	100
Income tax @ 20%	−15.60	−20	−20	−20
Tax credit	0	0	+22	0
Cash to shareholders	62.40	80	80	80

Figure Source: (Ooi, Newell, & Sing, 2006)

G. Real Estate Assets Invested

A substantial majority of a REIT's assets are typically required to be invested in real estate. In Asia, the industry standard has been a minimum 70% requirement. Aside from its name, the commitment to the real estate concentration in REITs is due to the passive and relatively low risk returns derived from real estate. Real Estate is a proven provider of consistent and predictable income. In relation to its consistency and predictability, real estate has also proven to be a natural hedge against inflation which decreases the earnings of other asset classes like bonds. In fact, as shown in Figure 7, US REITS provide evidence that over the long term, dividend growth in REITS have exceeded inflation rates. A prime reason for this is, in times of rising inflation, income from property rents, which are not fixed, will usually rise to offset any increase in inflation. As such, regardless of REIT market maturity, these advantages provide the rationale for requiring the REITs' high concentration in real estate assets.

Figure 7: US Equity REIT Growth vs. Consumer Price Index (CPI)

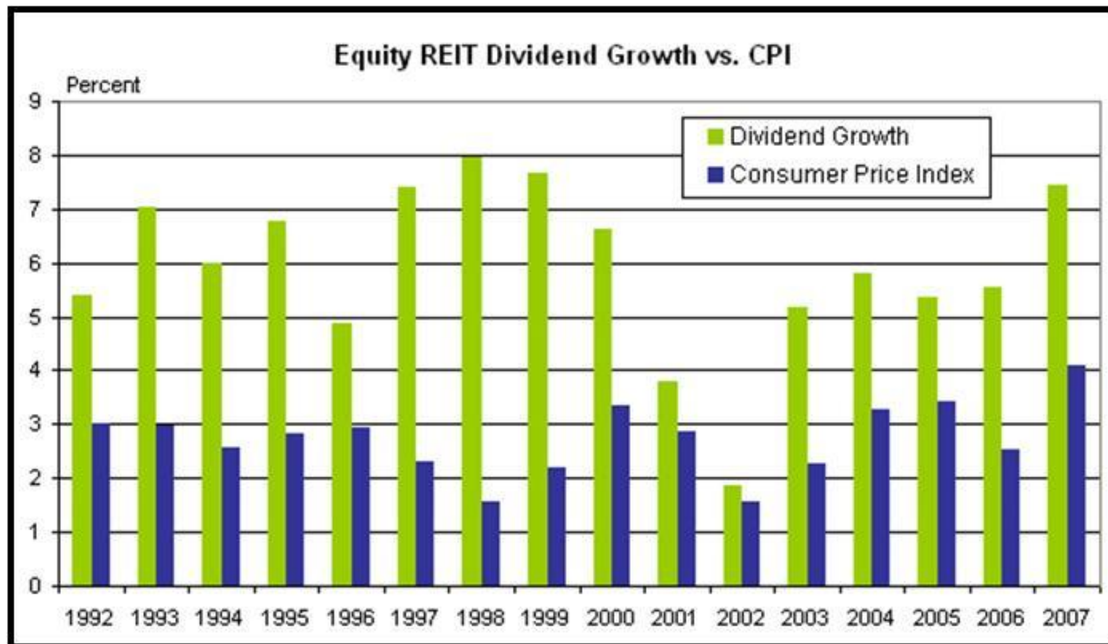


Figure Source: NAREIT and Bureau of Labor Statistics

H. Tax Concession for Investors

While the tax transparency (with regard to corporate income tax) status of REITS will guarantee that investors will not have to deal with double taxation, it has also been suggested that a successful REIT market needs the participation of foreign (nonresident) investors. The REIT framework has to facilitate as an attract investment for foreign capital flows (Reuters News, 2005). Among the items that have typically been considered are tax concessions on the following REIT activities:

1. Acquisition/Disposal/ Transfer of real estate assets
    a. stamp duties, capital gains and withholding tax, registration fees

2. Dividends

3. Taxes on public offerings

Among the Asian countries, Singapore has been the most proactive REIT Market in this respect. By reducing taxes on foreign corporations and institutional investors to 10% and providing a 5 year stamp duty exemption on foreign REITs buying properties, Singapore has clearly positioned itself as the REIT regional hub. As there are countries who still have not achieved the right REIT legislature in their respective countries Singapore has effectively marketed itself as a tax haven to, not only foreign investment, but foreign REIT Listing as well,.

The only obvious downside of these concessions is that revenues generated by taxes, which individual governments value, are foregone. And this has been the persistent argument by tax collecting agencies of individual countries. Thus, this provides the reason for the time limits imposed by REIT regulators.

Chapter Analysis & Synopsis

Asian REIT Regulatory Factors which govern a REIT's structure and activities have been cited by numerous REIT experts as elements to a REIT market's success. Each regulatory factor has a specific reason and a consequential effect on the REIT market's growth and profitability prospects, namely:

1. Internal management structures have outperformed external management structures in mature REIT markets. Furthermore, while external management is argued to be more professional, conflict of interest issues, regarding fees and governance, have been a consistent counterargument to this structure.
2. Higher investments in foreign assets have been due to lower availability of yield accretive investments in the REIT's local geographical markets. The ability to find alternative property markets are traits of good REIT management.
3. REIT dividend policy require REITs to distribute a substantial majority (90%+) of their Net income. Asian REIT managements have been creative in following this requirement and being competitive with other Asian REITs. However, a shareholder should be wary of financial engineering, a tool which has a basic purpose of lifting dividends now and paying for it later.
4. Higher REIT development activities are function of market maturity. In the US, as yield accretive acquisition deals dry up and the opportunity for greater development returns arises, regulation evolved with market conditions and relaxed development restrictions.
5. Corporate tax transparency is a REIT's most important element. For countries contemplating REIT legislature, granting tax transparency has been a major hurdle.
6. REITs are required to own and invest in a substantial majority in real estate or real estate related assets. In the US, this has been cited a major reason for REITs' inflation hedging characteristic.
7. REITs need the participation of foreign nonresident investors in order to be successful. While granting tax concessions to foreign investors has been difficult to rationalize with governments due to the loss of tax revenue, it has been a critical element to attracting foreign capital.

While different REIT regulations have both upside and downside effects, one thing is certain: without tax transparency, the REIT is no different from a typical Real Estate Operating Company. Without tax transparency, there will be double taxation and thus, no benefit for the REIT shareholder and no investor demand for the REIT structure. This has been a crucial lesson for upstart REIT Markets in Asia (see Appendix 8) which had to learn this the hard way.

CHAPTER 3: PHILIPPINE REITS SUPPLY: THE PHILIPPINE PROPERTY MARKET

In Chapter 2, this paper outlined the origin of Asian REITs and the regulatory factors critical to a REIT market's success. In particular, the chapter isolated tax transparency as a major reason for the demand in the product. Chapters 3 and 4 shall focus on the business factors affecting the Philippine REIC market. Chapter 3 shall go in-depth on the supply aspect of Philippine REITs, in particular, the disposition and acquisition opportunities of Philippine investment grade real estate assets. In the proposed Real Estate Investment Company (REIC) Act, 75% of a Philippine REIT's assets "must be invested in, or consists of, income producing property in the Philippines." In light of this fact, we shall briefly look at the macroeconomic factors which can have a major impact on Philippines real estate assets. An intensive review and analysis of the different property uses/segments and supply - demand factors, which influence them, shall also be undertaken.

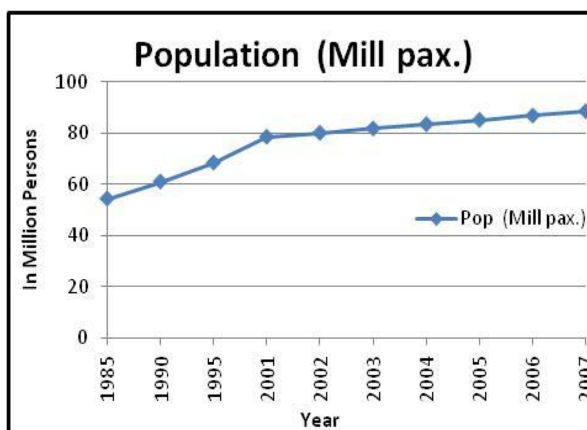
I. PHILIPPINES: MACROECONOMIC INDICATORS

A. POPULATION

A shown in Figure 8: The Philippines' Population has been growing at a (compounded annual) rate of 2.25%/yr since 1990 (from 61 million to 88 million).

Figure 8: Population Statistics & Growth Graph

Year	Population (Mill pax.)	Density (pax/sqm)	Growth Rate
1985	54.24	180.80	-
1990	60.94	203.13	2.4%
1995	68.41	228.03	2.3%
2001	78.59	261.97	2.3%
2002	80.16	267.20	2.0%
2003	81.88	272.93	2.1%
2004	83.56	278.53	2.1%
2005	85.26	284.20	2.0%
2006	86.97	289.90	2.0%
2007	88.71	295.70	2.0%
Ave.			2.3%



Data Source: National Statistics Office, downloaded (May 2008)

B. GROSS DOMESTIC PRODUCT (GDP)

The Philippine economy grew by 7.3% in 2007, well above its 5.2% average rate over the previous 5 years, and is its best performance in 30 years. Moreover, inflation fell to low levels, the fiscal position improved, the peso strengthened, and the current account recorded a large surplus. "All demand-side sectors made substantial contributions to GDP growth (Figure 9). Private consumption, supported by $14.5 billion in remittances from Filipinos working abroad, rose by 6.3%, led by increased spending on food and beverages and on transportation and communications. Automobile sales, for example, increased by 18.5% last year in terms of units sold, compared with an increase of just 2.5% in 2006." (Tamaki, 2008)

Figure 9: GDP Contributors & GDP Growth Graph

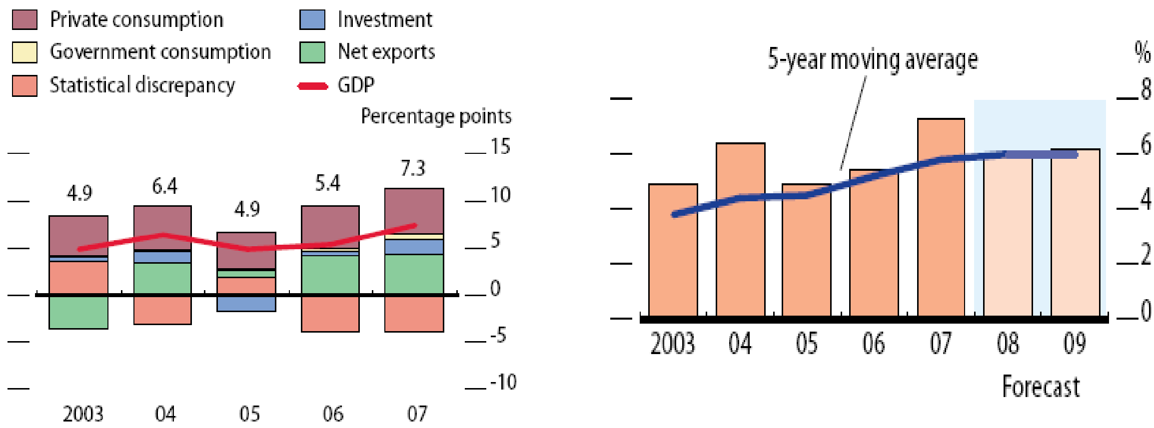
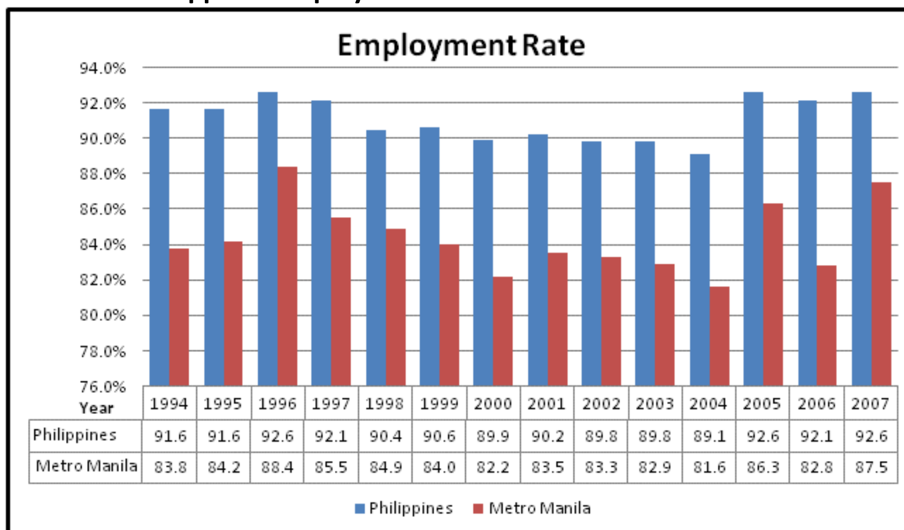


Figure Source: Asian Development Bank (ADB)

C. EMPLOYMENT

The employment levels in the Philippines has been at its highest in over 10 years (at 92.6%; shown in Figure 10). The Employment level in Metro Manila, which is the National Capital Region (NCR), is also at its highest level (87.5%). In terms of industry numbers, Agriculture is still the primary source of livelihood for the majority of the country's labor force at 32%. As shown in Figure 11, it is also important to note that Metro Manila has a substantial percentage of employment in Manufacturing (19%), Electric Gas and Water (18%), Construction (18%), Wholesale and Retail, Hotel and Restaurants (17%), Transport Storage and Communications (29%), Financial Intermediation (35%), Real Estate Renting and Business Activities (40%).

Figure 10: Historical Philippines Employment Rate



Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Philippines	91.6	91.6	92.6	92.1	90.4	90.6	89.9	90.2	89.8	89.8	89.1	92.6	92.1	92.6
Metro Manila	83.8	84.2	88.4	85.5	84.9	84.0	82.2	83.5	83.3	82.9	81.6	86.3	82.8	87.5

Data Source: National Statistical Coordination Board (NSCB): 2007 Philippine Statistical Yearbook

Figure 11: Employment by Industry in the Philippines and Metro Manila (October 2006)

Industry	Number (In thousands)	Philippines Percentage of Total Number	Number (In thousands) in M. Manila	Percentage of Philippines' Number
Agriculture, Hunting and Forestry	10,754	32%	25	0.23%
Fishing	1,412	4%	17	1%
Mining and Quarrying	136	0%	1	1%
Manufacturing	3,012	9%	566	19%
Electricity, Gas and Water	123	0%	22	18%
Construction	1,627	5%	292	18%
Wholesale and Retail, Repair of Motor Vehicles & Personal Household goods	6,227	19%	1,079	17%
Hotel and Restaurants	914	3%	268	29%
Transport, Storage & Communication	2,469	7%	468	19%
Financial Intermediation	372	1%	129	35%
Real Estate, Renting and Business Activities	813	2%	327	40%
Defense, Compulsary Social Security Compensation	1,541	5%	212	14%
Education	1,009	3%	110	11%
Health and Social Work	376	1%	95	25%
Other Community Social and Personal Service Activities	773	2%	177	23%
Private Household with Employed persons	1,629	5%	385	24%
Extraterritorial Organization & Bodies	2	0%	1	50%
TOTAL	**33,189**	**100%**	**4,174**	**13%**

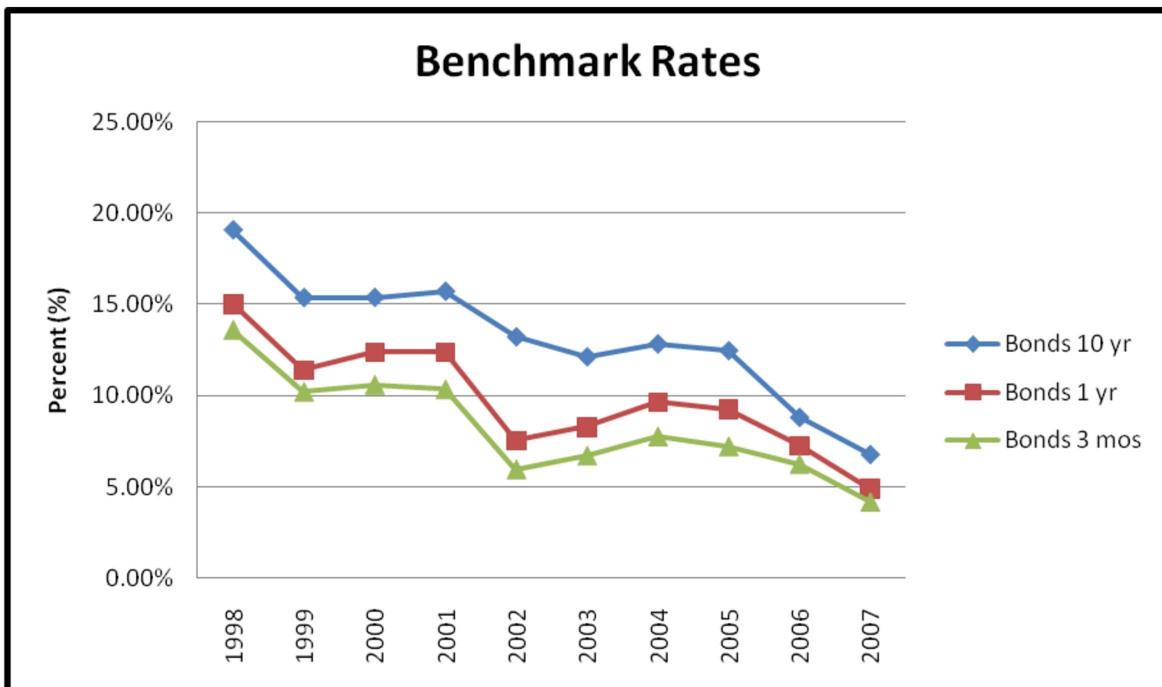
Data Source: National Statistical Coordination Board: 2007 Philippine Statistical Yearbook

D. INTEREST RATES

Treasury bond rates, which have been typically used as the standard definition of risk-free returns on any domestic investment, have slowly been going down. Both the three-month and long term bond rates have decreased to record levels, from January 2001 highs of 15% and 19%, respectively to January 2008 lows of 4% and 6% (as shown in Figure 12). With the global credit crunch, it appears that bond rates will not go down any further. This would indicate that, at these current bond rate levels, positive investment spreads and investment pricing will be more favorable for alternative investments such as real estate. Also, "it is worth noting that mortgage rates have also fallen, given that these move in step with the decline in benchmark rates. With the banking sector desperate for loan growth and unlikely to find it in a significant manner in corporate borrowers, this is likely to lead to pressure on mortgage rates" (Credit Suisse, 2007). These decreasing mortgage rate would imply two things, namely:

1. There will be refinancing opportunities for mortgage borrowers
2. As mortgage interest payments go down, there will be additional disposable capital for borrowers.

Figure 12: Treasury Bond Rates (Jan 2000 - Jan 2007)



Data Source: Money Market Association of the Philippines (MMAP)

E. SERVICES INDUSTRY

In terms of Total Domestic Output (TDO)[30], the services sector has been consistently gaining ground in terms of percentage of TDO[31], as well as actual growth of output[32] (as shown in Figures 13 & 14). On the other hand, the country's main industry, Agriculture, has been decreasing consistently (at 2.67% /yr) as a percentage of TDO even though the Agriculture output has increased (from .5% in 1990 to 4.9% in 2007). In short, the services sector is growing faster than Agriculture. As a developing economy, this will gradually reflect itself even more as the country veers away from the traditional sources of livelihood (e.g. agriculture).

Figure 13: Business Segments as a Percentage of Total Domestic Output[33]

	1990	1995	2000	2002	2003	2004	2005	2006	2007	2008
Agriculture	21.9%	21.6%	15.8%	15.1%	14.6%	15.1%	14.3%	14.2%	13.8%	13.5%
Industry	34.5%	32.1%	32.3%	31.8%	31.9%	31.7%	31.9%	31.6%	31.4%	31.3%
Services	43.6%	46.3%	52.0%	53.1%	53.4%	53.2%	53.7%	54.2%	54.9%	55.7%
TDO	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Figure 14: Growth of GDP and Key Business Segments

	1990	1995	2000	2002	2003	2004	2005	2006	2007	2008
GDP	3.0%	4.7%	4.4%	4.4%	4.9%	6.4%	4.9%	5.4%	7.3%	5.8%
Agriculture	0.5%	0.9%	3.4%	4.0%	3.8%	5.2%	2.0%	3.8%	4.3%	4.9%
Industry	2.6%	6.7%	4.9%	3.9%	4.0%	5.8%	4.2%	5.5%	5.8%	6.0%
Services	4.9%	5.0%	4.4%	5.1%	6.1%	7.7%	6.8%	6.7%	6.8%	7.0%

Data Source: Asian Development Bank

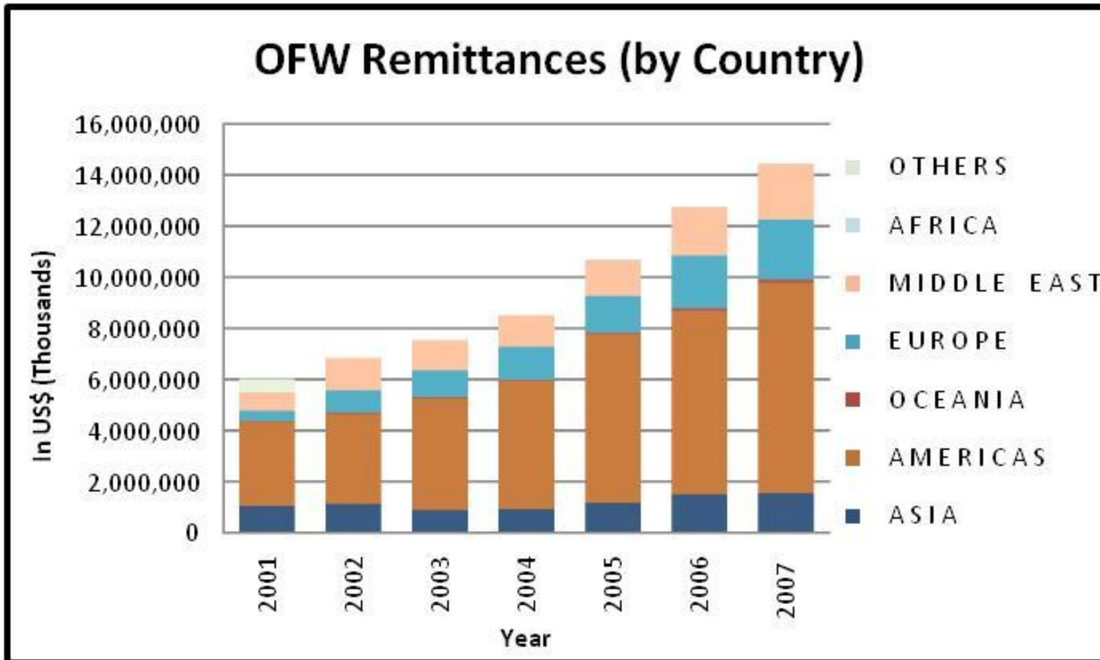
F. OVESEAS FOREIGN WORKERS(OFW) REMITTANCES

Undoubtedly, one of the Philippines' main export is its labor and manpower. Overseas Filipino Foreign Workers (OFW) are scattered around the globe and dutifully repatriate their income and savings (in foreign currency) to their families still residing in the Philippines. They provide the local economy with its much needed foreign reserves. At the same time, their incomes fuel consumer spending which the local economy requires. It has been well noted, in news articles as well as in local film, that the overseas Filipino workers are truly the modern age heroes of the Philippines. For 2007, OFW Remittances provided a US$ 14.5 Billion dollar source for foreign resource reserve to the Philippine Government, as well as, additional spending on consumer goods and services to its local economy. Average year on year growth, since 2001, has been phenomenal at 16.3%. For 2007, OFW Remittances provided a US$ 14.5 Billion dollar source for foreign resource reserve to the Philippine Government as well as additional spending on consumer goods and services to its local economy. Average Year on year growth, since 2001, has been phenomenal at 16.3%. The chart below (Figure

[30] This indicator represents the total quantity of material outputs to the environment released on the national territory by economic activity (in economy-wide material flow accounting).
[31] The services sector has been growing at a compounded annual growth rate at 1.4%.
[32] TDO has a 4.9% growth rate in 1990 (vs. 7% in 2008)
[33] Industry is defined by the following Business Segments: Manufacturing, Construction, Mining, Quarrying, Electricity, Gas & Water

15) depicts the value and origins country of the OFW remittances to the Philippine government and economy.

Figure 15: OFW Remittances Growth



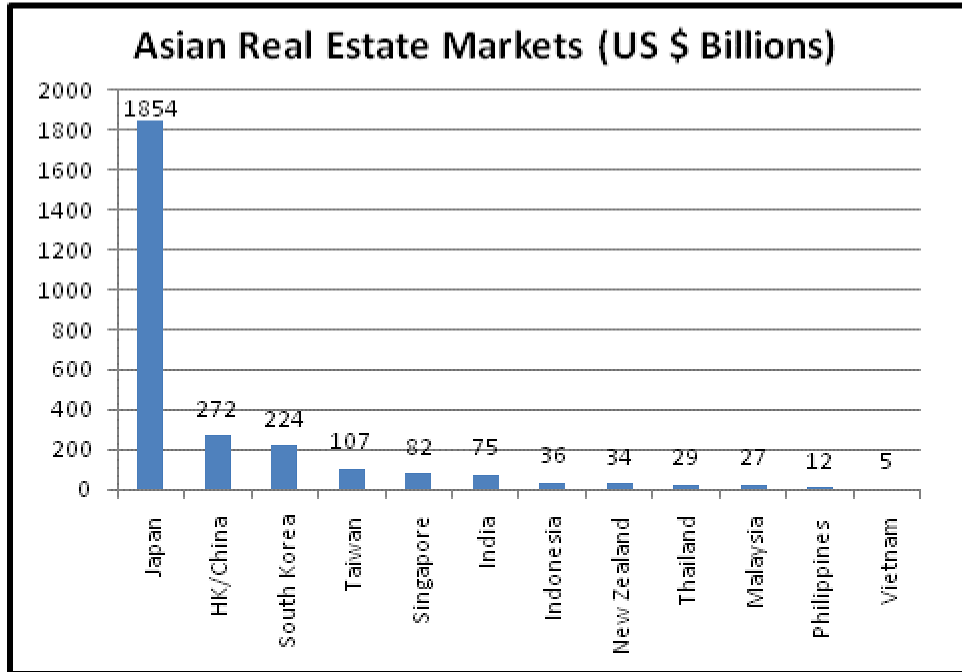
Data Source: Bangko Sentral ng Pilipinas[34] (BSP)

II. SUPPLY: THE PHILIPPINES PROPERTY SECTOR

Currently estimates of REIT investment grade property in the Philippines (as shown in Figure 16) range from approximately $5 (source: Edmund Ho, Citigroup Asia Real Estate Investment Banking) to $13 Billion (Source: Philippine Stock Exchange representative). These figures include the Residential, Office, Retail and Hotel property estimates. Due to the availability of data, with the exception of the Residential Market, the property segments will focus mainly in the Metro Manila, the Philippines' national capital.

[34] Central bank of the Philippines

Figure 16: Asian Real Estate Market Estimates (in US$ Billions)



Data Source: Richard Newell: Asian REIT Review

The Philippines property market has been booming as of late. The property market has seen a 23% growth rate from 2006, exceeding the market estimated growth rate of 18%. "Given the property sector's direct correlation to the Philippines' GDP driver of overseas foreign workers' (OFW) remittances and the recent steep drop in interest rates, we find that the sector offers the best earnings per share growth in the Philippines market, overshadowing all other sectors (as exhibited in Figure 17)". (Credit Suisse, 2007)

Figure 17: ROE Comparison Among the Philippine Industries 2007

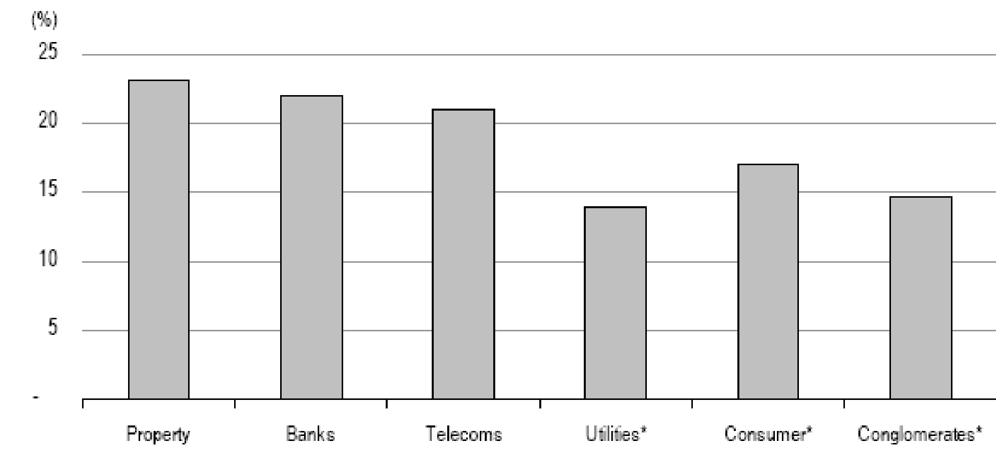


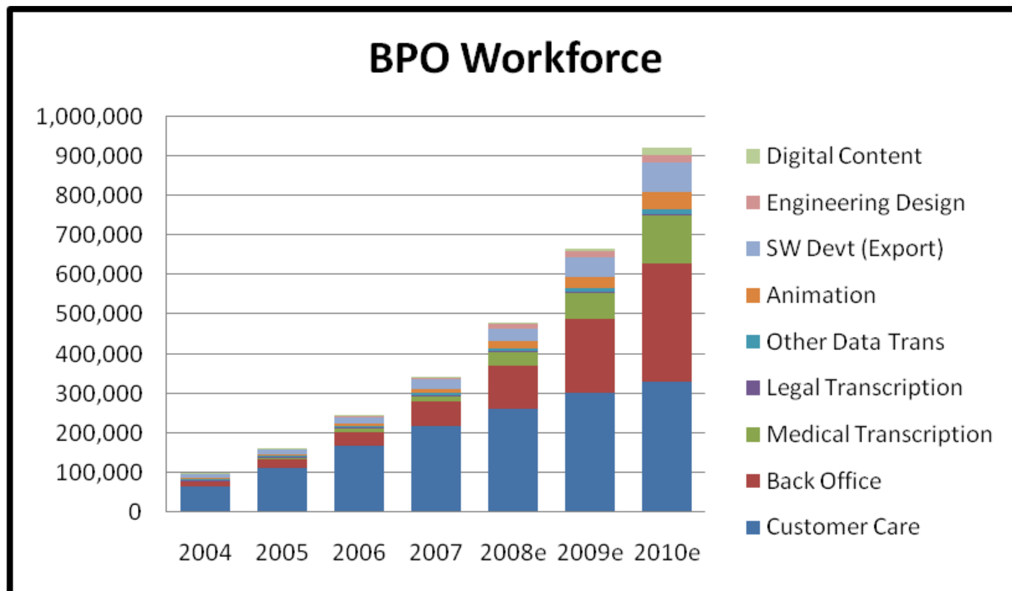
Figure Source: Credit Suisse & Bloomberg consensus

A. OFFICE[35]

A major driver in the Philippines, particularly in Metro Manila, is the recent growth of the Business Process Outsourcing (BPO) industry. Business Process Outsourcing services range from the following services: Customer care, Legal Transcription, Software Development, Back Offices, Engineering Design, Medical Transcription, Animation and Digital Content Creation. As displayed in Figure 18, in 2008, the biggest segments of this group are Customer Care (at approx. 57% of total market share) and Back Offices (at approx. 20%). Medical Transcription is poised to catch a bigger market share in the next two years.

Since 2001, the Manila Office Sector has been through several years of consistent growth. Vacancy has been at record lows[36]. According to JLL, annual rentals and capital values grew by 18.2% and 11.2%, respectively. "The demand is largely driven by the tremendous growth of the Business Process Outsourcing (BPO) industry. With limited supply and vacancy rate at low levels, rents have been rapidly moving up in the past quarters." (Jones Lang LaSalle, 2006). In an interview with Mr. Claro Cordero and Ms. Kathy Marcelo, respective heads of Consultancy and Research & Valuation for Jones Lang LaSalle, they concur that even with the current US Recession which curtailed growth of US (BPO) Industry, the BPO Industry is still poised for growth (as shown in Figure 18 & 19). "With estimates from the Business Processing Association of the Philippines (BPAP) conservatively estimating an annual growth rate of 25% over the next five years, this is a sector which should ensure that demand would be robust for several years." (Credit Suisse, 2007)

Figure 18: Business Process Outsourcing Workforce Estimates



Data Source: Business Process Association of the Philippines (BPAP)

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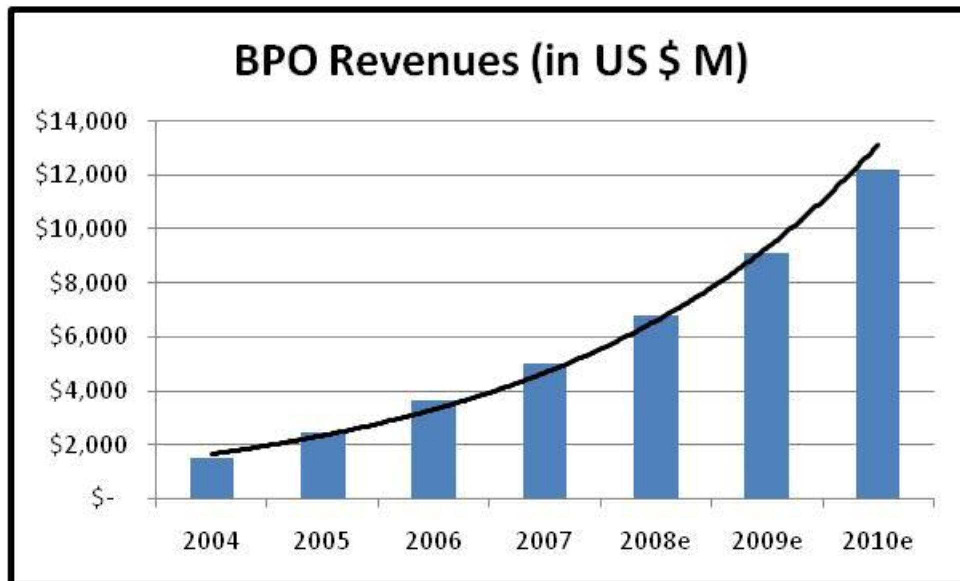
[35] The Philippines office market review will primarily be focused in Metro Manila (National Capital Region), in particular, the Makati and Ortigas Central Business Districts.

[36] In the first quarter of 2008, the lows reached to 3.5% from highs of 35%.

Figure 19: BPO Revenues



Data Source: BPAP

As per Credit Suisse' estimates, the expected demand is roughly equal to 2 Million square meters[37] of office space in the next five years. Presently, the sum of all recently announced projects[38], at 100% occupancy, are expected to reach just half of the expected demand level[39]. Provided they sign a longer lease term, BPO's have had the negotiating leverage to demand custom built offices and facilities. Due to the highly intensive interior renovations undertaken by BPO's and the correspondingly long term commitment on their leases (typically, 5 years with an option to renew for an additional 5) of their leases, BPO Offices will be a tremendous driver for office property yield within the next five to ten (5-10) years.

B. RESIDENTIAL

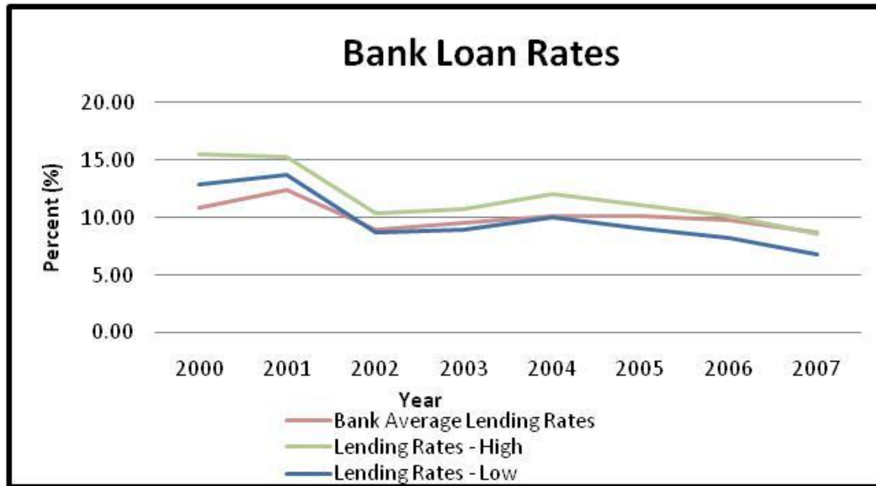
The Residential sector has been a key segment for growth in the Real Estate Industry. Several factors have contributed to the Residential sectors boom over the past couple of years. Bank lending rates, which have been the industry measure for cost of capital, have never been lower. As of April, loan interest rates(see Figure 20), which have spiraled down from highs of 15% during the Asian financial crisis era (2001) to its current lows of 7.88%, have enticed both end–users and investors alike to purchase their first home or expand their investment portfolios to include direct real estate holdings

[37] In the Philippines, office area is typically quoted in square meters (1 sq.m. = 10.76 sq.ft.)

[38] These include projects that have already "broken ground", as of October 10 2007.

[39] As per Colliers International, a total of 500,000 sq m of new developments due for completion in 2008 were under construction during 1Q 2008. Projects scheduled for 2009 completion amount to 630,000 sq.m. of office space.

Figure 20: Bank Loan Rates

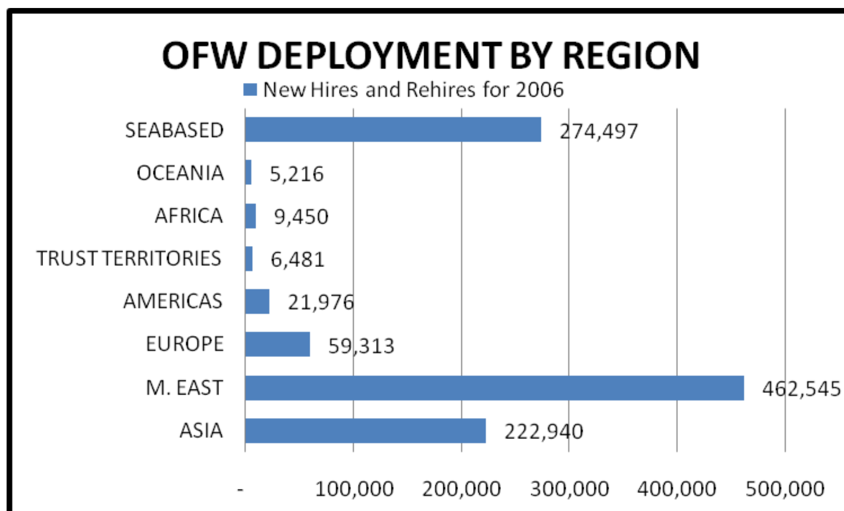


Data Source: BSP (Central Bank of the Philippines)

1. Residential-for-sale Demand: OFW Remittances

The Residential-for-sale sector has been one of biggest sectors of OFW Consumer spending. The basic notion that almost every Filipino, regardless of financial stature or adopted nationality, will eventually want to return or have a second home in the Philippines, has driven the residential-for sale sector to tremendous growth. With an estimated 1.2 Million deployed OFWs (Figure 21) and $14.5 Billion worth of dollar remittances, it is no surprise why the residential market has boomed as of late. In fact, if Ayala Land Inc., one of the biggest real estate companies in the Philippines, is an indicator, it has stated that 40% of its P14 billion residential sales in 2006, came from OFW's.

Figure 21: OFW Deployment by Region



Data Source: Philippine Overseas Employment Agency (POEA)

Another factor expected to increase demand in the sector is the expected liberalization of the mortgage industry. Due to the local commercial banks' strict underwriting and conservative nature, the Philippines has one of the lowest mortgage to GDP ratios in the world. With a low 2% mortgage to GDP percentage[40] , "a substantial portion of Philippine home buyers pay, either through cash or developer in-house financing (which is extremely expensive)". (Credit Suisse, 2007) This also represents an opportunity for the banks to further spur residential growth by providing more flexible terms, such as longer terms/duration and lower interest rates[41]. With decreasing interest rates and a more competitive lending environment, the residential sector will be poised for growth.

In the Philippines, residential supply is not segregated between residential-for-lease and residential- for-sale. Thus, with regard to current supply for residential properties, estimates of supply include both lease and sale residential sectors. Credit Suisse estimates approximately 0.9 Million households (of the 6 million households which can financially afford housing) will still demand for new residential construction. "We estimate that there will be more than enough demand to cover expected additional supply for at least the next three years. We estimate new supply in the range of 0.25 million units per annum over the next three years" as shown in Figure 22.

It is important to take note though that the residential-for-sale sector is not a Philippine REIT potential sector. In the proposed Philippine REIT Law (REIC Act), Philippine REITs are required to hold on to the properties they develop and acquire. Thus developing or acquiring and selling for profit, without reinvesting the proceeds back into properties within one year, will be taxed, not only on the gains from the sale, but the entire proceeds will also be included in the Taxable income.

Figure 22: Residential Unit Approvals

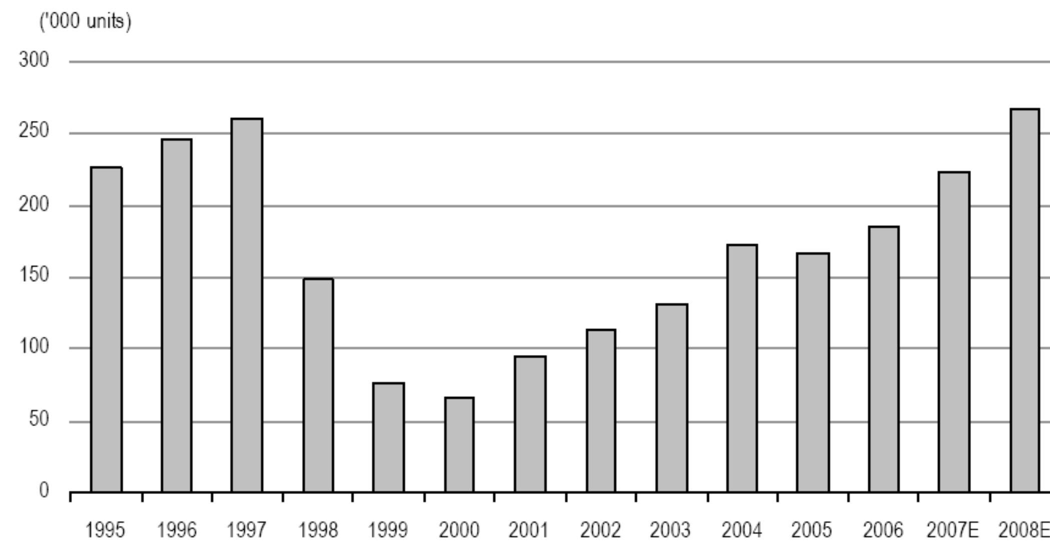


Figure Source: Housing Land and Regulatory Use Board, Credit Suisse Estimates

[40] This mortgage to GDP ratio is unrealistically low, compared to Hong Kong's 43% and Singapore's 37%

2. Residential–for-Lease: Demand

A key demand factor to be considered in the residential leases is the strength of the BPO Industry as foreign expatriates come to Manila to set up shop, train personnel and staff and manage the business operations. This is an unexpected multiplier effect caused by the tremendous growth of this industry. Assuming the expected 25% yearly growth, quoted by the BPAP, is realistic, we can expect more cushion to the demand estimates for the residential-for-lease sector.

C. RETAIL

In the Philippines, SM Prime dominates the Philippines retail mall market (as exhibited in Figure 23), with 21 malls occupying Gross Leasable Area (GLA) of 3.5msm[42]. "SM Prime has been successful because of its highly profitable SM department stores, which use effective supply chain and cash flow management to ensure the lowest costs for customers. SM department stores attract high footfall into the malls, thereby boosting rentals for other specialty stores" (UBS, 2005).

Figure 23: Philippines Retail Market Share

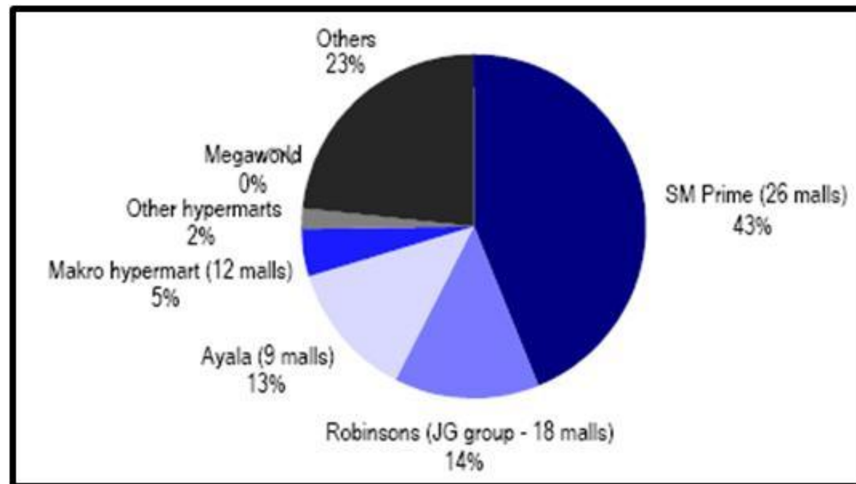


Figure Source: UBS (2005)

Add retail to the multiplier effect caused by the BPO growth phenomenon. Current trends show that, not only is consumer spending increasing due to lower unemployment rates (11.20% in 2000 vs. 6.3% in 2007), but more importantly, demand for retail space has consistently increased as retail sales are being driven due to the location of BPO's inside malls or by positioning retail stores and shopping malls beside the agglomerating BPO facilities. According to Colliers International, vacancy rates in Metro Manila have been consistently decreasing and are expected to bottom out at 11%[43] (as shown in Figure 24).

[42] Million square meters
[43] Previous vacancy rates in Metro Manila have reached highs of 18.7% (2001)

Figure 24: Metro Manila Retail Supply and Demand

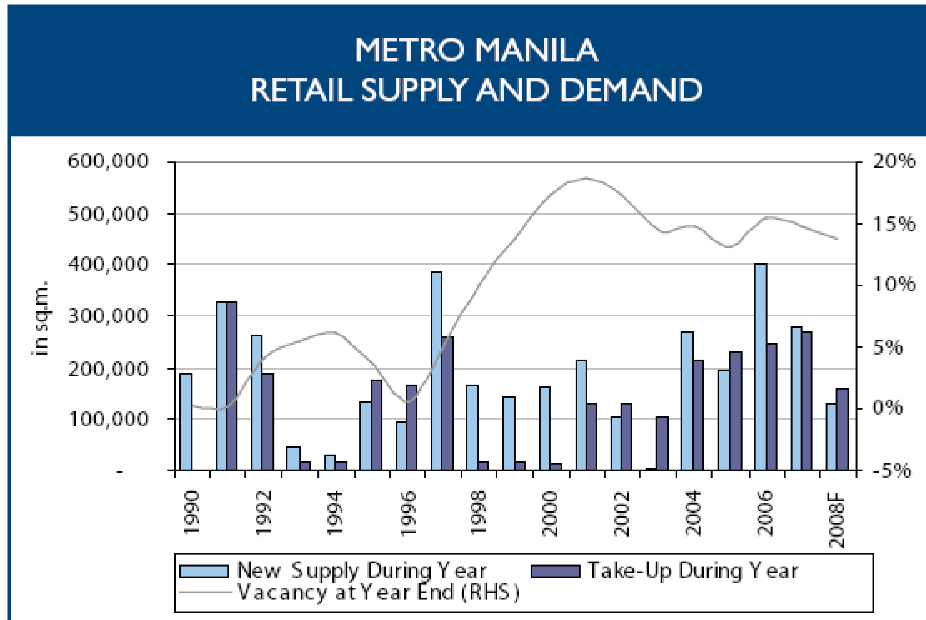


Figure Source: Colliers International Philippines Research

Typically, the BPO will act as an anchor to the retail/mall (as shows below) and create a fixed, steady and spending market for them. Herewith are three examples of BPO offices in shopping malls.

Mall Operator	BPO Tenant Exposure
Ayala Land	Approx. 23,000 sq.m. allocated in Market Market Shopping Mall
Robinsons Land	Over 40,000 sq.m. in 5 malls: Cainta, Novaliches, Pioneer, Metro Bacolod, Lipa
SM Prime	36,000 sq.m. spread in malls of Baguio, Mall of Asia, Bacoor, Batangas, Manila

Source: Credit Suisse estimates

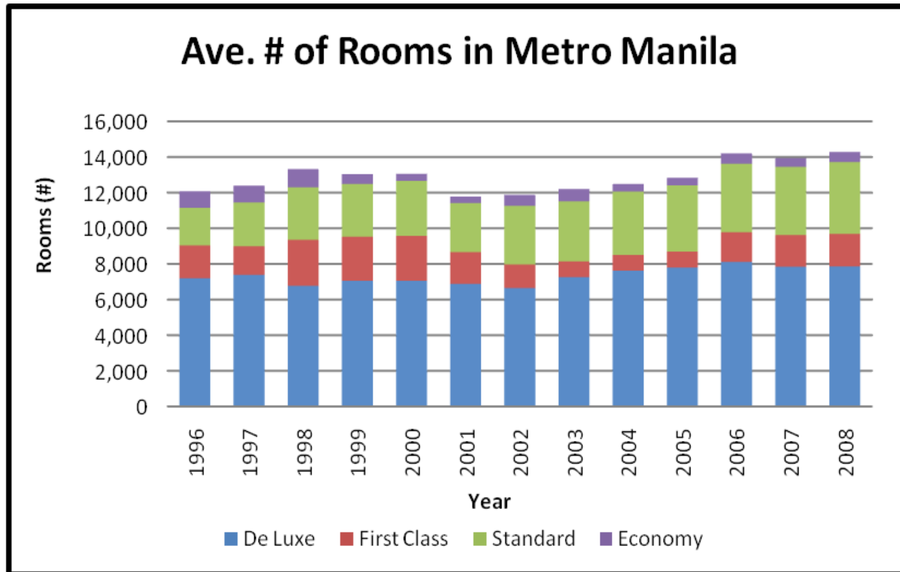
D. HOTELS

1. Supply

Hotel supply in Metro Manila is at an all time high of 14,279 rooms[44] (as seen in Figure 25). Thus with new supply, occupancy rates (Figure 25) have recently declined (from 77% to 74%). Another possible reason is that "many hotel rooms in Metro Manila were undergoing renovations, which translated to more pricey room rates" (Nepomuceno, 2008).

[44] Source: Department of Tourism (Philippines)

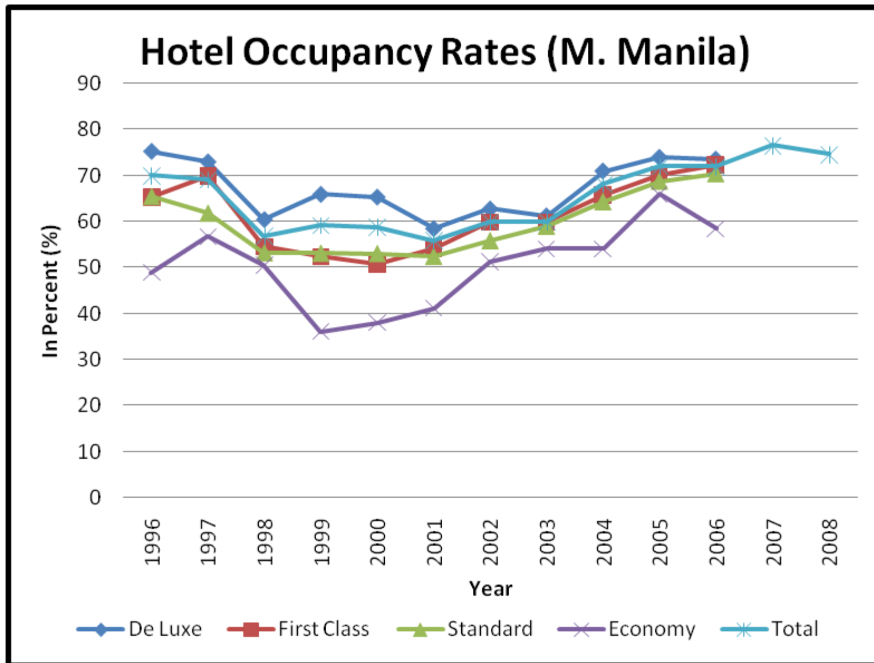
Figure 25: Metro Manila Average Hotel Room Numbers



Data Source: Department of Tourism

Due to investment grade asset requirement of REITS, the Deluxe hotel segment, which has a 55% share of the Manila Market, will offer a good supply of investment grade properties. Furthermore, as Hotels are highly seasonal and will lower rates during “off–peak” times, it can be seen (in Figure 26), that the Deluxe segment will always have better occupancy rates than the total average occupancy rates. This element of this particular Hotel segment will mean more consistent and stable earnings and thus will be a good supplier of Philippine REIT properties.

Figure 26: Metro Manila Ave Occupancy Rates per Class

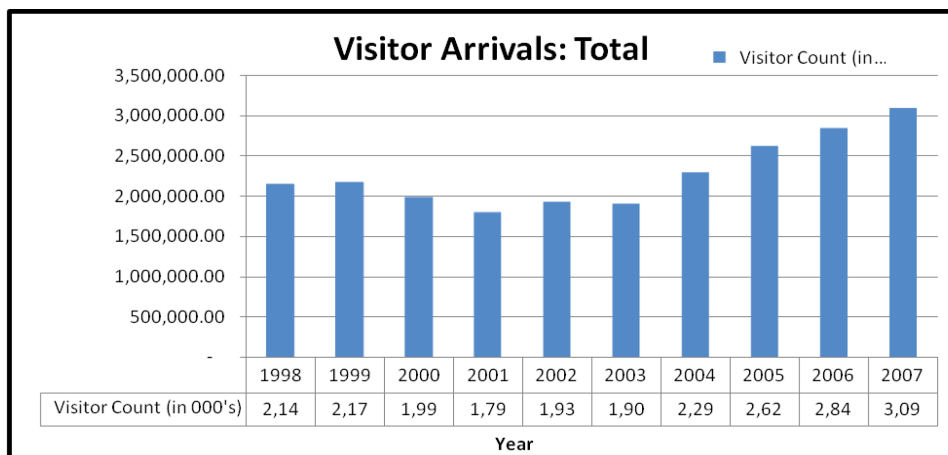


Data Source: Department of Tourism

2. Demand

Due to strategic marketing by the Department of Tourism, total visitor arrivals (Figure 27) in the country have been growing at an average at 4.55%. This can be primarily attributed to the influx of tourists from the Philippines' Asian neighbors, Korea and China, whose economies have been growing over the last few years.

Figure 27: Growth of Philippines Visitors



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Visitor Count (in 000's)	2,14	2,17	1,99	1,79	1,93	1,90	2,29	2,62	2,84	3,09

Data Source: ISI Emerging Markets

In data collected January to February of 2008 (shown in Figure 28), Koreans accounted for the largest number of tourists with 56,832 or 20.5% of total visitor arrivals. Arrivals from Korea grew 14.6% from 49,579 the previous year. The volume of Korean visitors in the Philippines for the January to February period reached 126,354, surpassing the 120,312 of the same period last year. Overall, data from the Department of Tourism (DOT) indicate that tourist arrivals soared 11.74% to 276,809 in February 2008 from 247,731 visitors of the same month last year despite political tensions that occurred during the same month this year. Visitors from the US also increased with 50,372[45] visitors against last year's 46,036. For the first two months of 2008, visitor arrivals from the US amounted to 108,858.

Japan, China and Taiwan complete the top five sources of visitors for the Philippines. Despite the slight monthly decrease of Japanese tourists, it still accounted for the third largest number of visitor arrivals at 31,469. In the same period last year, Japanese visitors numbered 33,053 last year. Chinese tourists are also finding the Philippines a good country to visit with arrivals reaching 22,446[46]. Tourism Secretary Ace Durano said arrivals are expected to rise 10% this year, while international tourism receipts are seen hitting $5.6 billion. This follows a year of phenomenal peak for tourism when arrivals reached 3.1 million and tourist consumer spending amounted to $4.89 billion. "Mr. Durano said last year's growth also raised the total number of direct employment in tourism to 3.78 million and contributed significantly to the country's 31-year high economic growth of 7.3% last year. In line with this, the DOT expects a sharp increase in visitor arrivals via cruise ship this year (2008)". (Nepomuceno, 2008)

The department is also currently looking to position the country as a major Asian destination for sea travelers and cruise ships.

Figure 28: Tourist Arrival (by country of origin): January to February

Rank	Country	2008	2007	% Growth
1	Korea	126,354	120,312	5.0%
2	USA	108,858	101,688	7.1%
3	Japan	65,901	68,000	-3.1%
4	China	36,137	25,362	42.5%
5	taiwan	22,766	21,961	3.7%
6	Australia	20,079	16,841	19.2%
7	Hong Kong	20,039	18,761	6.8%
8	Canada	18,980	15,991	18.7%
9	Singapore	15,582	14,111	10.4%
10	UK	13,540	11,440	18.4%
TOTAL		448,236	414,467	8.1%

Figure Source: Department of Tourism, Business World (2008)

[45] Or 18.2% of the total arrivals for February, 9.4% better than last year
[46] 45.3% higher than the 15,455 the previous year

Chapter Analysis & Synopsis

The Philippine economy has been consistently growing over the past several years. In particular, the massive growth of the Business Process Outsourcing Industry, the increase in Overseas Foreign Workers, and the rising number of tourist arrivals have led to increased consumer spending and demand for real estate in the Philippines.

The BPO industry has led to higher office lease rates, residential rental rates and retail rates. In addition, the OFWs' US$14.5 Billion remittances are a major source of foreign reserves and a driver for consumer spending in goods and residential-for-sale real estate. Thus, earnings and yields for retail real estate are rising, as well as, residential-for-sale construction and unit prices. Increasing tourist arrivals have led to the highest hotel construction and occupancy rates in 10 years.

For the prospective Philippine REIT market supply, the office, hotel and retail sectors will offer significant growth and price appreciation opportunities. The residential sector, however, might be a different story. If, indeed Ayala's sales percentage is an indicator and 40% of the residential consumers are OFWs, who do not use their units and instead put these units back in the rental market, this might lead to an oversupply in residential units. And while BPO expatriates are still growing, this oversupply might eventually put pressure on rental rates to decline. For future Philippine residential REITs, this might potentially lead to a decrease in rental yields.

CHAPTER 4: DEMAND FACTORS FOR PHILIPPINE REITS

In chapter 3, we determined that current optimal macroeconomic factors are spurring the recent boom in the real estate industry. The office, retail and hotel sectors will offer significant supply for growth and capital appreciation and thus, are acquisition targets for REITs in the Philippines. In order to fully assess the business factors for Philippine REITs, demand for the new REIT structure should also be weighed. Thus, it is important to determine what benefits it will provide, as well as who will take advantage of these benefits. This chapter will look at the Philippine REIT players and their motivations in this new structure. In particular, this chapter shall provide the evidence that nonresident or foreign investment, through the Philippine stock exchange, is the prime goal for the Real Estate Investment Company Law and that the tax concessions on dividends and corporate tax transparency will provide them attractive tax savings.

I. REIT PLAYERS & REIT BENEFITS

There will be basically two positions of interest in the current passage of the Real Estate Investment Company Act (2007), namely owners/sponsors of REITs and end-investors[47]/shareholders. Due to the nationality requirement in land ownership[48] and REIC law's motivation, which is to increase local and foreign investments through the local stock exchange, this thesis shall focus only on investors/shareholders in Philippine REIT shares/units. It is important to differentiate that there are two types of Philippine REIT shareholders. The first kinds are residents of the registering country, the Philippines. Residents are further classified as resident citizens, resident aliens, domestic corporations and resident foreign corporations. The second classes of investors are nonresidents. Nonresidents are further classified as nonresident citizens, non-resident aliens and nonresident foreign corporations. These classifications will have further significance as we go through the different tax efficiency benefits to these different potential Philippine REIT shareholders. In lieu of this, the following benefits matrix, which is a compilation of all benefits mentioned in REIT literature and articles, summarizes the benefits of the current REIC proposal to these two major Philippine REIT players.

[47] End-investors, like pension funds, family trust funds, endowments, do not have shareholders who can diversify their own portfolio exposures, so these entities have to actively diversify for their members.

[48] Only Filipino citizens and corporations and associations, at least 60% of whose capital is owned by Filipinos, may acquire private lands or property, inclusive of land. For foreign nonresident corporations who want to acquire land, this would imply that they would have to set up corporations domestically with Philippine partners.

REIT BENEFIT MATRIX	Developer/ Sponsor/ Owner	End Investor/ Shareholder
Alternative Source of Capital	x	
Specialization		x
Exit vehicle	x	
Liquidity/Transparency		x
Stable Dividend Yields		
High Income Yields		x
Diversification		x
Developing Fee Based Business	x	
Professional Management		x
Tax Efficient	x	x

Figure Source: Author

A. DEVELOPER/SPONSORS/OWNERS

This section highlights the different benefits that REITs may provide to developers / sponsors / owners, namely:

1. Alternative Source of Capital

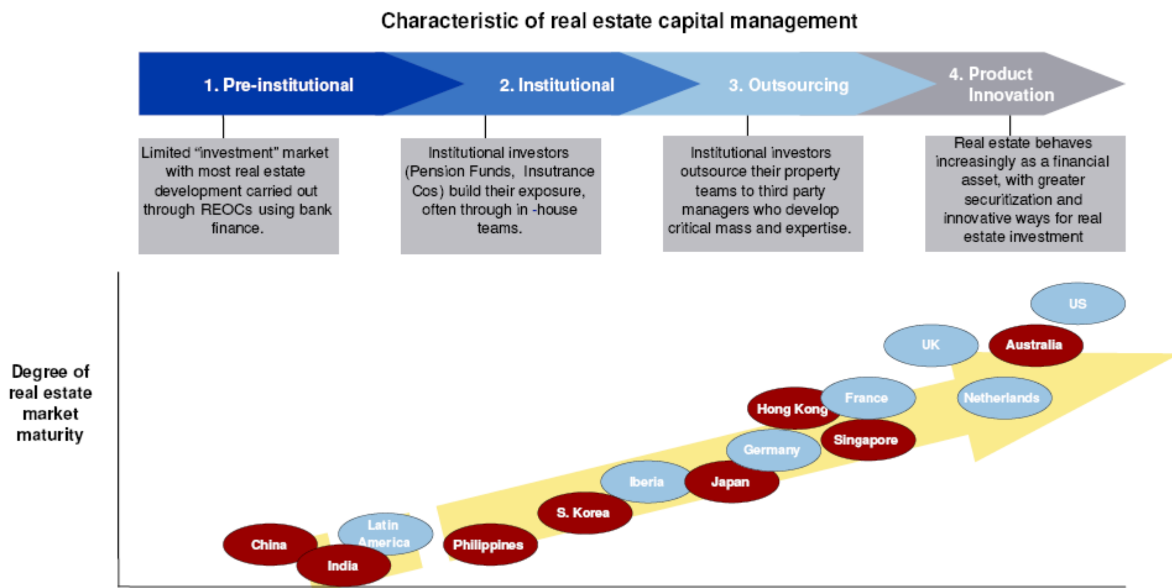
In the Philippines, local developers have typically relied on bank financing for their development projects. This is a significant aspect of the Philippines' real estate capital flow maturity. As shown in Figure 29, the Philippines, albeit nearing the next phase, is still at the pre-institutional phase of its real estate market maturity. And while mature real estate markets also use bank financing, the main difference between the Philippines' lending system and others' is that there is no lending specialization within the banking community. Thus, there is no disparity between construction financing, which finances a percentage of the value of the project during construction, and permanent financing, which is used as long term finance for the project after construction and during stabilization. And as there is no recognition of the different risks associated with a project during construction and a project that is already completed, leased up and stable, the loan interest rate reflected is usually high. In addition, standard loan terms include low loan to cost ratios, recourse and collateral conditions. This makes for a very conservative lending industry. During boom times, local developers will often lunge at these terms, on the optimistic view that the project can be leased or sold out. In periods of bear markets, credit will be tight and largely unavailable for real estate projects. It was during one of these down markets that the REIT structure emerged. REITs, in the realm of international real estate, are perceived as the best vehicle for international real estate investments. And for the major investors in real estate, which are institutional investors[49], REITS provide the key to investing in other countries real estate assets. Stephen Hayes of Perennial Real Estate Investments discloses that "the REIT model is superior in our view; the increasing availability of tax transparent structures provides professional real estate managers with greater access to debt and equity capital to improve the underlying property assets and generate excess returns."

[49] An institutional investor is a non-bank person or organization that trades securities in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions.

(Global Pensions, 2007) Mr. Augusto Bengzon, a member of the Asian Public Real Estate Association and Treasurer for Ayala Land, one of the biggest real estate developers in the Philippines, also believes in the REIT structure's viability. Of all the stated REIT benefits, he has stated that the REITs' ability to provide an alternative and lower cost of capital for real estate companies in the Philippines is most crucial for Philippine real estate developers and owners. (Bengzon Interview, 2008)

Figure 29: Real Estate Capital Maturity

Markets Mature Over Time Creating Greater Investment Opportunity



Note: Real Estate Market Maturity reflects the transparency and liquidity of each market, as well as the share of real estatate market that is 'investable'.
Source: DB Real Estate; DTZ; JLL; IPD

2. Developing Fee based Business

Typically, in Asia, not only will the sponsor own and control the REIT management company but it will be the prime seller of properties to the REIT as well. External management structures of Asian REITS, while adds an additional layer of costs to the REIT, was put in place to provide independent, professional management and to protect investors. Through this external management, developers/sponsors are able to create fund management businesses[50] which could provide consistent and fee-based income. "In Singapore, the first two S-REITs were initiated by CapitaLand and Ascendas, both of which subscribed to the economic value added (EVA)[51] metric. The two government linked companies see REITs as an attractive vehicle to

[50] In Asia, external fund managers are required to have some minimum qualifications. E.g. They must possess a financial services license. The fund management company must possess a track record in fund and real estate management.

[51] EVA is the calculation of what profits remain after the costs of a company's capital - both debt and equity - are deducted from operating profit.

realize immediate paper gains to boost their bottom line and at the same, scale down their balance and redeploy the capital locked in the investment assets into high service content businesses. Unlike an outright sale, the REIT structure allows them to retain control of the properties and to create a fee-based income business from managing the trust, as well as the properties sold to the trust." (Ooi, Newell, & Sing, 2006)The question remains on how to align the interests of the external management system and the REIT shareholders as it is highly plausible that a manager and a REIT sponsor could connive to bring bad deals just to earn a fee. The following table (Figure 30) illustrates the current fees that external fund managers charge from Asian REIT's.

Figure 30: Comparison of Singapore REIT Management Fees as a Percentage of Forecasted 2006 Revenue

REIT	Property Management Fees	Base Trust Management Fees	Management Performance Fees	Other Management Fees	Total
Allco	2.80%	6.60%	2.50%	-	9.10%
Ascendas	2.70%	5.00%	2.30%	2.70%	10.00%
CapitaCommercial	1.80%	1.90%	3.90%	-	5.80%
CapitaMall	3.50%	2.90%	2.90%	0.20%	5.90%
Fortune	2.00%	4.20%	2.20%	-	6.40%
Mapletree	n.a.	5.90%	2.90%	0.20%	8.90%
MM Prime	3.00%	7.40%	0.10%	-	7.50%
Suntec	2.80%	4.70%	3.20%	0.60%	8.50%

Data Source: Playing the REITS Game (Whiting, 2007) and Credit Suisse Research

3. Focusing on Core Business through Divestment

Traditionally, the driving forces for REITs came largely from both real estate companies and non-real estate companies that have significant holdings in real estate. Banks, saddled with non-performing loans (NPLs) involving collateralized real estate, were also pioneer REITs. "In Japan and South Korea, REITs were seen as a potential route for banks to recapitalize in a market burdened with high non-performing loans" (Ooi, Newell, & Sing, 2006)

Over the past several years, as non real estate companies focus on core businesses, REITs also provide an exit strategy for real estate held directly by private funds such as ERGO, ING, Lend Lease, Macquarie Bank and Prudential. Similarly, many corporate real estate owners, having reviewed the merits of focusing on their core competencies, decided to divest their non-core assets such as real estate. One example is Japan Airlines Corporation, Asia's biggest airline, which announced that it is selling its central Tokyo headquarters building for JPY$ 65 billion (US$ 631.2 million) to a J-REIT run by Nomura Real Estate (Reuters News, 2005). Japan Retail Fund Investment is another REIT capitalizing on this trend. Recently, Japan Retail Fund investment has been acquiring retail assets from ''electronics manufacturers that built shopping malls after scrapping the plants on the land they owned, and supermarket chains whose job is to sell retail products and not to own malls,'' (Tanikawa, 2003).

In the Philippines, however, this trend may be highly unlikely. In an Interview with Jones Lang LaSalle Research & Valuation and Consultancy Heads, Ms. Kathy Marcelo and Claro Cordero believe that Philipine corporate real estate owners will always value their real estate assets highly. While this has been apparent in other countries, they state that this has not reflected in the Philippines.

4. Tax Efficiency:

a. Property Transfer fees

As a financial innovator, one of the REIT's functions is to decrease transfer costs and ease the flow of capital, regardless of source, in and out of the country. Among the costs which have greatly impeded the real estate activities of real estate operators and managers are property transfer costs. The current Philippine REIC act proposal makes specific reduction in property transfer costs during the first 7 years of its effectivity, as outlined in Figure 31. To illustrate the tax savings from the following incentives (in consultation with Atty. Victorino, 2008), a comparison of Transfer fees, assuming listed Real Estate Operating Companies (REOCs) convert themselves to REITs within 7 years, is simulated. While listed REOCs would be levied 5% creditable withholding tax (CWT), 1.5% document stamp tax (DST) and 45% in registration fees, a listed Philippine REIT would be exempt from both CWT and DST and would only pay half of registration fees. As the example shows, after creditable withholding tax, documents stamp charges, transfer taxes, registration fees, notarial fee, value added tax and broker's fee, the listed Philippine REIT has an approximated tax advantage of 7% over listed Philippines REOCs. However, the tax savings will decrease to 2% as the exemption regarding CWT expires after 7 years, unless this specific tax exemption is extended.

Figure 31: Comparison of Property Transfer Liabilities of Investing in REOCs vs REICs[52] in the Philipines

TRANSFER FEES Involved	Listed REOC %	Listed REIT %	Difference %
Creditable Witholding Tax	5.00%	0.00%	5.00%
Documentary Stamp Tax	1.50%	0.00%	1.50%
Transfer Tax	0.50%	0.50%	0.00%
Registration Fee	0.45%	0.23%	0.23%
Notarial Fee	0.10%	0.10%	0.00%
Value Added Tax	12.00%	12.00%	0.00%
Broker's Fee	3.00%	3.00%	0.00%
Total	**23%**	**16%**	**7%**

Data Source: National Internal Revenue Act 2007, REIC Act (May 12, 2008), Atty. Carmen Victorino

[52] Transfer costs are based as a percentage of total sales price.

b. Initial Public Offering Tax

Another tax efficiency measure for Philippine REITs is the exemption from IPO Tax. Depending on the value of the proportion of the sold shares to the total number of shares outstanding after the listing, which ranges from a minimum of 25%, tax savings for private real estate operating companies can range from 1-4%, of total value of stocks sold, in saved taxes.

B. END INVESTORS/SHAREHOLDERS

1. Specialization

One of the primary differences with REOC and REIT operations is that REITs focus and specialize on property uses. This will prove to be highly significant to returns. In a 1997 study by Eichholtz, Veld and Schweitzer, it was found that managerial specialization in property type showed significance in explaining a specific REIT's outperformance against the market, which in this case was the S&P 500. It is not surprising that, when we look at the oldest and biggest REIT market in the world, the United States, the top REITs in the S&P 500 (available in Appendix 2) are mostly REITs that specialize in a particular property type. US REITS such as Simon Properties and General Growth Properties have repeatedly shown that concentration on retail has provided them with higher returns. This proven strategy has led to REIT analysts evaluating the different property segments and analyzing the growth potential attributable to them as shown in Figure 32.

With Asian REITs' international standard of 90% dividend distribution, there is a more solid commitment to provide a high yield driven investment product. This commitment has made it a necessity for REITs to focus and specialize in property segments where it has a distinct managerial and operational leverage.

Figure 32: Asian REIT Market Growth Potential by Property Use

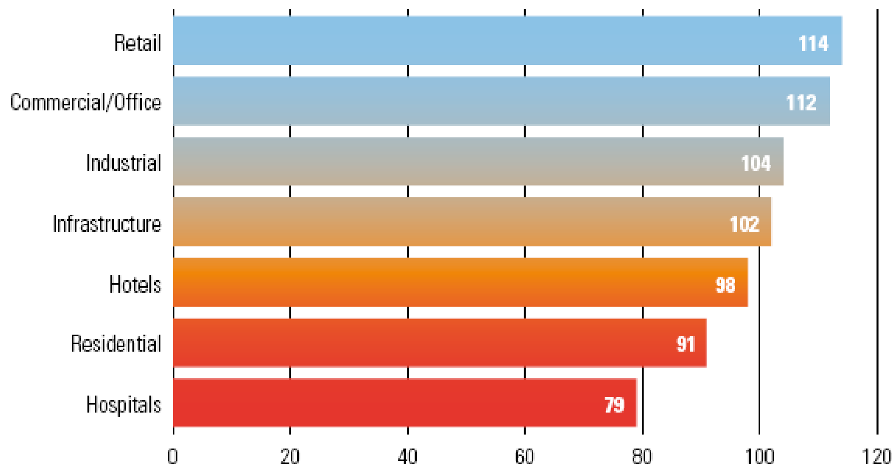


Figure Source: Asian Public Real Estate Association (APREA) & Latham Consulting Survey 2007: 100 points = average expected

2. Stable dividend income

"On the demand-side, REITs have proven to be popular with investors who view stocks as too risky and bonds as not giving enough yield. REIT stocks complement other investment products. by offering a defensive position in the volatile equity market and as an investment product characterized by high dividend yield with the prospect for long term capital growth." (Ooi, Newell, & Sing, 2006)

REITS are still essentially a yield driven vehicles. This is why majority (90% or more) of its Net Income, is slated to be distributed to its shareholders. While allowing development in other continents has given REITS the ability to produce alpha[53] and growth through REIT managers specialized knowledge of the local market and specific property use, REITS shall still be viewed and analyzed based on the stability of their returns and yields.

3. High income yields

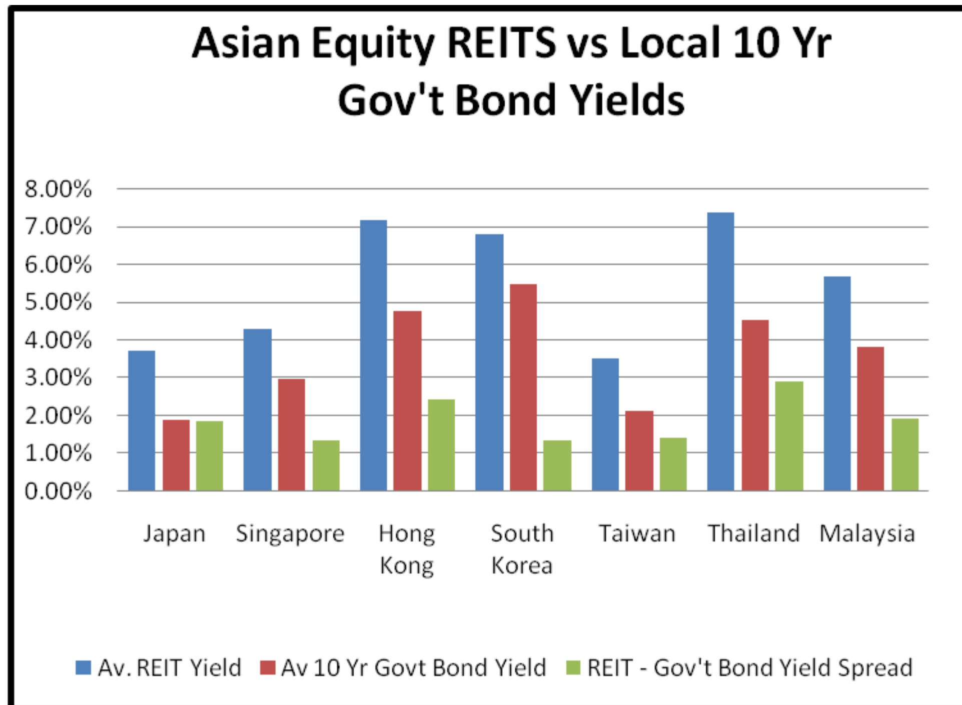
"The spread of REITs legislation has opened up the world of property investment: as direct property funds continue to securitize at a rapid rate and the REIT market expands across the globe" (Global Pensions, 2007). In the same article, Stephen Hayes, managing director of Australian-based Perennial Real Estate Investments explained that in the past investors were constrained by choosing between direct property funds in available markets but now investors are able to identify robust real estate markets and select the investments – whether in offices, retail property, industrial property or even car parks, located in the Americas, Europe, asia & the Pacific – which offered the best total return.

"In Japan, the main buyers for REIT stocks are regional financial institutions, which had been suffering from low lending, as well as individual investors who are attracted to the stable distributions offered by J-REIT stocks (Nikkei Report, 2005a). REIT stocks not only offer more stable returns than common stocks, but they also provide higher dividend yields than the low interest rates" (Ooi, Newell, & Sing, 2006). As shown in
Figure 33, since the start of 2000, the yield on 10-year Japanese and Singapore government bonds, which are used as a base line measure for a risk free rate of return, has averaged about 1.4% and 3%, respectively. In contrast, J-REITs and S-REITs have higher yields of about 3.7% and 4.4%, respectively.

The historically low interest rates have forced institutional investors to find higher yield alternatives. And as institutional investor demand for secure, yield-oriented investments drives more mature REIT Markets like the U.S. and Australian REITs higher, REIT stocks in Asia will similarly offer investors opportunities to diversify their risks. Furthermore, given the adolescence of the Asian REIT Markets, investors can take a position in real estate markets with more up-side rather than downside risk.

[53] Alpha is the abnormal rate of return on a security or portfolio in excess of what would be predicted by an equilibrium model like the capital asset pricing model (CAPM).

Figure 33: 10 yr Bond vs. of Asian REIT yield, as of June 2007



Data Source: CBRE (as of June 2007) and QVM Group

4. High liquidity and transparency

"REITs offer liquidity and transparency in the historically illiquid and non-transparent property sector. Although they can be traded, like equities, their returns are still ultimately tied to the property market" (Global Pensions, 2006). In the same article, Arlington Securities posited that indirect investment, such as REITS, is also an attractive option to bigger pension funds that can afford direct investment.

REITs have provided institutional investors the benefit of daily valuation and market liquidity. Liquidity has become an increasing necessity as investors have required more flexibility in their asset portfolios. According to Howard Yata, managing director of Wilshire Associates, "Real estate is one asset class that, if you can enter and exit at will, you can exercise some level of market timing." William Hill, head of property at Schroder Investment Management, also state that the rise in investments in indirect property was due to increased transparency; "Pension funds now have more confidence in the industry and therefore they are definitely more likely to invest." Martha Peyton, Managing Director of Global Real Estate at TIAA CREF[54], goes on further to say that in international real estate investments, there is no trade-off between liquidity and higher returns. Only markets with liquidity are considered in their global real estate portfolio.

[54] Teachers Insurance and Annuity Association – College Retirement Equity Fund

5. Professional management

Real estate was once considered to be a passive investment. But this has all changed with increased competition and maximizing value for shareholders through the public markets. The Public markets have started to shift investment from direct real estate to indirect. Indirect real estate investments have also provided for professionalized management through strict regulations in the public markets and intense scrutiny from shareholders, analysts and regulators. Although some concerns are still prevalent with indirect investment such as REITS, slowly but consistently, indirect investments have started to attract the large pools of institutional investors which are the target investors of all investment vehicles.

Loss of control in the decision making process has been a key issue with indirect investments such as REITS. However, in a 2006 Global Pensions article, several international investment players addressed these concerns. Greg Wright, principal, Mercer Investment Consulting Europe, believed that this was no longer a major issue. "The indirect route sees investors bringing in specialized managers which makes up for the lack of control when it comes to decision-making," he said. He added that pension funds were becoming more comfortable with handing over their property investments to high quality local managers. Patric Kanters, head of European and Asian real estate at ABP[55] "spoke in favor of indirect investment saying it allowed the fund to align itself with the strongest local managers around the world". (Global Pensions, 2006)

6. Portfolio diversification

As Asian real estate markets mature, liquidity and transparency also start to improve. As such, investments in Asian countries have started to increase due to the diversification potential that Asian real estate markets offer. There are two aspects of REITS that provide true diversification benefits to global portfolios. The first aspect is with regard to the specific hedge nature of real estate against other asset classes. This hedge provides advantages for residents looking to diversify in the same geographical market. The second is in relation to the diversification benefit provided by the securitization of international markets. As ingress and egress in other markets becomes easier, this allows the investor to diversify with respect to the domestic market.

a. Diversification of real estate against other asset classes

As low correlations[56] of real estate, both private and listed, with other asset classes, such as equities and bonds, exist, significant diversification potential exists. In countries where real estate return data exist, the low correlations between real estate returns and returns from other asset classes can be clearly demonstrated. In 2006, a report by UBS highlighted just that. For example, the correlation across regions is considerably lower for real estate securities than it is for stocks and bonds. As exhibited in Figure 34, the inter-regional correlations of the three

[55] Stichting Pensioenfonds ABP is the Dutch pension fund for government employees

[56] A correlation is the measure of how two assets move in relation to each other. The higher the correlation, the greater the relationship of the two assets to move in the same direction.

asset classes of stocks, bonds and public real estate in Europe, Japan, Australia, UK and US, are compared. From the figure, it is shown that the correlation of real estate returns has increased in recent years. However, it remains significantly lower than the inter-regional correlations for both bonds and equities. In the same UBS report, it was found that private real estate correlations across countries are also quite low. [57]

Figure 34: Correlations Across Regions for Public Real Estate, Bonds and Equities

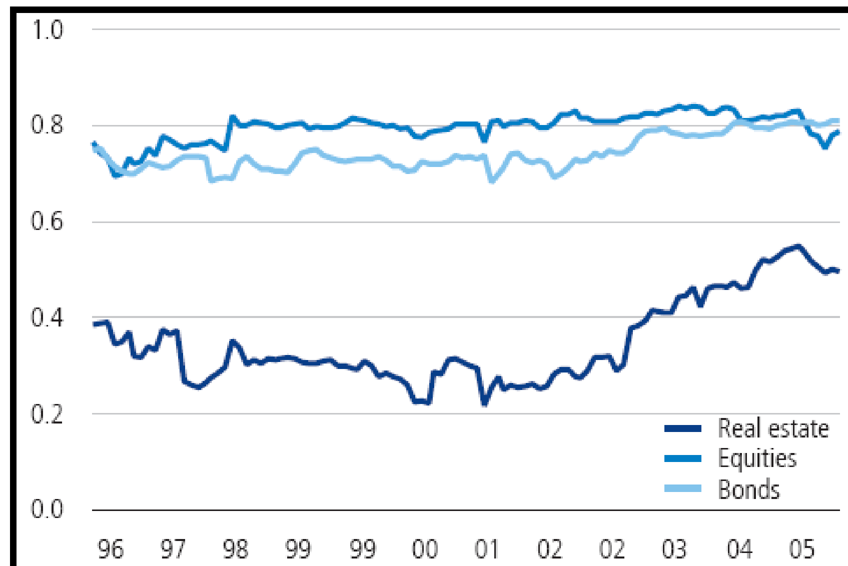


Figure Source: UBS Global Asset Management Real Estate Research

b. Diversification through the international markets

In the global public markets, certain markets provide natural hedges against each other. A study by Eichholtz, Huisman, Koedijk and Schuin (1998) reported real estate returns are driven by a strong continental factor in that countries in the same continents, with the exception of Asia, were highly correlated with each other and that real estate markets were integrating on a regional basis. The study supports the theory that US and European investors should look to international markets for a more effective diversification. "At the same time, it suggests that investors can only attain optimal diversification by investing across continents, as opposed to simply investing in neighboring countries". (Mullins, 2004)

In a study by Pareto and Associates (2007), investment management and financial planning consultants, comparing the real estate correlations, as shown in Figure 35, of regions within the Well Dow Jones Wilshire Global Real Estate Securities Index (RESI) Fund[58], which contains non-

[57] The average correlation of private office market returns in Australia, France, the UK, and the US between 1986 and 2004 was approximately 0.4.

[58] Introduced in 2006, the Wells Dow Jones Wilshire Global RESI Index Fund offers the diversification of a global real estate portfolio with the liquidity of publicly traded real estate stocks. Mirroring the holdings of an index that is backed by the strength of a worldwide index leader, Dow Jones Wilshire, this new mutual fund mirrors the

U.S. REITs, we indeed see that real estate correlations among individual regions is quite low. This provides the international rationale for diversification. The only caveat to this is that "for true diversification, one needs to invest in a number of different properties, which is a sizeable task". Liquidity issues make investing in numerous properties across the globe as a risky strategy, even if the pension fund has large amounts of money at its disposal. Investing in REITs, through fund of funds or pooling, is becoming the more attractive option for pension funds to diversify internationally in real estate, without taking on all the information and transaction costs involved. According to Ubbe Strihagen, international director for Aberdeen Property Investors, "this route sees pension funds reducing their transaction costs and benefiting from the expertise of managers in the local markets overseas,"

Figure 35: Real Estate Correlations of Americas, Europe and Asia/Pacific

	Americas	Europe	Asia Pacific	World
Americas	1.00	-	-	-
Europe	0.57	1.00	-	-
Asia Pacific	0.53	0.60	1.00	-
World	0.95	0.75	0.72	1.00

Data Source: State Street Global Advisors (SSGA) Funds and Investopedia Web Site

c. Tax Efficient

REITS, by their very nature, are tax efficient vehicles. The tax efficiency means they are high yielding, and the high yield tends to reduce share price volatility, which has been the consistent concern with securitization. As mentioned in Chapter 2, there are several segments of tax advantages available only in REITs. Using the most current Real Estate Investment Company Law proposal (May 12, 2008),this section shall attempt to give an in depth analysis of the different tax advantages to investing in listed REITs against listed REOCs in the Philippines.

a. Corporate Tax Transparency

In the Philippines, corporate and personal income tax is levied based on classifications. In Philippine Philippine accounting standards, dividends is not an operating expense item and is included in a company's taxable income computation. Hence, dividends are non tax-deductible. The Philippines Real Philippines Real Estate Investment Company Act changed this and exluded dividends distributed from from taxable income. Thus, not only did dividends became a tax-deductible expense and significantly significantly reduce the tax base of REITs in the Philipines, for investors, the value of dividednds they they receive will will be 35% higher as they receive the full value of their dividends.

Figure 36 shows the different tax classifications (in consultation with Atty. Victorino ,2008) and sumarizes the benefits of corporate tax transparency for different classifications of investors, in the event of the passage of the most current Real Estate investment Company Act.

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holdings of the Dow Jones Wilshire Global Real Estate Securities Index (RESI). This Fund is carefully designed and monitored to reflect the values of institutional-like direct ownership of commercial real estate around the world.

In summarizing the effect of corporate tax transparency for investors who invest in Philippine REITs, the unit/shareholders and corporations can get as much as 27% to 32% higher yield in a REIT than a listed REOC in the Philippines. This 27% and 32% can also be viewed as the tax savings and additional earnings for the Philippine REIT shareholder from eliminating the double taxation which occurs on the corporate level and personal level. The complete formula and computation are available in Appendices 3 & 4.

Figure 36: Corporate Tax Transparency Benefits to individual shareholders and corporations[59] in the Philippines

Classification	Corporate Income tax	Personal Income tax	Tax Savings (in %)
RESIDENTS			
Resident Citizens	N.A.	32%	21%
Resident Alien	N.A.	32%	21%
Resident Aliens employed by multinationals	N.A.	15%	27%
Domestic Corporation	35%	N.A.	32%
Resident Foreign Corporation	35%	N.A.	32%
REIT	0%	N.A.	N.A.
NONRESIDENTS			
Overseas Filipino Investors/ Nonresident Citizens	N.A.	32%	21%
Non-Resident Alien Engaged in Business in the Philippines	N.A.	20%	21%
Non-Resident Alien Not Engaged in Business in the Philippines	N.A.	25%	24%
Non-Resident Foreign Corporation*	10%	N.A.	9%

Data Source: Isla, Lipana & Co, How to Invest in the Philippines (2007), National Internal Revenue Code (NIRC 1997), Atty. Carmen Victorino

b. Dividends

As figure 35 highlighted the tax savings for resident and nonresident investor classifications from excluding dividends as part of taxable income, Figure 37 shall present the dividend tax incentives for resident and nonresident individuals and corporations. The dividend tax incentive further strengthens the Philippine REIT as a yield driven vehicle. Continuing the tax savings analysis (in consultation with Atty. Carmen Victorino, 2008) to include the dividends tax (from

[59] The current draft of the Philippine REIC Act requires REITs to payout a minimum 90% of their Operating Income to their shareholders. E.g. For Type A Investors in Listed REOC, After Tax Income to Shareholders = (100-35)*.90 = 59, while for Listed REIT, dividends are tax deductible expenses and thus are not taxed at the corporate level. A step by step run through of the computation is available in Appendix 4

Figure 36 to Figure 37) exemptions and discounts, we find that of all individual investor classification, it is only the resident citizens and aliens which were not considered for dividend tax incentives, thereby decreasing their dividend yield. It is also evident that greater tax savings are given to the nonresidents namely, nonresident citizens (up 4%), of which OFWs are included, nonresident aliens (up 2-3%), whether or not engaged in business in the Philippines and aliens employed by regional multinationals.

For corporations, while domestic and resident foreign corporations maintain their tax exemptions from dividends received from domestic corporations, non-resident foreign corporations get an added tax incentive by reducing their 15% dividend tax rate to 10%. This effectively increases their tax savings to 12% (up 4%). In an interview with Philippine Stock Exchange representatives, they stated that one of the main goals of the REIC Act was to increase the participation of OFW's and the foreign investors in the Philippine Stock Exchange (PSE). This provision, thereby, is consistent with PSE's motivations.

Figure 37: Computation of Tax Liability of Investors from Dividends received from Domestic Corporation - REIC (For One Taxable Year)

Classification	Domestic Corporation engaged in real estate business under NIRC of 1997	"REIC" under Senate Bill	Tax Savings (in %)	Change in Tax Savings from Corporate Tax Transparency
RESIDENTS				
Filipino Citizens	10%	10%	19%	DOWN 2%
Resident Alien	10%	10%	19%	DOWN 2%
Resident Alien employed by a multinational	20%	10%	29%	DOWN 2%
Domestic Corporation	0%	0%	32%	-
Resident Foreign Corporation	Dividends received are included in taxable income of recipient corporation subject to **35% income tax rate**	0%	32%	-
NONRESIDENTS				
Overseas Filipino Investors/ Nonresident Citizen	10%	0%	25%	UP 4%
Non-Resident Alien Engaged in Business in the Philippines	20%	10%	23%	UP 2%
Non-Resident Alien Not Engaged in Business in the Philippines	25%	10%	28%	UP 3%
Non-Resident Foreign Corporation	Dividends received shall be subject to final withholding **income tax rate of 15%** as provided under Section 28(B)(5) thereof, or the applicable tax treaty rates.	10%	12%	UP 4%

Data Source: National internal Revenue Code of 1997, REIC Act (May 12, 2008), Atty. Carmen Victorino (complete computation is available in Appendices 3 – 4)

Chapter Analysis & Synopsis

From all the listed benefits to Philippine REIT sponsors and owners, the REIT structure, as an alternative and lower cost of capital, is most important for developers. Other benefits, however, are constrained by limits in regulation. Asian REITs have been able to create fee based businesses through fund management fees. This, however, is an output of the external management regulation currently imposed in Asian REIT Markets. Historically, as REITs mature, external management systems are taken over by internal management systems due to cost inefficiencies brought about by additional costs and fees charged by these fund management systems. With regard to the tax savings caused by the tax concessions in transfer fees for Philippine REITS, at the onset, these concessions amount to 7% tax savings in transfer and registration fees. However, after 7 years, when the limit on the exemption on the creditable withholding tax expires, the tax savings goes down to 2%. Another fiscal incentive are exemptions from Public offering taxes which can give a company a range of 1-4% depending on the gross value of shares sold in proportion to the total value of outstanding shares after the listing. This would indicate that these are “early bird” concessions, meant to jumpstart the REIC Market. Add this with the current listing requirements, and it is apparent that these concessions would likely be advantageous to those currently listed in the stock exchange.

For the potential Philippine REIT shareholders, the benefits are clear and concrete. REITs are investments that will give investors more stable dividends than stocks, higher yield than treasury bonds, diversification from both stocks and bonds for resident investors, diversification from European and American investments for nonresident international investors, more product-focused management than typical real estate operating companies and higher liquidity and transparency than private real estate ownership. While regulators have said that externally managed REITs will provide more professional management, there exists a downside, which is, that this regulation creates cash cow businesses for REIT Sponsors and decreases the investors’ dividend yields. Furthermore, historical data from mature REIT markets imply that external management structures have more debt at higher costs. Thus external management is an inefficient regulation which will potentially disappear as REITs in Asia and the Philippines, similar to mature REIT markets, become more mainstream investments. In terms of tax efficiency benefits, adding dividends in the computation of operating expenses and making them a tax deductible expense eliminated the double taxation present in other real estate investment structures. More than anything, this is what gives the REIT structure its high yields and this is what makes it distinct from other asset classes. To recap the tax analysis conducted in Figure 36 & 37, tax savings amount from 21-32% for Philippine residents, depending on investor classification, while nonresident investors can get a range of 9-24%. Additionally, as the Philippines Stock Exchange’s primary motivation is to increase participation in the local capital markets, tax concessions on dividend taxes are further granted, increasing tax saving by an incremental 2-4% for nonresident citizens, nonresident aliens and nonresident foreign corporations with non-treaty status.

Chapter 5: PHILIPPINE REAL ESTATE LEGISLATION

In chapters 3 and 4, we determined that supply and demand factors for a successful Philippine REIT market exist. In this chapter, we shall assess the two laws which were designed specifically for the real estate sector: the Special Purpose Vehicle law (SPV), which was used as a restructuring device for the Asian Financial Crisis, and the Real Estate Investment Company (REIC) Act, a local adaptation of the highly innovative and internationally accepted REIT structure. Given the momentum to pass the current REIC Law, it is important to assess the effectiveness of the previous SPV law and its limitations before proceeding to its successor. This chapter shall also briefly provide a history of REIT Legislature (PAST), compare the Real Estate Investment Company Act with other Asian REIT Regulation to evaluate its competitiveness (PRESENT) and, using Australia as a roadmap, assess the future outlook of the REIC Act (FUTURE).

I. The Special Purpose Vehicle Act

The SPV Act basically eliminated any regulatory and agency barriers in the purchase of huge amounts of nonperforming assets and loans caused by the Asian Financial Crisis. SPV's, as asset management companies, were envisioned as a means of disposing the bank's bad assets through their specialization of managing and disposing assets. Banks, on the other hand, were given fiscal incentives to transfer these assets to SPV's, for their eventual liquidation and divestment. In order to assess the effectiveness of the SPV law, this section will review its main features, its limitations and its effectiveness

A. Main Features of the SPV Law

1. Process and timeline

The Law mandated that all SPV's register by September 2004, transfer of assets from bank up to April 2005 and transfer of assets to third party buyers (from sale, renegotiations with original lender, public auction etc) within five years following the date of acquisition. Only loans/assets, which were either nonperforming or under litigation as of June 30, 2002, were given a Certificate of Eligibility (COE) under the SPV Law. The COE's are then used by the seller/buyer with regard to availing of the fiscal benefits from the government agencies. Failure to comply with said deadlines meant that the transactions would not be able to avail of the tax and fiscal benefits available under the law. The original April 2005 deadline was extended for three years, up to May 2008.

2. Fiscal benefits

The fiscal benefits include exemptions from payments of documentary stamp tax, capital gains tax, creditable withholding tax and value added tax. Other incentives include fee reductions on mortgage and land registration, filing fees and transfer fees by as much as 50%. In addition to this, banks were allowed to deduct a portion of their losses from the SPV transaction on their gross taxable income for up to 10 years.

B. Limitations of the SPV

1. Time Constraint

Due to the time bound nature of the Law, SPV's were more inclined toward short term strategies which could allow them a quick return. Examples include resale of debt to original borrowers, auction of assets. In short, liquidation was the preferred strategy of the SPV's.

This concern was tried to be addressed by granting income tax holidays on net interest income arising from new loans (for corporate restructuring) and waiving the documentary stamp taxes on the loans. However, the five year after-acquisition-deadline of all fiscal incentives prevented a long term strategy for the SPV's.

2. Bureaucracy and Government Coordination factors

Added to the fact that the Law was time bound, there were numerous delays in drafting all the necessary rules and guidelines necessary for the implementation of the SPV Law. To briefly look at the timeline before the law became effective: "the Law was signed on January 10, 2003, the implementing rules and regulations was approved on March 19, 2003 and took effect April 9, 2003, but the Bureau of Internal Revenue (BIR) Revenue Regulation came out much later, leaving banks with little time to prepare all the necessary documentation and paper chase to meet the deadlines mandated by the SPV Law. In addition, the implementation of the Securitization Act which is, supposedly, a companion law to the SPV Act has been delayed for lack of implementing rules. This affected the use of asset-backed securities by SPVs". (Pasadilla, 2005)

Another delaying factor is the bureaucratic requirements for obtaining the Certificates of Eligibility (COE) from the appropriate regulatory agency which, for banks, was the Central Bank of the Philippines (BSP). On one hand, a BSP official considers the COE application a "cleansing process" for banks whose data documentation support or information systems for their bad assets have been relatively weak. Meeting the BSP requirements for the COE issuance, therefore, forces banks to have all their loan and asset records and documents in order. However, banks considered the process of reconciling any given pool of bad assets with what the BSP have in their master list, for purposes of verifying eligibility under the SPV Law, tedious and time consuming.

In addition, government agencies were also not informed and coordinated in implementing the fiscal incentives. There were even reports/complaints that some government agencies, when presented with the COEs, for the availment of tax or registration fee reductions, were unknowledgeable of the fiscal rewards from the Law.

3. Opposing Incentives between the Banks and SPVs

There were two major reasons why the banks and the SPVs did not achieve a win-win situation under the provisions of the SPV Law. The first major reason was pricing. The banks considered the proposals on the NPAs as extremely low. Given the banks' loss provisioning for NPAs is capped at 50 per cent of the difference between book and appraised value of the real estate

property and does not start until years 6 to 10 following the acquisition of the asset, while that for NPLs starts immediately and ranges from 5 to 100 per cent. Keeping the NPAs in banks' books and waiting for the upswing in the real estate cycle is cheaper, on the basis of loss provisioning, than selling them to the SPV's.

Secondly, the terms of payments that were offered by SPV, particularly the portion paid in debt securities or notes, are riddled with uncertainties. However, the SPVs had to assume the worst bankruptcy, foreclosure and litigation costs, making the terms proposed by the SPVs too one-sided. "After assuming the maximum delay, the projected value of loan collateral is conservatively estimated and the projected proceeds of sale in the far future are discounted back at a high rate to the purchase date. Once the buyers purchase the asset pool, it approaches the borrower with a heavy carrot and stick, but with greater flexibility than banks". (Pasadilla, 2005). For banks, if it turns out that the value of the notes is worthless, the bank merely pushed back the book recognition of its loss, which defeated the purpose of the law. Thus, depending on the risk appetite of banks, they can accept full payment with majority paid in notes, or accept some losses upfront but with greater cash component. For a relatively conservative bank, more cash payment upfront, while definitely preferred, also had its downside.

4. International Accounting Standards

The final constraint on the law was the Philippines Central Banks' differences in financial reporting standards with the International Accounting Standards Board (IASB)[60]. In particular, with regard to the recognition of losses, the BSP's rules, which allowed the loss carry over from the NPA sale for a 10 year period, is contradictive with the International Accounting Standards (IAS) which does not allow deferred loss recognition. Thus, as banks were also respectful of IAS, losses from the NPA sale would have to be immediately reflected in their balance sheets.

C. Effectiveness: Did it work?

Of the P520 Billion (approx. US$ 10 Billion) NPA's (as of June 30, 2002), representing 14.9% of the banking system's gross assets of 3.5 trillion, P170 Billion was sold to SPV's[61]. This represents 32% of the total NPA portfolio and a low turnout for the much heralded restructuring vehicle.

Currently, there are no plans to further extend the SPV law. BSP Deputy Governor Nestor Espenilla has stated that the SPV law had completed its function. According to him "The role of the SPV was really to break the inertia because for a long time nobody wanted to do it, but the SPV has broken the inertia, so now we believe the SPV can safely fall away," (Dumlao, 2008). He also mentions that the banks had significantly improved their asset quality by selling bad assets, through joint venture development and auction sales, and expects that the banking system's nonperforming loans (NPL) will fall below five percent of the total loan portfolio this year.

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[60] The International Accounting Standards Board (IASB) is the standard-setting body of nearly 100 countries, committed to developing a single set of high quality, international financial reporting standards for general purpose financial statements.

[61] P100 Billion during the first SPV deadline of April 2005, P70 Billion during the extension of May 2008

While this may be a comforting sentiment, it should be noted that the majority of the work done to improve the NPL/NPA ratios in banks is due to the recent and current real estate boom in the Philippines. Thus, it appears that the banks, which waited for the trough segment in the real estate cycle to pass, were rewarded for their patience.

As the new Real Estate Investment Company law comes into the forefront, it will be interesting to see if the limitations and constraints from the previous SPV law have been addressed. While not exactly equal or similar, one cannot help but see the resemblance between these two laws, in terms of the financial benefits it grants to its players and the presence of constraints in its structures.

II. REAL ESTATE INVESTMENT COMPANY (REIC) Act 2007

On June 30, 2007, at the 14th Congress of the Republic of the Philippines, Senator Edgardo Angara filed Senate Bill No. 63, entitled The Real investment Trust Act of 2007. In his explanatory note, Senator Angara "acknowledged the integral role of the private sector and its capital market towards achieving the Constitutional objective of equitably distributing and enhancing the democratization of wealth and the development of the Philippine economy as a whole towards the realization of the collective objective of achieving a strong republic." (Angara, 2007)

Currently, the law has undergone several revisions through consultation with the Philippine REIT Technical Working Group of which the following entities are members/consultants:

- Philippine Stock Exchange (PSE)
- Law Offices of Angara, Abello, Concepcion, Regala & Cruz Law Offices (ACCRA)
- Department of Finance (DOF)
- Bureau of Internal Revenue (BIR)
- Chamber of Real Estate & Builder's Association (CREBA)
- Foreign Banks Representative Office Association of the Philippines (FBROAP)
- Investment House Association of the Philippines (IHAP)
- Investment Company Association of the Philippines (ICAP)
- Government Services Insurance System (GSIS) – Investment Office
- Social Securities System (SSS) –Securities trading & Management Department
- Central Bank of the Philippines (BSP)
- Chamber of Thrift Banks, University of Asia and Pacific (UA&P) - School of Economics
- Asian Public Real Estate Association (APREA)
- Fund Managers Association of the Philippines (FMAP)
- Trust Officers Association of the Philippines (TOAP)
- Villaraza & Angcanco Law Offices
- Sobrevinas, Hayudini, Bodegon, Navarro & San Juan Law Offices

As the law has undergone several revisions, it will be interesting to see which version of the REIC law is approved. Based on Macquarie's Evolution & Cycle of Listed Property Securities (ECLIPSE) Model of REIT Legislation Phasing as shown in Figure 38, which was derived on the development of Australia's listed property trust market, Asia will also undertake the same process and roadmap[62]. According to Macquarie, the only difference could be in Stage 5, the phase (Path 1) when Australian REITs started stapling operating businesses to the REITs, in order to undertake development. In Asia, development is

[62] Full description of the ECLIPSE stages are available in Appendix 5

still viewed, by regulators, as too risky. Thus, unless legislation allows Asian REITs to increase its risk aversiveness, Macquarie forecasts that Asian REITs will instead go through Path 2. Path 2 is where "REITs will become susceptible to interest rates and rental yields in the physical property markets". (Whiting, 2007). The ECLIPSE model is also significant as it provides "a useful model to understand the probable evolution og Asian REIT Markets". (Whiting, 2007)

Also, based on the ECLIPSE Model's different stage descriptions, Philippines is currently in Stage 1. Stage 1 is characterized namely by

- Listed property companies are lowly geared, illiquid and are usually composed of single asset.
- Shares are owned mostly by individual investors and do not have a competitive cost of capital.

Figure 38: Macquarie's Evolution & Cycle of Listed Property Securities (ECLIPSE) Analysis

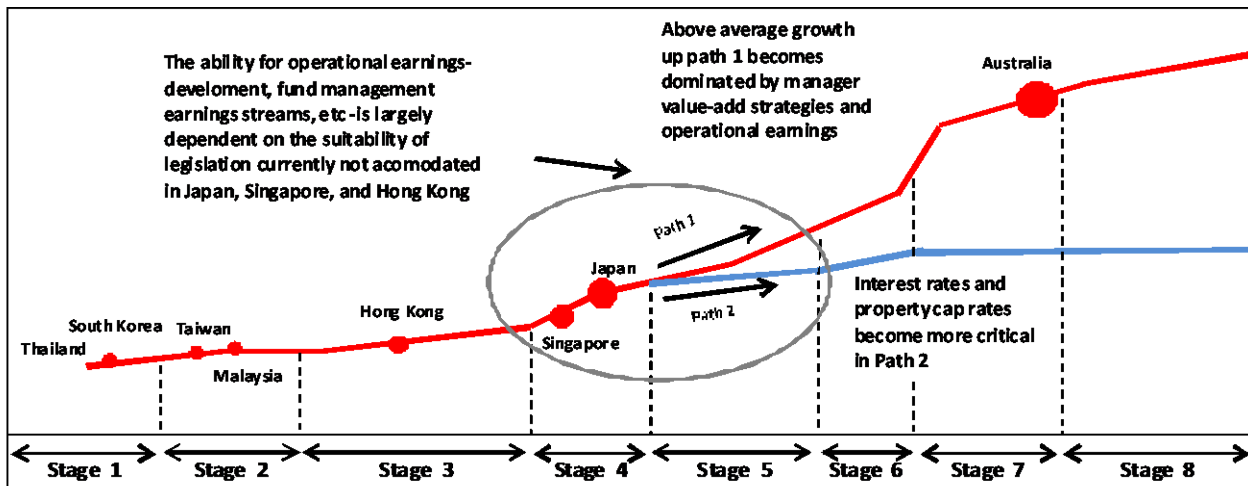

Figure Source: Macquarie,

A. Main Features of REIC Act 2007 (as of May 12, 2008)

Majority of the features that were adopted by the Philippine REIT are similar to Singapore's REIT framework. It is still uncertain to what degree the Philippine REIC will copy the example of other Asian Countries, as the tax collecting government agencies (Bureau of Internal Revenue, Department of Finance), in the Philippines, have already provided significant concern and opposition to the tax incentives that are inherent in the REIT structure. Quoting all the salient provisions of the May 12, 2008 REIC Act proposal, this section will enumerate the following Philippine REIT elements and explain them in local and international context. A summary comparison of the REIT factors per country is exhibited at the end of the chapter (in Figure 39).

1. Type

The Philippines will not use a trust vehicle as there are no current laws governing listed trusts. According to an interview with Atty. Serafin Salvador, a Philippines tax law specialist, "In line with Philippines' Civil Code Law, only companies may be publicly listed in the Philippines Stock

Exchange”. Thus, REITs in the Philippines will be aptly named Real Estate Investment Companies or REICs.

2. Management

a. Fund Manager

“A REIC must appoint an independent Fund Manager who shall be responsible for managing the funds of the REIC. The Fund Manager shall be appointed in accordance with, and perform duties and functions and subject to such requirements and restrictions as may be prescribed by, the rules and regulations of the Commission”

b. Property Manager

“The REIC must appoint a REIC Property Manager who shall be responsible for managing the real estate assets such as apartment buildings, office buildings, warehouses, hospital buildings, medical facilities, hotel buildings, resort facilities, manufacturing plants and other physical assets of the REIC. The contract between the REIC and the Property Manager must be: (a) approved by a majority of the entire membership of Board of the REIC, including all the independent directors of the REIC; (b) on arms-length basis and its terms are fair and reasonable to the REIC; and (c) promptly disclosed to the Exchange and the Commission.”

“The REIC Property Manager shall possess the qualifications and be subject to such functions and responsibilities, restrictions and other requirements prescribed by the Commission.”

Similar to the majority of Asian REITS, the Philippines have chosen an external fund and property management structure. While internally managed REITs have historically outperformed external managed REITs due to management fees, the security and protection of investors is the first priority of REIT regulators. The widely held belief is that only maturity of the REIT structure can eventually change the management structures of REITs in Asia. And as shown in the ECLIPSE model, the Philippine lags behind its Asian neighbors in terms of REIT legislation, this structure will have to first be tested in other Asian shores before it may be adapted in the country.

3. Tax Transparency for shareholders/investors

“A REIC shall be subject to income tax under Chapter IV, Title II of the National Internal Revenue Code of 1997 as amended, on its Taxable Net Income as defined in this Act: Provided, however, That REICs that are listed within three (3) years from the effectivity of the IRR of this Act and that qualify as a public company pursuant to Section 8.1 hereof shall be subject to income tax at the rate of twenty-five percent (25%) for a period of seven (7) years from the date of listing in lieu of the income tax rates prescribed by Title II of the National Internal Revenue Code of 1997, as amended. For purposes of computing the Taxable Net Income of a REIC, dividends distributed by a REIC from its Distributable Income after the close of a taxable year and on or before the fifteenth day of the fourth month following the close of the taxable year shall be considered as paid on the last day of such taxable year.”

For Philippine REICs, the corporate tax on retained earnings was reduced from 35% to 25%, for 7 years from the date of listing, provided the company lists within the first three years of the effectivity of the implementing rules and regulations of the REIC Act. While this is not a clear cut exemption from corporate income tax, granted in other Asian REITs, it does include the most salient feature of the Philippine REIC. And, this is the inclusion of dividends in computing the taxable net income[63] as a tax deductible expense. Thus, shareholders will receive 100% of dividend value rather than suffering a corporate level tax of 35%[64].

4. Tax concession for shareholders/Investors

a. Dividends

i. "If the Investor is a Filipino citizen, a resident alien, a nonresident alien whether or not engaged in trade or business in the Philippines, or a nonresident foreign corporation (as these terms are defined in the National Internal Revenue Code of 1997, as amended) the dividends shall be subject to a final tax of ten percent (10%)".

ii. "If the Investor is a domestic corporation, a resident foreign corporation, or an Overseas Filipino Investor, the dividends shall be exempt from income tax".

The Department of Finance (DOF) has pressed some reservations in the proposal to exempt OFW, who invest in REICs, from dividend tax. The DOF has stated that tax incentives on any law should be fair to all sectors and not just benefit a certain few. However, the PSE persists that in order to increase non-resident citizens, such as overseas Filipino workers, and foreign nonresident investor participation, the Philippines should grant dividend tax exemptions to OFW while lowering dividend tax for non resident aliens, resident foreign corporations, and nonresident foreign corporations. As exhibited in Figure 37, these tax savings are substantial and increase the yield for these investor groups.

b. In case of sale or transfer of property to REICS, provided it lists within three years of passage of REIC law

i. "Exemption from Documentary Stamp Tax (DST)"

Documentary Stamp tax costs are currently at 1.5% of the Gross Selling Price. The DOF has stated that REICs, as alternative investment vehicles, should be

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[63] "Taxable Net Income" means the pertinent items of gross income specified in Section 32, less all allowable deductions enumerated in Section 34, of the National Internal Revenue Code of 1997, as amended, less the dividends distributed by a REIC out of its Distributable Income as of the end of the taxable year as: (a) dividends to owners of the common shares; and (b) dividends to owners of the preferred shares pursuant to their rights and limitations specified in the Articles of Incorporation of the REIC.

[64] Except as otherwise provided in this Code, an income tax of thirty-five percent (35%) is hereby imposed upon the taxable income derived during each taxable year from all sources within and without the Philippines by every corporation, as defined in Section 22(B) of this Code and taxable under this Title as a corporation, organized in, or existing under the laws of the Philippines.

made to compete on the basis of the merits inherent in the structure and let the market if it is worthy of capital allocation.

ii. "Exemption from Creditable Withholding Tax (CWT) for a period of 7 years from the date of effectivity of the REIC Act"

Creditable Withholding Tax for real estate dealers are currently levied at 5%. The Department of Finance stand is if there is income realized by the owner/seller of the property, CWT should be assessed and paid.

iii. All applicable registration and annotation fees to be paid, related or incidental to the transfer of assets or the security interest thereto, shall be fifty percent (50%) of the applicable registration and annotation fees.

Registration and annotation fees are currently at 1-1.25% of the Gross Selling Price. A complete breakdown of all registration costs and procedures is available in the Appendix 6.

c. Listing Concessions – IPO Tax

i. "Any initial public offering and secondary offering of Investor Securities shall be exempt from the tax imposed under Section 127(B) of the National Internal Revenue Code of 1997, as amended."

IPO Tax is currently levied at 1-4% of gross value of shares sold[65]. This is a concession for those private real estate companies to list in the Philippine stock exchange as REICs. The DOF has signified their support for this concession.

In order to jumpstart the Philippine REIC Industry, with the assumptions that most developers who qualify will transfer their income producing properties into Philippine REICs, the following incentives, mentioned above, are being proposed by its proponents. Figure 30 represents the substantial tax advantages of listed Philippine REICs. However, looking at other international REIT structures, we should also take note of US Umbrella Partnership[66]

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[65] NIRC 127 (B) Tax on Shares of Stock Sold or Exchanged Through Initial Public Offering. - There shall be levied, assessed and collected on every sale, barter, exchange or other disposition through initial public offering of shares of stock in closely held corporations, as defined herein, a tax at the rates provided hereunder based on the gross selling price or gross value in money of the shares of stock sold, bartered, exchanged or otherwise disposed in accordance with the proportion of shares of stock sold, bartered, exchanged or otherwise disposed to the total outstanding shares of stock after the listing in the local stock exchange:

a. Up to twenty-five percent (25%) 4%
b. Over twenty-five percent (25%) but not over thirty-three and one third percent (33 1/3%) 2%
c. Over thirty-three and one third percent (33 1/3%) 1%

The tax herein imposed shall be paid by the issuing corporation in primary offering or by the seller in secondary offering

[66] Under the UPREIT structure, the REIT holds its properties through an operating partnership in which the REIT is a partner, ordinarily with the controlling interest. UPREITS were developed in the early 1990's to provide a way for

(UPREIT) (illustrated in Appendix 7) tax deferral system as another model to ease transfer costs. The UPREIT Structure was considered to be the one of the major catalysts to the US REIT revolution in the early 1990s. The UPREIT structure caused real estate owners to defer the income/gains from the sale that would have otherwise resulted from their contribution of negative basis assets to a trust or corporation in preparation for an IPO. Starting from the UPREIT's initial public offering in 1992, others quickly followed suit. The total market capitalization of US REITs grew from US$ 8.7 billion, in 1990, to 330 billion in 2005.

The only problem with the UPREIT structure is that this cannot be used in the Philippines as "there is no law governing like-kind exchanges in the Philippines" (Interview with Atty. Salvador, 2008). Thus, each specific case would have to individually apply for the approval of the Bureau of Internal revenue for tax deferral.

5. Dividend Distribution

"REICs must distribute annually at least ninety percent (90%) of its distributable income to its Investors. However, this excludes income on the sale of the REIC's assets that are re-invested by the REIC within one (1) year from the date of the sale."

This is in line with the international standard REIT dividend distribution ratio. The current minimum of Asia REITS' dividend ratios is 90%. With regard to the exclusion of sale proceeds which are reinvested within one year from sale date, this would go back to REICs requirement to hold on to property they develop and acquire. This is also a safety measure to avoid using the REIT structure for develop/buy and sell activities, as this is construed as risky by regulators.

6. Leverage/Gearing

"The total borrowings and deferred payments of a REIC shall not exceed thirty-five percent (35%) of its Deposited Property: Provided, however, that the total borrowings and deferred payments of a REIC that has a publicly disclosed investment grade credit rating by a duly accredited or internationally recognized rating agency may exceed thirty-five percent (35%) but not more than seventy percent (70%) of its Deposited Property."

Unlike in the US and Australia, Asian REITs still has some form gearing restrictions. The Philippines gearing regulation was clearly patterned after the Singapore REIT model. In an interview with CapitaLand Financial representative, Mr. Haihong Zhu, "Restrictions to gearing are put in place probably to keep distributions attractive enough to pull in investors". (Zhu & Boon, 2008). Also, based on the ECLIPSE model, mature REIT markets relaxed their gearing limits in response to periods of high growth. This can also be expected when the opportunity arises in the Philippine REIC market.

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real estate property owners to contribute their appreciated assets to REITs without incurring immediate taxation. In many instances, REITs will raise cash through an initial public offering (IPO) in exchange for a general partnership interest. The operating partnership will then acquire real estate either directly or through subsidiary partnerships in exchange for limited partnership interests in the operating partnership. This contribution can be structured on a tax deferred system basis under the partnership rules of the US Internal Revenue Code. The transaction will only become taxable until shares in the UPREIT are converted to REIT shares, on a one for one basis, or when the REIT shares are sold.

7. Foreign Property

"A REIC may invest in local or foreign assets, subject to the terms of its Constitutive Documents and the legal requirements of the foreign country"

Currently, while most Asian REITs allow for investments in foreign assets, Philippine REICs are restricted to invest a maximum of 25% of its deposited property in other countries. As previously noted, restrictions on foreign property is a supply issue. As mentioned in Macquarie's ECLIPSE model (in Appendix 5), Australia, which pioneered these cross border REITs have done so in response to their small geographic investment markets. As investment grade property in the Philippines gradually runs out, we can expect restriction on cross border transaction for Philippine REICs to gradually relax.

While this clause deals only deals with Philippine REICs which invest in property outside of the country, it should be noted that foreign REITs which decide to buy land in the Philippines will be subject to the nationality requirements on land ownership (as stated in Chapter 4).

8. Development

"REICs must not undertake property development activities whether on its own, in a joint venture with others, or by investing in unlisted property development companies, unless it intends to hold the developed property upon completion. The total contract value of property development activities undertaken and investments in uncompleted property developments should not exceed ten percent (10%) of its Deposited Property."

As previously mentioned, given the REITs' commitment for consistent distributions to their shareholders, development, in the immature Asian REIT markets, is still viewed as too risky. As Philippine REICs are viewed by tax collection agencies as passive investment vehicles, going into risky development operations might be construed as crossing the line between the traditional REOC and REITs.

9. Ownership

a. "A REIC must, at all times, be a public company and to be considered as such, the REIC must, upon and after listing, (a) have at least one thousand (1,000) shareholders each owning at least one hundred (100) shares of a class of shares who in the aggregate own at least thirty percent (30%) of the outstanding capital stock of the REIC, and (b) must not be considered a closely-held[67] corporation under Section 127(B) of the National Internal Revenue Code of 1997, as amended."

[67] Closely held firms are those in which a small group of shareholders control the operating and managerial policies of the firm. Over 90 percent of all businesses in the United States are closely held. These firms differ from most publicly traded firms, in which ownership is widely disbursed and the firm is administered by professional (cont'd) managers. Most—but not all—closely held firms are also family businesses. Family businesses may be defined as those companies where the link between the family and the business has a mutual influence on company policy and on the interests and objectives of the family. Families control the operating policies at many large, publicly traded companies. In many of these firms, families remain dominant by holding senior management positions,

In an effort to ensure that REICs are not used by closely held firms and avoid paying taxes, the "1000-100" rule was recommended by the Department of Finance in the draft. It is worth noting that while the most REIT legislation has some minimum shareholder requirements (as shown in Figure 39), this regulation is very stringent and restrictive to companies not currently listed in the Philippine Stock Exchange[68]. Even if we compare this to the biggest REIT market, the US, the current shareholder requirements only require 100 shareholders with 1 share each.

b. "A REIC must have a minimum paid-up capital of One Hundred Million Pesos (PHP 100,000,000.00) at the time of its registration."

   In Asia, the majority of REIT regulation requires public listing. Public listing typically requires companies some minimum capitalization value. In line with the PSE's incentive to entice Philippine property companies with investment grade properties to list in the Philippine Stock Exchange, the PSE included this minimum paid-up capital. Notably this requirement is also a guideline for listing in the PSE's first board, which is for its biggest members.

10. Investments in Real Estate

a. "At least seventy-five percent (75%) of the Deposited Property of the REIC must be invested in, or consist of, income-producing Real Property located in the Philippines."

While this regulation limits cross border transactions, these are currently in line with industry standards. As mentioned earlier, the Philippines, is in the early stages of REIT legislation maturity. REIT cross border activity is a supply of investment grade asset shortage effect. Hence, with an estimated US$ 13 Billion worth of investment grade assets still to be put into REITs, there is no need to relax the current regulation.

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seats on the board, and preferential voting privileges even though their shareholdings are significantly less than 50 percent.

[68] Philippine Stock Exchange listing guidelines and requirements are available at www.pse.org.ph

Chapter Analysis and Synopsis

As successor to the SPV Law, the REIC Act has made significant strides in addressing the limitations of its predecessor. In particular, the perpetual life of corporations and tax transparency in the proposed REIC Act, in line with the maturity of the REIT markets in other countries, is the Philippines' testament to its commitment and support to adhere and foster international standards in its REIT legislation. Unlike the SPV sponsors, REIC Sponsors will have more freedom to sell their properties to REICs at competitive prices and terms, as REICs will compete with other REICs for choice investment grade properties. The nationality requirement, which restricts land ownership to corporations which are owned by a Filipino majority, is a highly political issue in the Philippines. This will severely deter the ability of foreign REITs to buy property in the Phillipines. However, this is the motive of the law as it intends to increase foreign investments through the local stock market.

Various agencies within the Philippines government have raised concerns over the loss of tax revenues that the REIC law is anticipated to cause, and therefore there has been a need to justify the REICs' fiscal incentives based on their other consequential benefits, like increased foreign investments. However, in terms of jumpstarting the REIC industry, the Philippines should learn, from other countries, that for a successful REIC market, both the REIC sponsor and shareholder should have equal incentive to pursue transactions and to further the growth of the industry. Thus, these initial tax concessions will serve to entice the sponsors. Furthermore, the limited time frame will give the Philippines government an option to extend, if the REIC market needs additional support, or cancel these fiscal incentives, in case the REIC market has grown to sufficient proportions and expectations.

Macquarie's ECLIPSE Model suggests a roadmap into the probable future of REIC Legislation. As the ECLIPSE model exhibits and forecasts, REIC Legislation will change when the REIC market conditions change. While currently, there is no REIC market in the Philippines, the proposed REIC Law is at par with existing Asian REIT Legislation. However, two potential regulatory provisions might hinder the fast growth of the Philippine REIT industry, in particular:

1. For companies with significant real estate holdings which are currently not listed in the Philippine stock exchange, reviewing their listing options will only become imperative once the law gets passed. It will take a significant time for the company to promote its name, its product and its future potential to retail stock investors in order to meet the 1000 shareholder spread requirement. This ownership requirement will also hinder domestic private real estate companies from listing as REICs. Therefore, there may be pressure to reduce this ownership requirement to lower minimum levels.
2. REIT sponsors who transfer and sell properties into REICs will likely hold back once the tax concessions on transfer and registration fees expire. Extending the life of these tax concessions may become important.

The current REIC Act is unlikely to be a dormant or passive law as evidenced by the recent changes in REIT Legislation in other Asian countries where substantial changes have been made to adapt the laws to the evolving market environment. In other countries, changes have included, increasing gearing levels, adopting tax transparency, adding tax exemptions and extending the law's effective dates. Looking at the mature Australian REIT markets, potential events may spur regulation changes in the Phillipines, namely:

1. As the number of listed REICs rise and competition to provide the highest yield to REIC shareholders increases, expect REIC regulators are likely to come under pressure to relax the following restrictions on REICs:

    a. REICs will likely argue that external management should give way to internal management in order to eliminate additional fees and costs charged by external managers.
    b. Especially if construction activity increases, REICs will argue to increase the constraint that development assets not exceed 10% maximum level of REIC assets.
    c. As the appetite for new investment grows, REICs will also want investments in foreign assets to increase beyond the currently proposed 25% maximum level. Likely targets that will interest REICs will be emerging markets with new REIT legislation

In anticipation of these changes, it may be wise for the Philippine REIC law to include provisions that would allow for non-bureaucratic and timely amendments to the law. Furthermore, in line with other REIT markets (NAREIT, EPRA), the industry would benefit from the formation of a REIC committee, composed of government representatives and REIT players, to ensure that the REIC industry maintain its international competitiveness and relationships and to guide these changes.

Another area of special consideration for REICs is to have significant comparability with other REIT markets. Therefore, it should adopt international standards for financial reporting. With the SPV Law, the Central Bank of the Philippines' rules regarding loss recognition was contradictory with the rules of International Accounting Standards Board (IASB). Thus, banks, conscious of their international reputations and positions, had to be respectful of these international reporting standards in addition to the domestic rules, which increased costs. This is a fairly important lesson which should be applied with the REIC Act. In Ernst & Young's Global REIT Report, they highlighted the inconsistent use of accounting standards throughout the world which seriously limited the "apples-to-apples" comparison of REIT performance. They suggest that all REIT markets should use the International Financial Reporting Standards (IFRS). The significance of IFRS is that investment properties are valued at fair market value. Thus, the increase or decrease in Net Asset Value through that entity's profit and loss is immediately recorded. And while this may increase the volatility of earnings, this will nonetheless, increase transparency and reflect the true value of the product. Of the Asian REIT markets, only Hong Kong and Singapore are IFRS compliant.

Finally, to ensure implementation of the prescribed tax benefits is not tedious and time consuming, an information campaign and proactive coordination among government agencies, such as the Bureau of Internal Revenue and Registry of Deeds and respective local city governments will be desirable. This will ensure that government representatives are knowledgeable about the incentives and are well coordinated. In line with this, it will also be critical to execute a marketing and advertising strategy, aimed at international investors, investment banks and end investors, before the law is enacted.

Figure 39: Summary Comparison among different REIT Factors in Asia (including US and Australia)

REIT Factors	US	Australia	Japan	Sinagapore	HK	Taiwan
Year started	1960's	1985	2001	1999	2003	2003
REIT Type	Corporate	Trust	Corporate	Trust	Trust	Trust
Management Structure	Internal - must be managed by 1 or more trustees or directors	External/Internal (Through stapled structure)	External	External	External/ Internal	External/ Internal
Investment Restrictions						
Investments in Real Estate	At least 75% of the value of its total assets must be represented by real estate assets, cash and cash items and government securities. Cannot own more than 10% of another corporation's stock, unless in a REIT or	At least 50% must be from passive income	At least 50% must be invested in real estate and 75% invested in real estate and/or real estate related assets.	At least 35% must be invested in real estate and 70% invested in real estate and/or real estate related assets.	100%	At least 80% in real estate or real estate related assets
Investments in Foreign Assets	YES	YES	YES	YES	YES	OK (with Central bank Approval)
Development Allowed	YES - in order to own operate and manage such property for the production of rental income	YES	May perform transactions concerning specified assets in accordance with asset management targets.	Max. of 10% of Total Assets but must hold the property upon completion	Prohibited	Prohibited
Leverage/ Gearing Limit	No restrictions	No restrictions	No limit but may only receive loans from qualified institutional investors	May exceed 35%, up to 60%, of its deposited property provided it gets an international credit rating from Fitch, Moody's or S&P.	45% of Total Assets	The competent authority may prescribe an upper limit regarding the money borrowed by the trustee.
Dividend Distribution	Minimum of 90% of taxable ordinary income (post depreciation)	100% of taxable income (post depreciation)	Greater than 90% of net income	Minimum of 90% of taxable income (post depreciation)	Minimum of 90% of annual net income after taxes	Use to 100% taxable income
Tax Transparency	YES	YES	YES	YES	YES	YES

REIT Factors	US	Australia	Japan	Singapore	HK	Taiwan
Tax Concession for Investors						
Resident	No - Witholding Tax of 10% on dividends and capital gains	Unit holders are entitled to tax creidt equal to witholding tax. Individuals - 50% discount on capital gains tax(CGT).	None	0% Witholding Tax for Resident Individuals,	0% Profits tax on dividends/ distributions. No stamp duty on initial issue of the units.	Capital gains from transactions of beneficiary certificat is exempt from income tax. Individuals will not be subject to alternative minimum tax (AMT) while corporattion wil be subject to AMT. Final witholding tax of 6%
Non Resident	No - Witholding Tax of 10% on dividends and capital gains	CGT on non-real property are exempt. Individual - 50% discount on CGT on real property	None	10% Dividend tax for foreign, non-individual unitholders from Feb 18, 2005 to Feb 17, 2010.		
Listing Mandatory	None	None	None	Yes	Yes	None
Minimum Capital	None	None	JPY 100 Million	S$ 20 Million	None	NT$ 300 Mill to NT$ 2 Bill (depends on scope of busines engaged by trustee)
Shareholder Requirements	Minimum of 100 shareholders. Also, no more than 50 percent of its shares may be held by five or fewer individuals orprivate institutions during the last half of the taxable year.	Minimum of 400 holdings with at least A$ 2000	Number of units to be listed must be at least 4,000. Expected number of unit holders must be at least 1,000. The 10 largest unitholders may now own 75% or more of all the listed units.	At least 25% of the REIT's capital has to be held by at least 500 public unit holders for listing	At least 25% of the REIT's capital has to be held by public unit holders for listing	Certificates shall be held by at least 50 persons for at least 335 days. Also, no five or fewer individuals or private institutions may own more than 50% of the total value of the issued certificates
2007 Market Cap (in Billion US$)	312.00	101.00	49.15	19.23	8.65	1.92

REIT Factors	Thailand	Malaysia	S. Korea (REIC)	Philippines
Year started	1992	2005	2001	Approx. 2009
REIT Type	Fund	Trust	Corporate	Corporate
Management Structure	External	External	External/Internal	External
Investment Restrictions				
Investments in Real Estate	At least 75% of Net Asset Value invested in property in Thailand	At least 50% must be invested in real estate and 75% invested in real estate and/or real estate related assets. At least 20% of the unlisted fund's total assets is invested in liquid assets at all times.	At least 70% must be invested in real estate and 80% invested in real estate and/or real estate related assets.	At least 75% in Philippines property
Investments in Foreign Assets	Prohibited	YES	YES	Max. of 25% of the value of its total assets
Development Allowed	Property must be 80% structurally completed	Prohibited	May develp of listed	Max. of 10% of the value of its total assets
Leverage/ Gearing Limit	Prohibited	Maximum of 35% on Net Asset Value	Maximum of 200% of Equity	Up to 35%, can go as high as 70%, as long as company can get int'l credit rating
Dividend Distribution	Min of 90% of Net Profit	Min of 90% of Total Income	Min of 90% of Taxable Income	Min of 90% of its Distributable Income
Tax Transparency	YES	YES	YES	YES

REIT Factors	Thailand	Malaysia	S. Korea (REIC)	Philippines
Tax Concession for Investors				
Resident	Individuals - 10% final witholding tax. Listed Corporations - 100% tax exempt. Non-Listed - 50% exempt provided it holds the REIT units 3 months before and after dividend distribution.	REIT dividends carry a tax credit, which will be available for set off against the tax xhargeable on the unitholder	Individuals - final witholding tax of 15.4%, if dividends does not exceed KRW 40 million. Corporations - exempt for witholding tax	None
Non Resident	No income or capital gains tax on foreign individual and corporate unit holder	None	None	YES - Non resident aliens, non resident foreign corps = 10% dividend tax, non resident citizens = exempt from dividend tax
Listing Mandatory	Yes	None	Yes	Yes
Minimum Capital	Baht 500 Million	RM 100 Million	KRW 25 Billion	PhP 100 Million
Shareholder Requirements	At least 250 unit holders are required for an IPO. At least 10 unit holders are required after listing. No more than 33.33% of unit holders can be related persons.	If listed, at least 25% of the REIT's capital has to be held by public unit holders for listing	A shareholder may not own more than 30% of the shares	Upon and after listing of 1000 shareholders with 100 shares each who own at least 30% of all shares outstanding
2007 Market Cap (in Billion US$)	1.32	1.45	0.60	N.A.

Data Sources: NAREIT, EPRA, REITS: A Global Analysis (Booth, 2007)

CONCLUSION

In an attempt to determine what business and regulatory factors are required for the successful establishment of a Real Estate Investment Trust (REIT) structure in the Philippines, this paper analyzed the macro and microeconomic factors affecting the Philippines property market, the demand for REIT-type structures and the proposed law (REIC Act) governing REITs (REICs) in the Philippines. We also compared the features of the proposed REIC Act with other REIT markets and regulations in Asia.

Currently, REITs are the most popular real estate investment vehicles in Asia. In 2001, REITs were enacted as a firefighting mechanism to address the aftermath of the Asian Financial Crisis. Today, few, if any, can merely label REITs as mere divestment vehicles. They have clearly taken a life of their own and are a highly growing and much publicized industry. From a market capitalization of US$6 billion in 2001, Asian REITs have grown at a phenomenal pace of 54%/year to US$80 billion as of December 2007. Every country in Asia without REIT legislation is eager to jump on the REIT bandwagon. Based on an in-depth literature review of REITs in Asia as well as key interviews with REIT industry experts, Philippine tax lawyers, international property consultants, and representatives of Philippine regulating bodies, REIT growth and success factors include not only supply and demand issues for real estate markets generally, but also the nature of the specific regulations governing their activities. As such, REIT experts have determined several key REIT regulation elements critical to a REIT market's success, namely:

1. Management structure (Internal or External)
2. Maximum allowable gearing levels
3. Allowing development activity in REITs
4. Allowing investments in foreign assets
5. Presence Income tax transparency
6. Minimum dividend distribution requirements
7. Minimum real estate investment requirements
8. Availability of tax concessions for investors

Asian REIT Markets have a combination of each of these elements. The only difference is that some REIT markets have chosen to regulate and restrict some elements more than than others. In Asia, nascent REIT market regulators have felt a need to increase regulation in order to protect the investors. However, it is worth noting that the US and Australia, the world's biggest and most mature REIT markets, are also the most non-restrictive in terms of REIT activities such as gearing, investments in foreign assets, development and structuring of management. Therefore, this would imply that as a market matures and investors become more knowledgeable, REIT regulators will also relax restrictions.

In terms of business factors for REITs, supply of investment grade properties as well as demand motivations for the REIT structure was reviewed and analyzed. On the Philippine REIT supply side, the following economic and demographic indicators demonstrate the continuation of several years of economic growth :

1. Philippine population, currently at 89 million, has been increasing at 2.25%/yr, since 1998.
2. Gross Domestic Product has been growing consistently for the past 5 years. Furthermore, GDP contribution from the services industry has been increasing as well. This indicates the movement away from traditional sources of livelihood, such as agriculture.

3. Employment levels are at its highest at 92.6%. Literature suggests that this is particularly caused by the booming Business Process Outsourcing (BPO) industry. Current estimates forecast a 25% year on year growth for this industry.
4. 10-year Treasury bond rates are at record lows indicating favorable pricing for alternative investments such as real estate.
5. Overseas Filipino Workers Remittances, a main source of foreign currency reserves and driver for consumer spending, continue to thrive and has been growing, since 2001, at an astounding rate of 16%/year. In 2007, remittances reached US$14.5 Billion, the highest in Philippine history.

These encouraging macroeconomic factors are responsible for the recent boom in the real estate industry. In particular, the office, retail and hotel sectors offer near term acquisition potentials for Philippine REITs as these sectors are currently climbing their pre-Asian crisis levels and are poised for more growth. Key demand drivers for real estate include increasing remittances from Overseas Filipino Workers, which have increased consumer spending prompting rent growth in the retail sector. OFWs are also cited as the reason for the current boom in condominium sales. However, as REITS are typically required to hold on to properties they develop or acquire, the residential-for-sale sector will not be a REIT potential target. Furthermore, the boom in residential-for-sale units, is overheating and eventually excess units will be dumped into the rental market, creating a potential for an oversupply in the residential-for-lease sector. This will eventually lead to a decline in rental rates and income yields for the sector if demand remains unchanged. Another factor to be watched is the phenomenal growth of the Business Process Outsourcing industry. As there is less and less space available in the central business districts, office rents and retail rents, as more and more BPO's locate adjacent or within malls as anchors, will be driven higher. Hotel construction and occupancy rates are also on the rise as visitors from other Asian countries, in particular, Korean and Chinese, have been growing annually.

On the Philippine REIT demand side, there is a strong incentive for real estate developers/owners/sponsors to divest their properties into REITs. REITs, as an alternative exit vehicle for developers and owners, provide an alternative and cheaper source of capital caused by the increasing globalization and securitization of real estate. This is observed in the growth of the number of vehicles available to global investors such as institutional and pensions funds through which they can invest in the real estate sectors of specific countries. Creating fee-based businesses through external management contracts with REITs will also provide additional revenues for REIT sponsors as they receive management fees, amounting to 6-10% of the revenues. Finally, REITs also provide transfer tax advantages not available in other structures, lowering the costs of investment acquisitions and dispositions.

There is clear investor demand for a tax efficient, yield driven investment vehicle such as REITs, which provide not only higher transparency, liquidity and return, but also the prospect of diversification for their local and global portfolios. Earlier in this chapter, a tax savings analysis was undertaken of the current proposed REIT legislation, and I found that Philippine REITs will provide significant tax advantages for both resident and nonresident investors as compared to investments in REOCs. In particular, as cash flow at the corporate level is "passed through" without taxation to the shareholder level, double taxation is eliminated. Another tax advantage, dividend reductions and exemptions, were found to increase the tax savings of *nonresidents* further by 2-4%.

Real Estate investment legislation is not a new concept in the Philippines. The Special Purpose Vehicle law, enacted to solve the non performing asset and loans caused by the Asian Financial Crisis, is a

learning experience for the Philippines. Of the key lessons that could be derived from this law, the writer recommends the following considerations for the REIC Law:

1. **Matching time constraints on financial benefits** for both the REIC sponsor and shareholder to ensure a win-win situation for both parties and foster long term participation and growth in the market.
2. Using **International Accounting Standards** to report a REIC's financial performance to ensure performance comparability with other REITs in Asia.
3. Creating an **information and marketing campaign** to increase awareness about the REIC product, avoid confusion among government agencies and create a knowledgeable investor base.
4. Creating provisions that would **ensure non-bureaucratic procedural amendments** to the Law in anticipation of future changes.

Based on the different REIT regulatory factors mentioned above, the writer believes that the proposed Philippine REIT legislation is largely in line with international REIT legislature. Although it is not feasible to forecast the success of the first Philippine REIT offerings, Macquarie's ECLIPSE model provides a picture of the Philippines' position in the REIT maturation process. Considering that the Philippines is just in Stage 1, it has learned some of the lessons from the failures of other Asian REITs (summary case studies of other Asian REITs are available in Appendix 8). In particular, granting tax transparency at the onset of regulation, a crucial feature of successful REIT markets, has been an important lesson for the more conservative REIT markets.

The Philippines REIC is being modeled after more successful REIT markets. This is consistent with Philippine Stock Exchange's (PSE's) motivations. In an interview with the PSE representatives, they stated that Singapore is the right model for the Philippine REIC as it has already proven itself to be successful in the Asian REIT markets. However, as with other Asian REIT markets, wherein legislative changes (past legislative changes in other Asian REIT markets are available in Appendix 9) had to be made to adapt their respective regulations to the market environment, it appears that REIC legislation, management and structure shall be a case of "walking before running" and shall learn from its own market and players what is needed to ensure the success and continued growth of the Philippine REIC markets.

Due to the adolescence of the Asian REIT Markets, the availability of data has put some limitations on this thesis. A major hurdle has been, for countries which are currently trying to pass their own REIT legislature, the quantitative rationalization of tax revenue loss. REIT supporters persist in the idea of a REIT multiplier effect. The basic idea of a REIT multiplier effect is that while the government's tax revenue, on transfer charges, corporate tax exemptions, etc, are foregone, other economic benefits arise from the creation of a new REIT industry, such as increase in employment, increase in foreign and local participation in the stock market, increase in real estate transactions, construction, and development. However, no financial data in support for this argument has been presented and would be an excellent opportunity for future economic research.

Another excellent future research topic, which would be feasible when the data becomes available, would be an inquiry into Asian REIT qualitative and quantitative success factors. In a thesis by Elaine Vakalopoulos on "What makes a successful REIT, A qualitative and quantitative analysis", she conducted a research on the generally accepted reasons why some US Equity REITs are more successful than others. In particular, she focused on the qualitative and quantitative reasons that provide high Price-to-

FFO multiples, the standard of investor confidence, for some US REITs. In the future, I think it will be interesting to conduct the same research on Asian REITs when more performance data is available (10-15 years supply). Of particular interest and inquiry would be the comparison of success factor results of US versus Asian results as it would provide some insight into the differences of these REIT markets.

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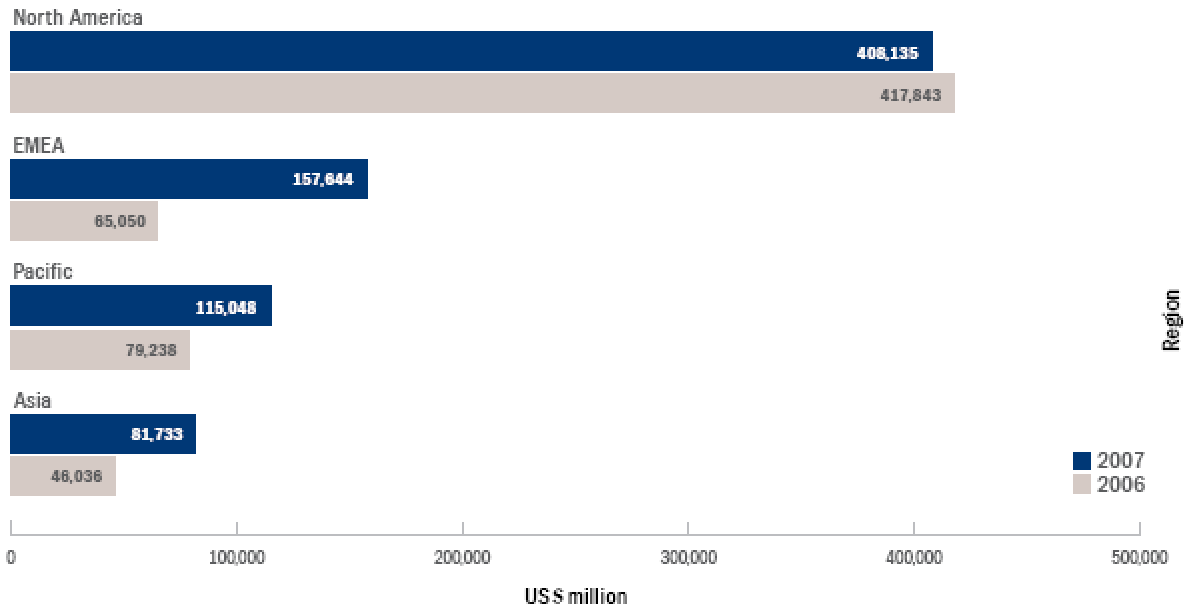
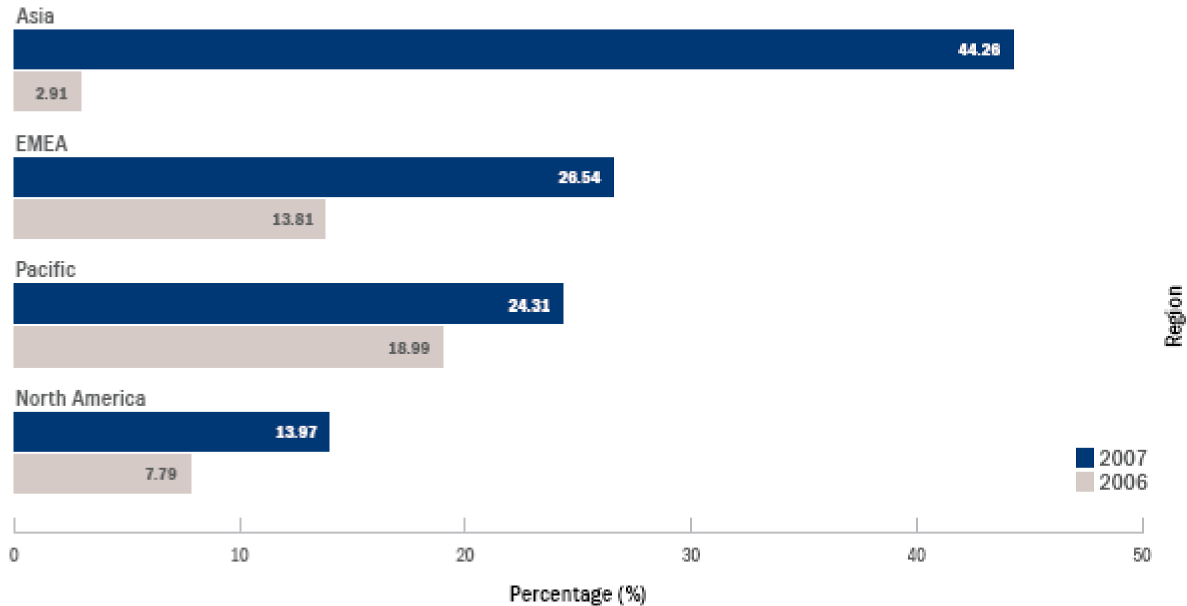
APPENDIX

Appendix I: REIT Measures in the Global Market
Source: Ernst and Young: Global REIT Report 2007

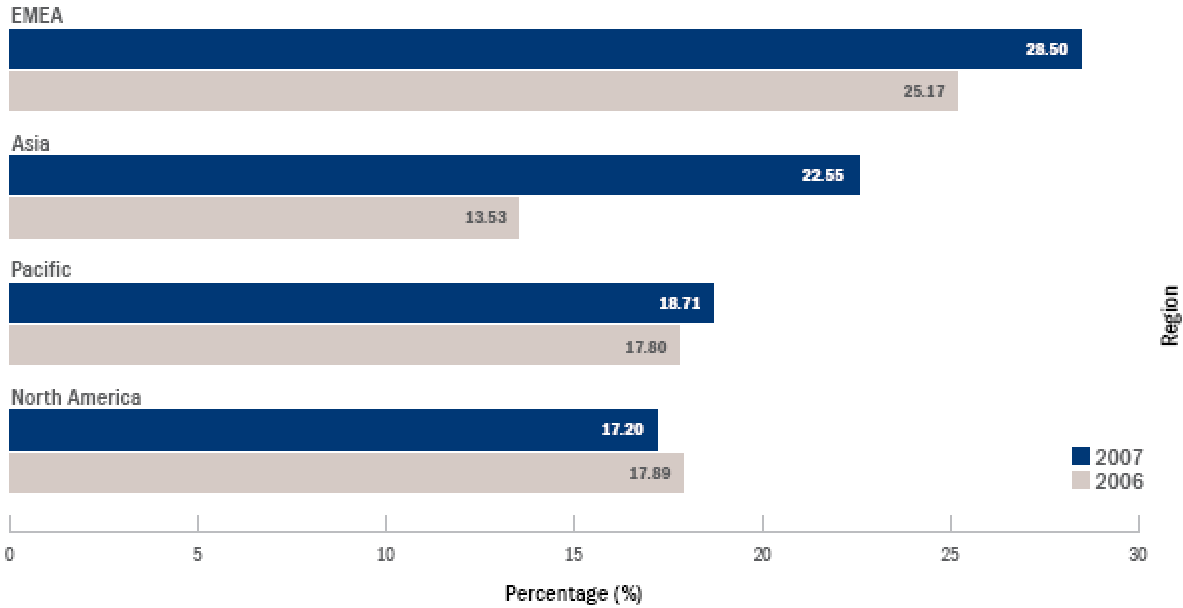
1. Market Capitalization



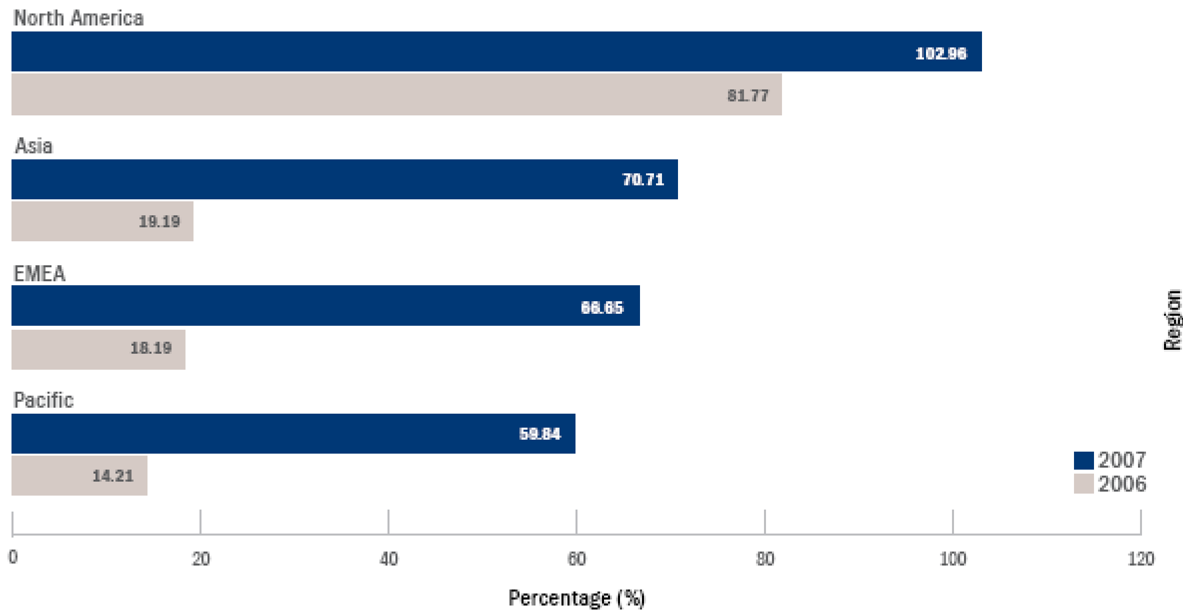
2. Total Returns (1 Year to June 30, 2007)



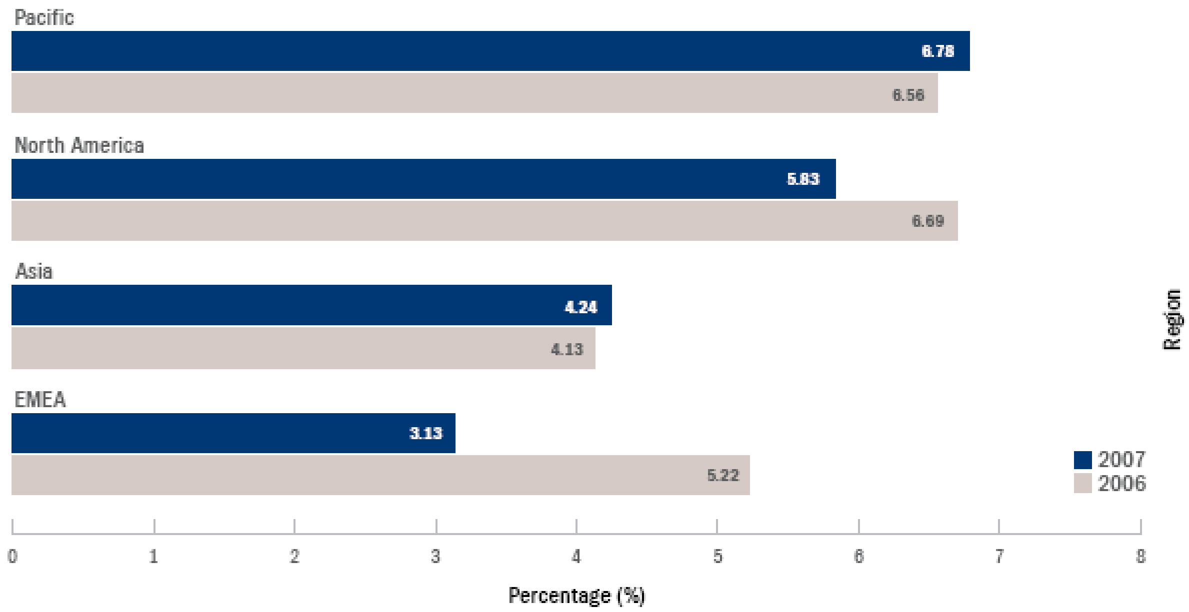
3. Total Return (3 Years to June 2007)



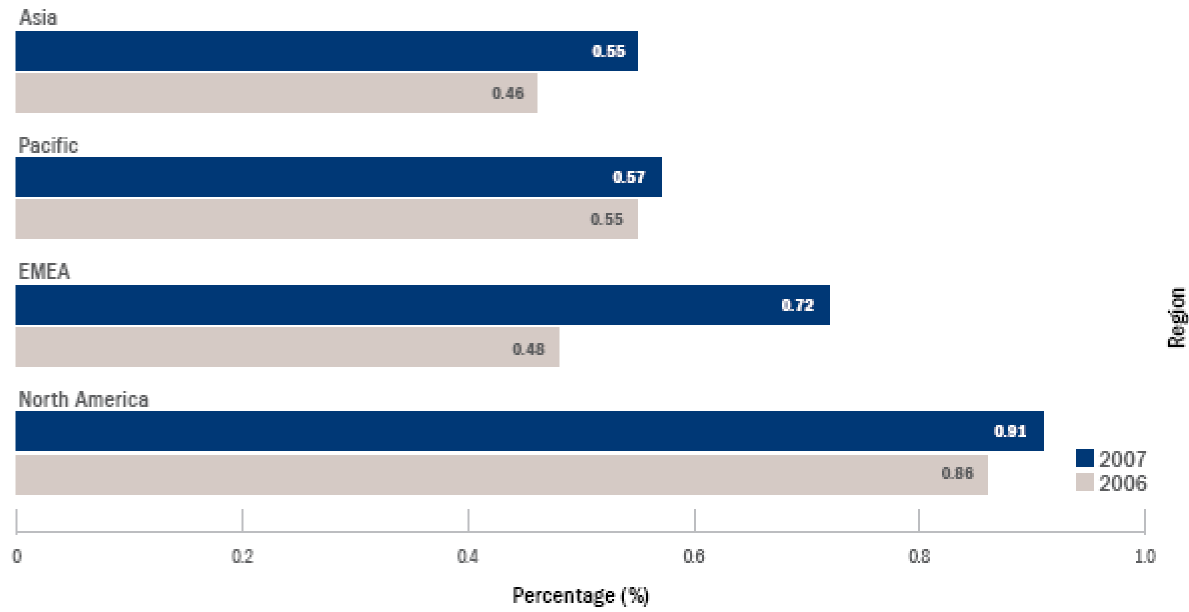
4. Premium/Discount to NAV



5. Dividend Yield



6. Beta



Appendix 2: US REITS in S&P 500
Source: (Booth, 2006)

No.	REIT	Sector	Equity Market Cap as of Dec. 2007 In US$ Bill	%
1	Simon Property Group, Inc.	Regional Malls	22.03	13%
2	Equity Office Properties Trust	Office	25.00	15%
3	ProLogis Trust	Industrial	16.24	10%
4	Public Storage, Inc.	Self Storage	14.90	9%
5	Vornado realty Trust	Diversified	14.80	9%
6	Equity Residential	Apartments	11.30	7%
7	Archstone-Smith trust	Apartments	12.30	7%
8	Boston Proeprties, Inc.	Office	13.00	8%
9	Aimco	Apartments	10.80	6%
10	Kimco Realty Corp	Shopping Centers	9.98	6%
11	AvalonBay	Apartments	9.60	6%
12	Plum Creek Timber	Timber lands	7.98	5%
	TOTAL		**167.93**	**100%**

Appendix 3: Computation of taxable Income/Income Tax Liability of Domestic Corp/REIC
Source: REIC Act (May 12, 2008 proposal), NIRC

For One Taxable Year	Domestic Corporation engaged in real estate business under NIRC of 1997	"REIC" under Senate Bill (May 12, 2008)
Gross income under Sec. 32 of NIRC of 1997	A	A
Less:Allowable deductions under Chap VII of NIRC of 1997	B	B
Taxable Income under NIRC of 1997	(C = A - B)	(C = A - B)
Less:		
Dividends distributed by a REIC out of its Distributable Income as of the end of the taxable year as: (a) dividends to owners of the common shares; and (b) dividends to owners of the preferred shares pursuant to their rights and limitations specified in the Articles of Incorporation of the REIC. *(at least ninety percent (90%) of its Distributable Income to its Investors)*	NA	(D = C*90%)
Taxable Net Income under Senate Bill	NA	(E = A - B - D)
Multiply by: Ordinary Income Tax Rate	35%	*REIC listed within three (3) years from the effectivity of the IRR of this Act = **25%** for a period of seven (7) years from date of*
Income tax due	(G = C x 35%)	(G = E x 35% OR G = E x 25%)
Income net of tax - distributable to shareholders	(H=C - G)	NA - since the dividends distributable were already considered before imposing the
Personal Income Tax Due to Shareholder (assuming a 32% personal income tax rate)	(H*32%)	(D*32%)
Cash to Shareholder	H - I	D - I

(Please take note of the Minimum corporate income tax (MCIT) rate of 2% imposed under Section 27(E) of the NIRC of 1997, which is imposed on a domestic corporation beginning on the fourth taxable year immediately following the year in which such corporation commenced its business operations, when the minimum corporate income tax is greater than the tax computed under Section 27(A) of the Tax Code. Which in the case of this Act, the MCIT may be considered as well against the 25% income tax rate proposed for the company that registers within 3 years of the law's effectivity

Appendix 4: Computation of Tax Savings from Coprporate tax Transparency and Dividend tax Exemptions and Discounts
Source: Source: REIC Act (May 12, 2008 proposal), NIRC

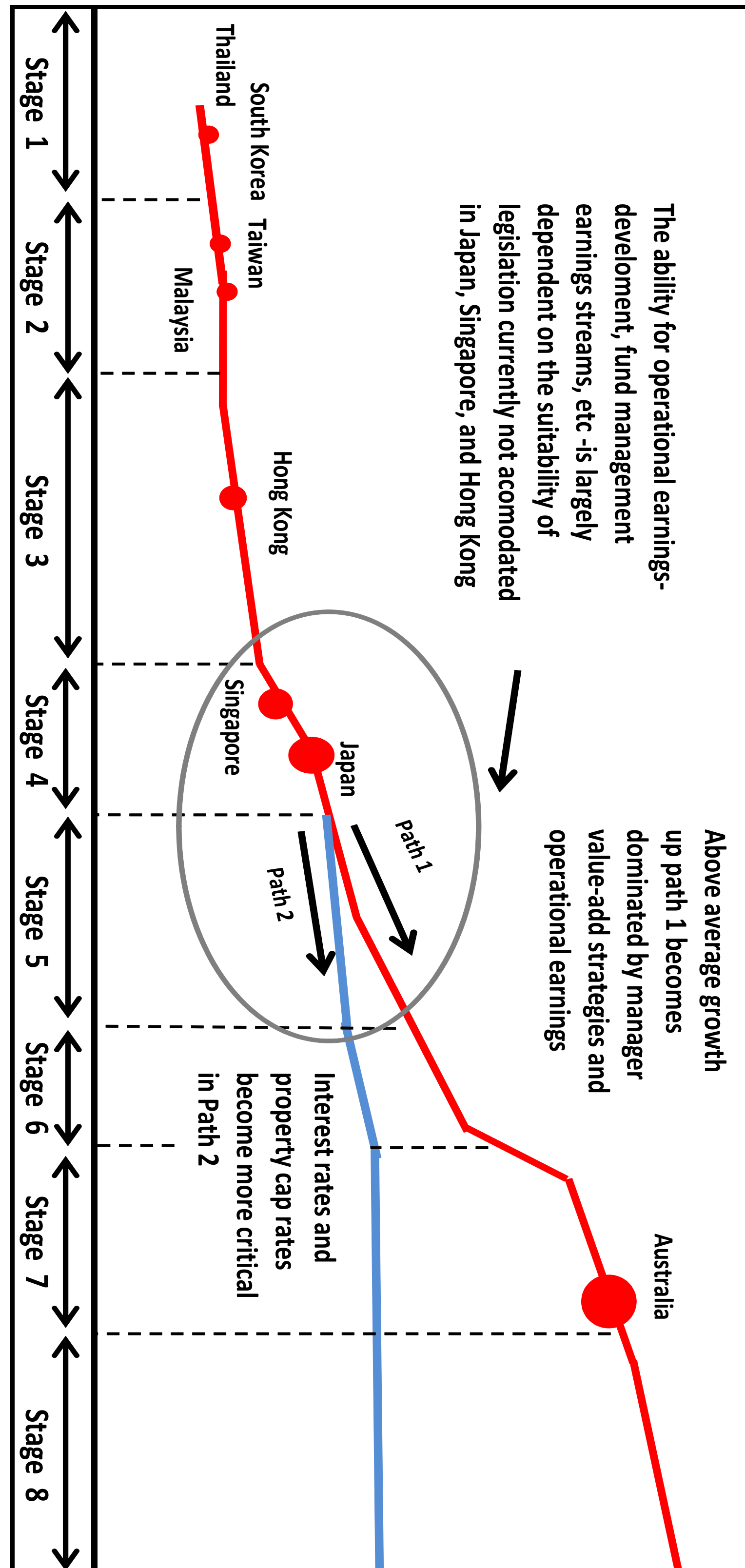
Investor Type	**Residents citizens/aliens**		**Non resident aliens not engaged in trade or business in the Phils.**	
Comparison	Listed REOC	Listed REIT	Listed REOC	Listed REIT
Corporate Income tax	35%	0%	35%	0%
Dividend tax	10%	10%	25%	10%
Personal Income tax	32%	32%	25%	25%
Taxable Net Income	100	100	100	100
Corporate Tax	-35	0	-35	0
After Tax Income for SH	59	90	59	90
Income Tax of Sh	-19	-29	-15	-23
Available Cash to SH	40	61	44	68
Tax savings from tax transparency incentive	**21**		**24**	
Dividend Tax	-4	-6	-11	-7
Dividend to SH	36	55	33	61
Tax savings including dividend tax incentive	**19**		**28**	

Investor Type	**Non resident aliens engaged in trade or business in the Phils.**		**Aliens employed by regional multinationals**	
Comparison	Listed REOC	Listed REIT	Listed REOC	Listed REIT
Corporate Income tax	35%	0%	35%	0%
Dividend tax	20%	10%	20%	10%
Personal Income tax	32%	32%	15%	15%
Taxable Net Income	100	100	100	100
Corporate Tax	-35	0	-35	0
After Tax Income for SH	59	90	59	90
Income Tax of Sh	-19	-29	-9	-14
Available Cash to SH	40	61	50	77
Tax savings from tax transparency incentive	21		27	
Dividend Tax	-8	-6	-10	-8
Dividend to SH	32	55	40	69
Tax savings including dividend tax incentive	**23**		**29**	

Investor Type	Overseas Filipino Foreign Workers/ Non Resident Citizens		Domestic /Foreign Resident Corporations	
Comparison	Listed REOC	Listed REIT	Listed REOC	Listed REIT
Corporate Income tax	35%	0%	35%	0%
Dividend tax	10%	0%	0%	0%
Personal Income tax	32%	32%	N.A.	
Taxable Net Income	100	100	100	100
Corporate Tax	-35	0	-35	0
After Tax Income for SH	59	90	59	90
Income Tax of Sh	-19	-29	0	0
Available Cash to SH	40	61	59	90
Tax savings from tax transparency incentive	**21**		**32**	
Dividend Tax	-4	0	0	0
Dividend to SH	36	61	59	90
Tax savings including dividend tax incentive	**25**		**32**	

Investor Type	Non Resident Foreign Corporations	
Comparison	Listed REOC	Listed REIT
Corporate Income tax	10%	10%
Dividend tax	15%	10%
Personal Income tax	N.A.	
Taxable Net Income	100	100
Corporate Tax	-10	0
After Tax Income for SH	81	90
Income Tax of Sh	0	0
Available Cash to SH	81	90
Tax savings from tax transparency incentive	**9**	
Dividend Tax	-12	-9
Dividend to SH	69	81
Tax savings including dividend tax incentive	**12**	

Appendix 5: Macquarie's Evolution & Cycle of Listed Property Securities Analysis
Source: Macquarie



Stage 1 – First Attempt

Listed Property companies are lowly geared, illiquid and are usually composed of a single asset. REITs are owned mostly by individual investors and do not have a competitive cost of capital.

Stage 2 - Legislative Change

Government recognizes the benefits of a healthy REIT market and brings in regulatory change to encourage REITs. These changes can provoke strong share price gains by property trusts. F or. Example, the waiver of dividend taxes in Singapore spurred a new wave of enthusiasm for REITs.

Stage 3 - Acquisition Driven Growth

The market provides REITs with a cost of capital low enough to acquire buildings that are yield- accretive. Early REITs gain first mover advantage and have limited competition in the acquisition market relative to mature markets. Large earnings per share and dividends per share revisions are also possible in Stage 3. This stage ends when yield accretive acquisitions are difficult to find and REITs start looking to buy abroad. For example, Australian REITs started looking in the United States in the mid 1990's.

Stage 4 – Growth Plateaus

As acquisition in local and foreign markets dry up. REITs will then focus on management efficiencies of their existing properties in areas such as leasing and property management,

internal organization restructuring and more aggressive development will also be apparent. Using Australian REIT Gander as an example, by late 2005, it had a development pipeline of $1.1 billion from which it expected to earn an average yield of 8%. Its buildings were 99.9% occupied.

Stage 5

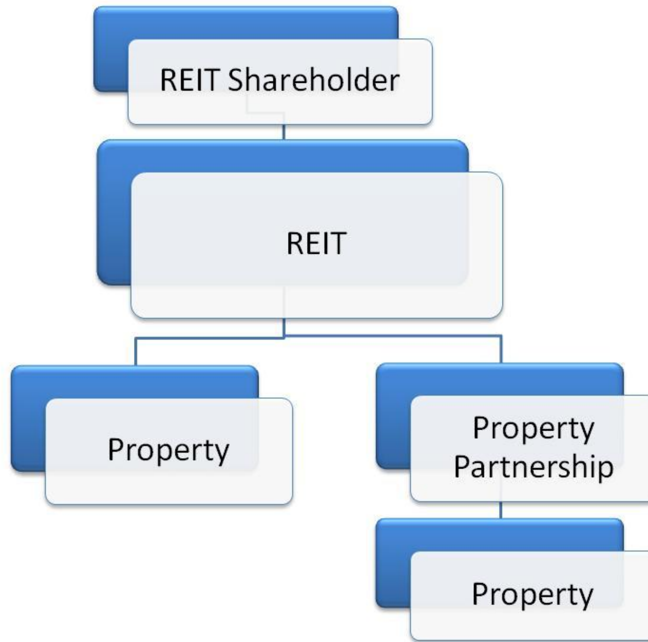
Path 1 - Operational Earnings enter the Income statement
As acquisitions run out and management efficiencies are maximized, legislation makes changes to allow operating businesses, such as property development companies, to be "stapled" to the REIT. Similar to the Australian structure, a REIT shareholder would not only own units in the trust, but shares in the company as well. This structure allowed Australian REITs to be exposed to construction activity at a time when there was a glut in real estate supply and there was opportunity to develop. However, Macquarie believes that Asian REIT regulators might not go this road as they believe that development might add too much risk and speculation in a REIT's activities.

Path 2 – Inertia
As Asian REIT Regulators prohibit development activities, they remain pure investments in rental income. REIT earnings become more susceptible to interest rates and rental yields in the physical property markets. They still provide consistent and stable sources of income but remain largely inert investment products.

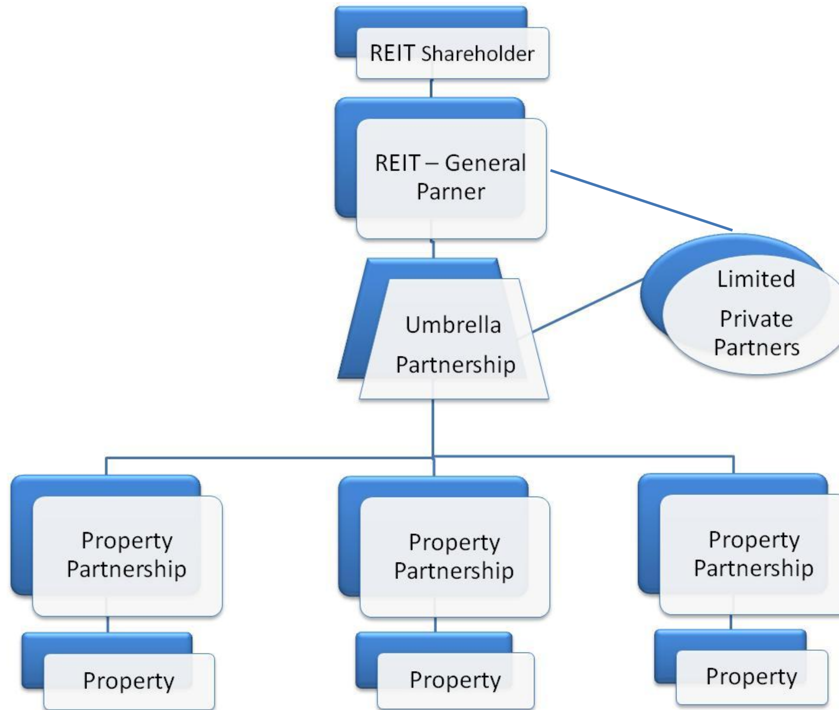
Sector 6 – Consolidation
Legislation allows REIT managers start to pursue merger and acquisition strategies. In an effort to stop the lost income due to external management fees, REIT managers merge with the REIT. This move aligns the interest of the REIT managers and the shareholders. Underperforming REITs are also the target of takeovers of more effective REIT managers.

Sector 7 – Growth Plateaus Again
Lower growth and price gain in the REIT markets. Internal Management structures dominate the REIT landscape.

Appendix 6: Traditional REIT Structure
Source: NAREIT



Appendix 7: Umbrella Partnership (UPREIT) REIT Structure
Source: (Geltner, Clayton, Miller, & Eicholtz, 2007)



Appendix 8: REIT Case Studies in Asia
Source: (Ngen, 2002)

In order to effectively learn the REIT markets in Asia, it is important to note down what challenges and problems early REIT offerings encountered:

1. **Hong Kong's Link REIT**

   Link REIT, whose 180 properties (mainly shopping malls and parking garages) were once owned by the Hong Kong Housing Authority was sued by its Public housing tenants because they feared the loss of subsidies from the commercial rents, sued and succeeded in postponing its initial offering for a year until 2005.

2. **Singapore's Sing Mall Property Trust**

   In November 2002, Capital Land sponsored the $530 Mill Singmall Property Trust. Hours before distribution of the tranche, the offering was pulled out. An earlier thesis by Ms. Angelina Ngen discusses the factors contributing to SPT's failure namely:

   a. **Offered Total Rate of Return was too low**

      REIT observers have stated that the offered 5.75% yield, while high in a Singapore context, was not attractive enough. In comparison to Australia listed property trusts, which offered 11-12% total rate of return.

   b. **Timing**

      Investors were not convinced about the SPT's near term growth potential, as the outlook for the Singapore retail market, which relied on tourism, was deeply affected by 9-11

   c. **Property Valuation Deemed Aggressive**

      Aggressive valuation of the assets injected into the SPT was also fairly evident. The three shopping malls that were to be injected by CapitaLand were revalued at S$100 million higher than the previous year, at a time when property prices in Singapore were set to decline due to the economic downturn. Moreover, the SPT was priced at a 2.7% premium to an already high Net Asset Value (NAV); hence, investors were concerned about the downside risks on valuation.

   d. **Lack of REIT Experience**

      Lend Lease was negotiating with CapitaLand to be the external fund manager of the SPT. However, two months before the scheduled listing, Lend Lease decided to back out from the deal. The loss of Lend Lease was a major setback, leaving some doubts as to whether CapitaLand had the experience to manage a REIT.

   e. **Distribution**

      Distribution was also fairly skewed primarily to institutional investors, and emphasized a few large orders from strategic investors. The portion allocated to retail investors appeared to be miniscule at the estimated 8% of the final order came from retail demand. "In retrospect, it also seems that the marketing of this new asset class to domestic retail investors was not sufficient, thus adversely affecting retail demand for the issue".[69] (Ngen, 2002)

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[69] Ngen, Angelina H., The Business Case for REITS in Singapore, p.48-49, August 2, 2002

3. Philippines' Far East REIT (FEREIT)

In the early 1970's, the Far East Bank and Trust Company of the Philippines launched the Far East REIT (FEREIT). FEREIT was "a corporation the majority stockholders of which were trust accounts managed by the trust department of Far East Bank and Trust Co. FEREIT disappeared from the radar screen decades ago when the smoke cleared after the first condominium boom in the country". (Geronimo, 2006)The FEREIT concept, however, was short lived as the Philippines' Bureau of Internal Revenue considered the FEREIT as an "unincorporated association". This label made the FEREIT taxable as a corporation, and thus created double taxation issues for its unit holders. This, in turn, removed the competitive advantage of a REIT, which is the pass through treatment of its income.

4. Malaysia Property Trust Funds.

Malaysia introduced a property trust fund market in the early 1990's, composed of funds. This was marred by a lack of tax incentives, relatively low yields and capital gains and asset overvaluation. The Asian Financial Crisis worsened matters when it left Kuala Lumpur Offices and shopping malls with 18% and 16% vacancy, respectively.

5. Thailand REITs

While Thai REITs do not pay corporate income tax, if they pass on at least 90% of the net income from their property to investors in dividends, Thai REIT regulators do not allow REITs to borrow or buy new property before first raising funds from investors. This seriously limited the growth and yield potentials of Thai REITs.

6. South Korean REITs

Originally, South Korea created two REIT structures. The CR REIT or corporate restructuring REIT, were used to allow companies to sell their property to the public at a good price during the Asian financial Crisis. The K REIT or Korea REIT was the ordinary trust structure. The main difference was that 70% of CR REITs' assets needed to be composed assets undergoing restructuring due to insolvency. Furthermore, CR REITs were given more tax incentives, such as waiver on acquisition taxes and corporate tax transparency. K REITs on the other hand were given a 50% discount on acquisition taxes but no corporate tax transparency. Another difference was that CR REITS was only given a 5 year term existence. Both, however, were prohibited from borrowing. In 2004, Korea created another structure, the Real Estate Trust Fund (RETF) which had advantages on the 2 original structures, including unlimited life, corporate tax transparency and less regulatory red tape.

Appendix 9: CHANGES IN REIT LEGISLATION
Source: Asian Public Real Estate Association/ REITS: A Global Analysis

As REIT markets in Asia mature and adopt with the needs of the market, legislation and structure has also needed to be flexible and change with the continuous evolution of the public real estate sector.

Below are some of the more noteworthy changes in REIT Legislature

1. **JAPAN**
    - The Tokyo Stock Exchange introduced a new rule in October 2004 prohibiting investors from selling their shares in a REIT for six months after the listing of the fund, or if they have bought new shares of the same REIT within six months of the submission of the REIT's application to list on a stock exchange. The new regulation was introduced to dissuade REITs from selling new issues to preferred investors shortly before its listing, in a bid to help them earn capital gains (Nikkei Report, 2004).

2. **SINGAPORE**
    - The condition for tax transparency granted to S-REITs was changed in December 2002 by lowering the dividend payout requirement from 100% to a minimum of 90%. "The tax transparency status was also extended to include Singapore permanent residents who are tax residents in Singapore and other non-corporate Singapore constituted or registered entities (such as town council and statutory boards)". (Ooi, Newell, & Sing, 2006)

    - In 2005, it announced the exemption of stamp duties for properties acquired by REITs over a period of five years. The prime minister said in the budget speech that REITs will help enlarge Singapore's capital market and ''grow its local fund management business, and benefit other areas of the financial sector.''

    - In July 1 2005, the Monetary Authority of Singapore announced further changes to the REIT framework. This involves incorporating more flexibility in key areas to accommodate domestic and international expansion, aligning of interests of investors and REIT managers, and improving investor protection (Deutsche Bank, 2005). The changes include raising the current 35% borrowing limit to 60%, requiring REITs to disclose more information on their exposure to tenancy risk in their annual reports, licensing of REIT managers to ensure high standards of business conduct and allowing partial ownership of properties to facilitate overseas real estate acquisitions.

3. **SOUTH KOREA**

In 2005, in response to investor concerns about the life span of CR REIT and unfair tax advantages of the RETF and CR REIT over the K REIT, regulators changed the following rules namely:

- Extended the corporate tax transparency to K REITs
- Allowed CR REITs to continue indefinitely
- Allowed external and internal management options for the REITs
- Eased restriction on initial capital borrowing

4. HONG KONG

Hong Kong’s Securities and Futures Commission amended the Code on REITs on 17 June 2005. Some of the key amendments:

- REITs can now invest in overseas real estate.
- The maximum borrowing ratio has increased from 35% to 45% of the total gross asset value of the REIT.
- Management companies are required to conduct due diligence investigations before investing in a particular property or country.
- There must be enhanced investor disclosures in the offering documents and by the management company regarding the overseas markets to be invested in by the REIT and the associated risks.
- The management company need no longer own 100% of all real estate, but must have majority control.
- REIT management companies must appoint listing agents with the same functions as a sponsor of a company seeking to list. The listing agent must also conduct its own independent due diligence on the properties in the REIT.
- Responsible officers of a REIT management company may now count experience in property portfolio management to be eligible.
- Payment of management fees by way of units in the REIT and payment of performance fees by reference to distribution increases may be allowed by the SFC on a case by case basis.

5. MALAYSIA

In February 2005, key revisions in the 1986 Property Trust Code were granted namely

- Granting tax transparency
- Liberalizing REIT’s borrowing limits to 35% of asset value
- Property trust was renamed to the more globally recognizable name: REIT