

An Analysis of Indirect Real Estate Investments in South Korea

by

Cho Hae Park

B.S., Architectural Engineering, 2010

Korea University

**Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in
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Signature of Author_____

Center for Real Estate

August 5, 2020

Certified by_____

Jen Cookke

Lecturer, Department of Urban Studies and Planning

Thesis Supervisor

Accepted by_____

Professor Dennis Frenchman

Class of 1922 Professor of Urban Design and Planning

Department of Urban Studies and Planning

Director, MIT Center for Real Estate

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ABSTRACT

Recently the South Korean government announced its comprehensive measure to revitalize the indirect real estate investment market, especially to expand the public offering market to be ten times larger than its current state. The measure can be interpreted as a change of state in the Korean real estate market and an acknowledgment of its need for the vital role of indirect real estate investments. As a low-interest environment continues and the amount of floating money increases, real estate speculation has never been more of an issue, which cannot be solved without changing the investment paradigm. Vitalization of the indirect real estate market can provide individuals alternative ways to invest their money in real estate and redistribute profits generated from real estate investments that are currently driven by few institutional investors. This thesis aims to study the overall indirect real estate investment market in Korea focused on two main vehicles, Real Estate Investment Trusts and Real Estate Funds. The two vehicles will be studied in depth on their history, current market status, behaviors and characteristics to analyze their roles in the market. Analysis will be done on indirect real estate investment vehicles in comparable countries to take away lessons learned and find areas for possible market improvements. Data will be collected from various literatures, journals, statistics from fund assessment companies and investment associations to attempt to find inefficiencies that can be improved in the market.

Thesis Supervisor: Jen Cooke

Title: Lecturer, MIT Center for Real Estate

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TABLE OF CONTENTS

Chapter 1 Indirect Real Estate Investment in Korea

- 1.1 Definition of Direct and Indirect Real Estate Investment
- 1.2 History of Korean Indirect Real Estate Investment
- 1.3 Real Estate Investment Trusts and Real Estate Funds
 - 1.3.1 Definition and Classification
 - 1.3.2 Legislative Framework

Chapter 2 Market Analysis

- 2.1 Market Size
 - 2.1.1 REITs
 - 2.1.2 REFs
- 2.2 Investment Assets
 - 2.2.1 REITs
 - 2.2.2 REFs
- 2.3 Sources of Funds

Chapter 3 Possible Market Improvements

- 3.1 REITs in Japan and Singapore
 - 3.1.1 Japan
 - 3.1.2 Singapore
- 3.2 Possible Market Improvements
 - 3.2.1 Clear Division between REITs and REFs
 - 3.2.2 Activation of Listed REITs market
 - 3.2.3 Larger REITs
 - 3.2.4 Sponsored REITs

Chapter 4 Conclusion

- 4.1 Conclusion

Chapter 1 Indirect Real Estate Investment in Korea

1.1 Definition of Direct and Indirect Real Estate Investment

Real estate investment can be divided into two broad categories: direct and indirect real estate investment. Direct real estate investment involves buying a specific property or a stake and making money through rental income, appreciation, and profits generated from business activities that depend on the real estate. Indirect real estate investment involves purchasing shares in a real estate fund or a publicly or privately held company.

Direct investments are usually more attractive for institutional buyers as they are usually of larger size and have high transaction fees. Investors have a greater control in decision making and can select properties to match preferences for location, product type, and financing structure, and also set how to operate the property to generate revenue. Investors can also take full advantage of positive cash flow and appreciation, and tax advantages. However, direct investments are usually less liquid and more exposed to risks.

On the other hand, indirect investments are attractive not only to institutional investors, but also individual investors because they access profits from real estate without having to own, operate, or directly finance properties. Investors can invest in lower amounts with low transaction costs and have more liquidity than direct investing. Indirect investment also reduces the investor's investment risks as funds are managed by professionals with more knowledge. However, investors cannot take full advantage of the positive cashflow and appreciation.

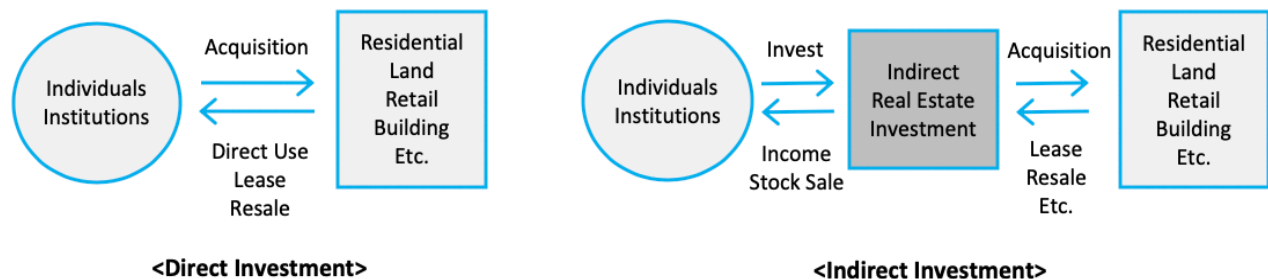


Figure 1-1 Concept of Direct and Indirect Real Estate Investment

Source: (Hyundai Research Institute, 2015)

1.2 History of Korean Indirect Real Estate Investment

After the financial crisis in 1997, Korea experienced extreme asset deflation during the restructuring process where the number of properties available in the market and amount of distressed debt increased sharply and real estate prices plummeted. To alleviate asset deflation and solve distressed debt, the government introduced Real Estate Securitization to securitize real estate in small price units to enhance liquidity in the market and thus expedite the restructuring process of enterprises and financial institutions at the time. Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS) were introduced in 1998 and 1999 respectively. Although these two systems are more focused on real estate securitization than real estate indirect investment, it is worth noting that the need for new systems are in many cases triggered by financial crisis as surely was the case in South Korea.

In 2001, Real Estate Investment Trusts (REITs) were introduced with “The Real Estate Investment Trust Act” and marked the start of the real estate indirect investment market in South Korea. Unlike other countries where the primary purpose of REITs was to provide individuals the opportunity to invest indirectly in real estate, REITs in Korea were primarily introduced as vehicles that would support restructuring of corporations and financial institutions by providing tax benefits at reversion. The driving forces for REITs came mainly from real estate companies and corporations that own large amount of real estate, as well as banks saddled with non-performing loans involving collateralized real estate. REITs were seen as a way for banks to recapitalize in a market burdened with high numbers of non-performing loans. (Joseph T. L. Ooi, 2006, p. 210) Through REITs, institutional investors were able to acquire large amounts of real estate and corporations were able to sell their assets and improve their financial structure.

REITs in Korea are mainly driven by the private capital. REITs were expected to use their nature of securitizing real estate to allow small units of investments and provide liquidity through public offerings to attract individuals to the failing real estate market at the time. Additionally, REITs were aimed to turn the strong speculation-minded, capital gains-oriented Korean real estate market into a healthy one that is dependent on operational income and to gain international competitiveness by specializing growing the size of real estate companies. (Hyun Seok Lee, 2012)

However, Korean REITs did not activate as planned in their early stages due to structural issues. According to “The Real Estate Investment Trust Act” at the time, the minimum capital required for establishment had to be at least 50 billion Korean won and corporate tax benefits were given only to Corporate Restructuring REITs. To supplement the system, in 2004 Real Estate Fund was introduced under “The Indirect Investment Asset Management Business Act,” but this system had a less restrictive

regime that eventually overshadowed REITs. In 2009, “The Indirect Investment Asset Management Business Act” was abolished and integrated into “The Capital Market and Financial Investment Services Act” (in brief, “Capital Markets Act”). Under “Capital Markets Act,” the legal term “indirect investment” is revised as “collective fund” and Real Estate Fund can be in broader options of forms, corporation, business trust, investment corporation, and investment product. REF can be raised both publicly and privately, but till now they have mostly been driven by the private equity.

Ever since the introduction of Real Estate Investment Trusts and Real Estate Fund in Korea, the indirect real estate market has rapidly grown to be 153 trillion Korean won. With a continued trend of low interest rates and slow economic growth, people are looking for diverse ways to invest money. Compared to traditional assets such as stocks and bonds, real estate represents a large amount of physical capital with unique risk and return characteristics. As such, real estate gives investors the opportunity to diversify their portfolios more broadly than they could with only stocks and bonds. (David M. Geltner, 2013, pp. 523-524) Compared to those of their global peers, REIT and REF markets are still small. With improvements in the two vehicles and governmental support, the real estate indirect market can grow much more in the future.

Table 1-2 History of Real Estate Indirect Investments in Korea

	Related Law	Event
1991	Real Estate Trust Act	Introduction of Real Estate Trust
1998	Asset Backed Securitization Act	Introduction of Asset Backed Securities
1999	Mortgage backed Securitization Business Act	Introduction of Mortgage Backed Securities
2001	Real Estate Investment Trust Act	Introduction of Real Estate Investment Trusts
2004	Indirect Investment Asset Management Business Act	Introduction of Real Estate Funds
2009	Capital Market and Financial Investment Services Act (Capital Markets Act)	Indirect Investment Asset Management Business Act abolished, Indirect investment integrated into Capital Markets Act.

1.3 Real Estate Investment Trusts and Real Estate Fund

Real Estate Investment Trusts (REITs) and Real Estate Fund (REF) are the two representative vehicles of indirect real estate investments in Korea, given their size and importance in their role in the market. Both vehicles are similar in the sense that they receive funds from investors and return profits generated from investing in real assets or real estate dependent loans or securities. However, REITs have more of a public character as they are purposed to benefit the public and REFs have more of a private character as they are driven by the private equity. This difference leads them to be governed by different laws and ministries that make them subject to different regulations in terms of legal nature and asset management.

The term “Real Estate Fund” is used in two ways. In a broad sense, it is a general term meaning the means of receiving funds from investors and returning profits. Thus, it is a high-level term that includes real estate investment trusts, real estate collective funds under Capital Markets Act, and foreign real estate investment funds. The term can also be used in a narrow sense to mean just the real estate collective funds, categorized under “The Capital Market and Financial Investment Services Act.” In the US, “Real Estate Fund” is a broad term with REITs as one of its representative vehicles, but in Korea, the term is typically used with the narrow meaning to distinguish from REITs. This thesis will use the term with the narrow meaning.

The two indirect real estate vehicles have been similar in their roles in Korea, ambiguous to be distinguished clearly, mainly because most real estate investment trusts (REITs) in Korea are non-listed REITs that are established mainly for corporate restructuring purpose or for private investors, with no merit for individual investors as they do not provide liquidity. Currently REITs are somewhat like REFs in that they are non-perpetual, finite life funds that are invested by large institutional investors. In this section, the definitions, structures, and legal systems of the two vehicles in Korea will be studied.

1.3.1 Definition and Classification

Real Estate Investment Trusts (REITs)

According to “The Real Estate Investment Trust Act,” a real estate investment trust (REIT) is a general stock corporation that pools the capital of numerous investors to own and operate income-producing real estate and related securities to distribute income as dividends to shareholders. In US, there are equity, mortgage, and hybrid REITs, but in Korea there are only equity REITs. The general structure of a REIT is as follows.

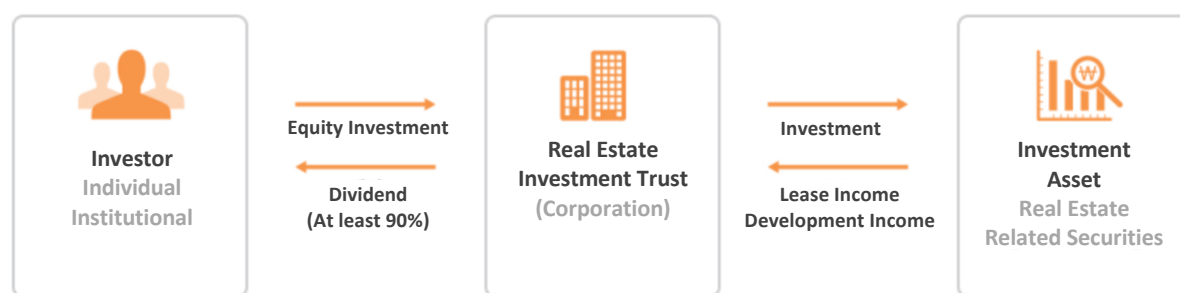


Figure 1-3 General Structure of a REIT

Source: REITs Information System (Ministry of Land, Infrastructure and Transport, 2020)

There are several pros in investing in REITs. Firstly, publicly listed REITs provide individuals the opportunity to invest in large real estate with a small amount of money. Listed REITs are traded on public exchanges, offering liquidity, which is a major drawback of investing directly in real estate. Secondly, there are several tax benefits when investing in REITs. With the continuous increase in real estate prices in Korea, the government is enforcing policies that burden real estate and capital gains tax. However, because REITs are investments that acquire shares in a real estate corporation, there are no registration fees when a property is acquired, no progressive tax on property tax, and they are exempt from comprehensive real estate holding tax. Additionally, there is no corporate tax on distributable income when more than 90% of distributable income is paid out to shareholders as dividends. Thirdly, REITs are known to provide higher yields than bonds or standard interest rate, yet provide stable income compared to stocks. REITs can be a stable investment in the low-interest, low-economic-growth environment. Lastly, REITs are operated like a corporation, and thus investors can participate in asset management at board of directors and shareholders' general meetings.

There are three types of REITs in Korea: Self-managed REIT (SM-REIT), Externally-managed REIT (EM-REIT), and Corporate-Restructuring REIT (CR-REIT). The Self-managed REIT has in-house management with at least three asset managers that operate assets themselves. The Externally-managed REIT and Corporate-Restructuring REIT are paper companies that have no internal staff, and asset management is entrusted to asset management companies. REITs were introduced in Korea to restructure corporations after the financial crisis. Thus, there were many CR REITs in the early stages of REIT market, but over the years EM REITs became the most prevalent type of REIT in Korea. Regulations under each type will be dealt later in the chapter.

Real Estate Funds (REFs)

According to “The Capital Market and Financial Investment Services Act,” a Real Estate Fund (REF) is a collective fund that invests at least 50% of its total assets in real estate and real-estate-related rights and assets. Other than acquisition and sales of real estate, a Real Estate Fund (REF) can invest in real estate derivatives, real estate loans, real estate development, management and improvement of real estate, real estate leases, real-estate-related rights and real-estate-related assets. Real-estate-related rights include superficies, easement, leasehold rights, right of lease, purchase right, and mortgage monetary claim. Related assets include profit-making securities, collective fund securities, backed securities investing more than 50% in any real estate, related rights, and mortgage monetary claim. They also include stock issued by REITs and Project Financing Vehicle (PFV), equity security issued by Special Purpose Company (SPC), derivative products setting real estate and real-estate-based asset, loans to corporates related to real estate development. (Koramco Fund, 2020)

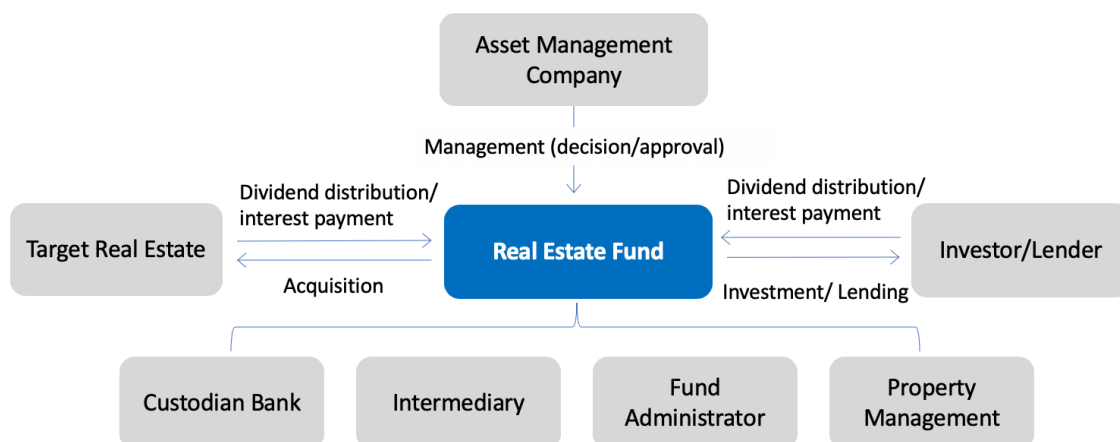


Figure 1-4 General Structure of a Real Estate Fund

Source: (Hangang Asset, 2020)

Generally, fund is collected through banks, insurance and security companies which is then entrusted to asset management companies that invest in real estate and related rights and assets. Income generated from assets are passed onto fund investors.

Real estate fund types can be classified by asset types, largely into four categories: real estate loan, lease, auction/short sale, and development. A real estate loan fund lends money to a development company for a certain amount of interest for profit. A real estate lease fund is a fund that acquires and operates income-generating real estate for its rental income and capital gains at reversion. An auction and short sale fund acquire properties for public sale for resale or lease to generate profit. Lastly, a real estate development fund is a fund that develops a property itself and earns development profits. When Real Estate Fund was under jurisdiction of “Indirect Investment Asset Management Business Act” from 2004 to 2009, a fund could only invest within 30% of its total assets in real estate development so there was no performance of this type of fund. However, under “Capital Markets Act,” there is no limit to investment ratio into real estate developments.

1.3.2 Legislative Framework

Real Estate Investment Trusts (REITs) and Real Estate Funds (REFs) are legislated under different laws. REITs are regulated by “The Real Estate Investment Trust Act” under the jurisdiction of the Ministry of Construction and Transportation. REFs are regulated by “The Capital Market and Financial Investment Services Act” under the jurisdiction of the Financial Services Commission. Because REITs aim to benefit the public, regulations are more stringent to protect the wealth of individuals than those of REFs that are established mostly for private equity. This is one of the reasons why real estate fund market has grown faster and larger than the real estate investment trusts market in Korea.

Real Estate Investment Trusts (REITs)

Under “The Real Estate Investment Trust Act,” a REIT, as a legal entity, must be incorporated in a form of a general stock corporation. Upon establishment, a REIT has to be approved by the Ministry of Construction and Transportation. The minimum capital requirement of a REIT is 7 billion Korean won for self-managed REITs, and 5 billion Korean won for externally-managed and corporate-restructuring REITs. SM-REITs and EM-REITs should invest at least 70% in real estate, or at least 80% in real estate and related securities and cash. CR-REITs should invest at least 70% in real estate that a company sells in order to repay its existing loans, real estate for corporate restructuring. REITs are allowed to invest their entire assets in real estate development projects. REITs must hold their real estate at minimum of one year, except for CR-REITs, which have no restriction on the rule. REITs cannot acquire more than 10% of the voting shares in other companies except for during mergers and acquisitions.

SM-REITs and EM-REITs must publicly offer at least 30% of their total shares within two years of operation from the approval date. CR-REITs are not subject to this restriction. A REIT cannot be possessed by one shareholder or anyone specially related to the shareholder in excess of 50% of the total stocks issued by REITs. This rule does not apply to CR-REITs. REITs are required to distribute at least 90% of their distributable income to their shareholders. If this rule is met, EM-REITs and CR-REITs can deduct that dividend amount from the REITs’ taxable income. Thus, EM-REITs and CR-REITs are exempt from corporate income tax when dividends are distributed. Additionally, all types of REITs get 30% of acquisition and registration fees deducted. For comparison of regulations with real estate funds, see Table 1-5.

Real Estate Fund (REF)

Under “The Capital Market and Financial Investment Services Act,” Real Estate Funds (REFs) can be in the legal form of a business trust, an investment corporation, a limited liability company, a limited partnership, an investment association, or an undisclosed association. REF forms are largely divided into business trusts and corporations, but typically real estate funds are business trusts, because under a corporation, no more than 70% of a fund’s assets can be invested in real estate, limiting the investment options of a fund.

The minimum capital requirement is one billion Korean won when incorporated into the form of a corporation and none when the REF is a business trust. Upon establishment, a real estate fund does not need to be approved, but only registered. Under a corporation, a fund should invest at minimum 50% and at maximum 70% in real estate. Business trusts are not subject to any limits on the amount of investment assets in real estate.

Table 1-5 Comparison of REITs and REF

	REITs			REF	
	Self-managed	Externally-managed	Corporate-Restructuring	Corporation	Business Trust
Law	Real Estate Investment Trust Act			Capital Markets Act	
Jurisdiction	Ministry of Land, Infrastructure, and Transportation			Financial Services Commission	
Company	Ordinary	Paper		Ordinary	
Min.Capital	KRW 7 Bil.	KRW 5 Bil.		KRW 1 Bil.	None
Management	Self	External		External	
Asset Composition	Above 70% in real estate, Above 80% in real estate and real estate securities		Above 70% in real estate	Above 50%	Real estate, rights, assets (No Limit in %)
Public offering	Capital of 30% or more		No Obligation	No Obligation	
Development Project	Below 30% of Total Asset (Up to 100% for development only REITs)			No Limit	
Acquisition tax	30% Deduction			30% Deduction	
Corporate tax	No exemption	If 90% of total distributable income is distributed, that amount is deducted from taxable income			N/A

Chapter 2. Market Analysis

2.1 Market Size

As of 2019 Q4, assets under management of the Korean indirect real estate market are estimated to be around 153 trillion Korean won. As for REITs, there are 248 operating REITs and their total assets amount to around 52 trillion Korean won. Since 2002, REITs have steadily grown in the market, especially after 2006 when the National Pension Service started investing in REITs, but compared to REITs of countries that introduced REITs in a similar period, K-REITs have grown slowly. Singapore introduced REITs in 2002 and in less than twenty years it has grown to be Asia's REITs hub. The Real Estate Fund was introduced in 2004, later than REITs, but has grown rapidly, driving the Korean indirect real estate market. As of 2019 Q4, assets under REF are about 101 trillion Korean won. The percentage of Real Estate Fund within the whole Korean fund market has steadily grown from 0.7% in 2005 to 15.1% in 2019. Despite the active growth, REF has yet to achieve its primary aim of providing individuals the opportunity of investing in real estate with a small amount of money. Sources of funds have been mostly from private capital for both REITs and REFs.

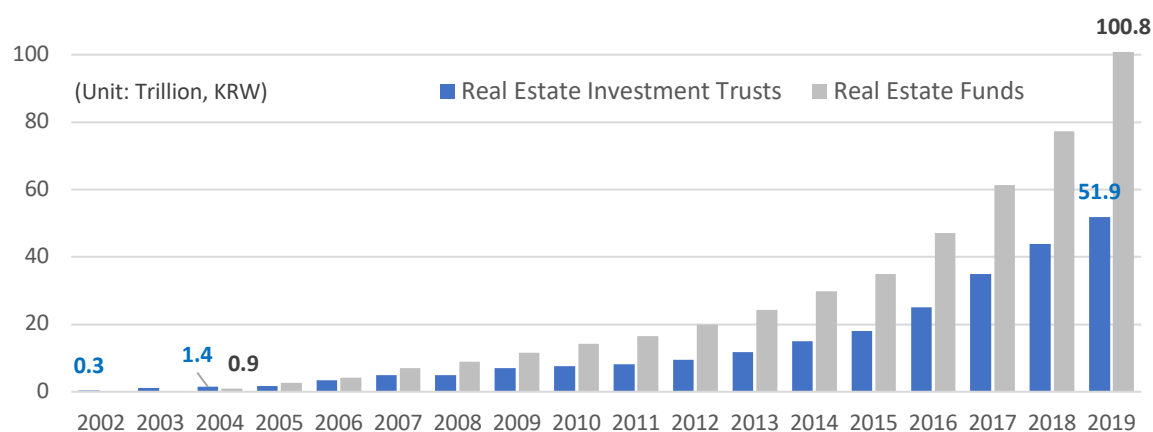


Figure 2-1 Total Assets of REITs and REFs

Source: (KAREIT, 2020), (KOFIA, 2020)

Table 2-2 REITs and REFs Market Size Overview (2019 Q4)

<i>REITs</i>		<i>REFs</i>	
<i>Total Asset</i>	KRW 52 Trillion (248 REITs)	<i>Total Asset</i>	KRW 101 Trillion
<i>Largest in Type</i>	Externally-Managed REITs (215 REITs)	<i>Investment Area</i>	Korea: 45 Trillion (44%) Overseas: 56 Trillion (56%)
<i>Listed REITs</i>	7 REITs	<i>Fund Sources</i>	Public: 3.4 Trillion (3%) Private: 97.4 Trillion (97%)

2.1.1. REITs

The number of operating REITs has been rising steadily over the years. Last year alone, 50 REITs were newly authorized, cumulating to a net total of 248 REITs in 2019 Q4. Market growth was stagnant in the first years of introduction when most of the REITs were purposed for corporate restructuring, but since 2006 the large institutions such as National Pension Service (NPS) started investing in REITs, boosting the total amount of assets of REITs. The average annual growth rate of total assets from 2002 to 2019 is roughly 30.6%.

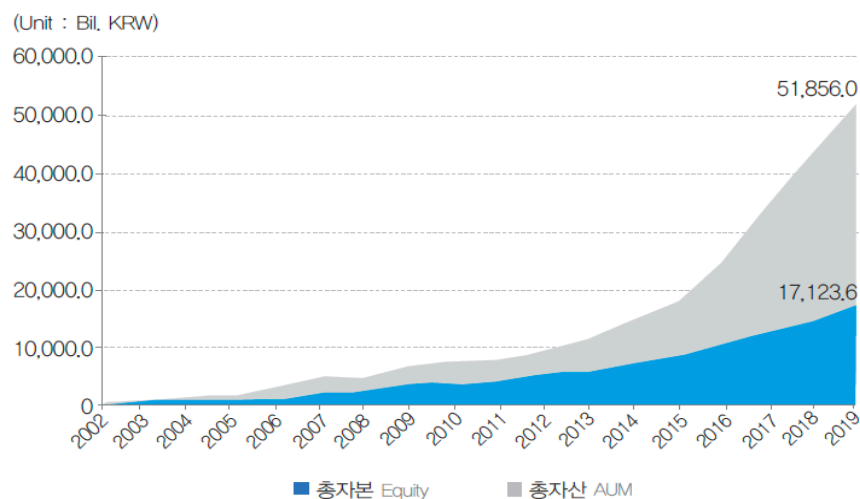


Figure 2-3 Annual REITs AUM and Equity

Source: (KAREIT, 2020)

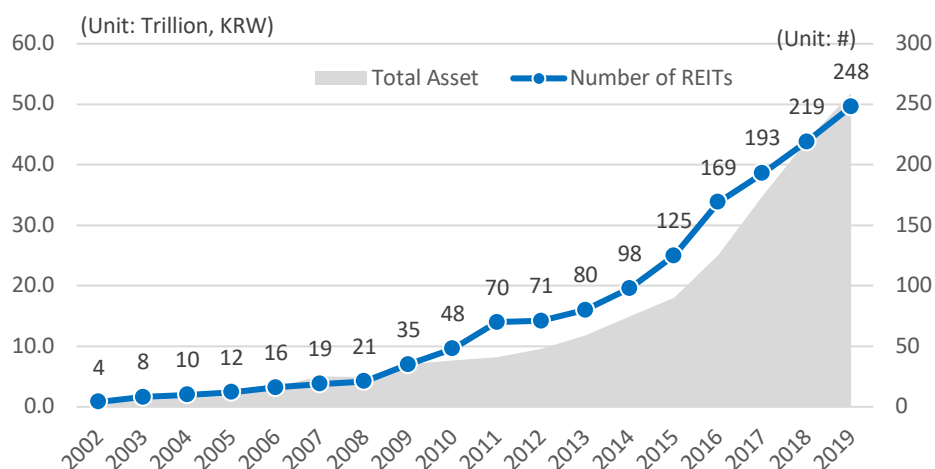


Figure 2-4 Total Assets and Number of K-REITs

Source: (KAREIT, 2020)

Scale of a REIT

Even though the REIT market in Korea has grown steadily, the AUM scale of a K-REIT is not big compared to those of advanced REITs of major countries. The average AUM scale of a K-REIT is roughly 210 billion Korean won (total assets of 52 trillion won/248 REITs) whereas the average AUM scale of a US REIT was 7 billion US dollars (roughly about 8.4 trillion won) in 2019. Similarly, the average AUM scale of Japanese REITs is roughly 260 billion Japanese yen (total asset of 17 trillion yen/64 REITs), which is about 3 trillion Korean won. Thus, the average AUM scale of a K-REIT is only about 2.5% of the size of a US REIT and 7% of the size of a Japanese REIT.

Table 2-5 AUM of major REITs countries (Data: 2019 Q4)

<i>Country</i>	<i>Year of Adoption</i>	<i>Number of REITs</i>	<i>AUM</i>
<i>U.S.</i>	1960	219	13.3 trillion USD
<i>Japan</i>	2000	64	16.4 trillion JPY
<i>Singapore</i>	2001	44	100 billion SGD
<i>Korea</i>	2001	248	52 trillion KRW

Source: NAREIT, Korea Association of REITs, ARES Japan, Singapore Exchange

In advanced REITs markets, the size of a REIT is larger, which means that numbers of newly authorized REITs decrease and existing REITs develop to become larger in total assets. Among the countries dealt with above (US, Japan, Singapore, Korea), Korea has the largest number of REITs, yet the smallest REIT market. The average AUM scale of a REIT is around 200 billion Korean won, and about 70% of the market share of REITs is less than 200 billion Korean won each. The scale per REIT is very small compared to those of advanced markets, and only in the last recent few years has the number of REITs with AUM of more than 300 billion Korean won increased.

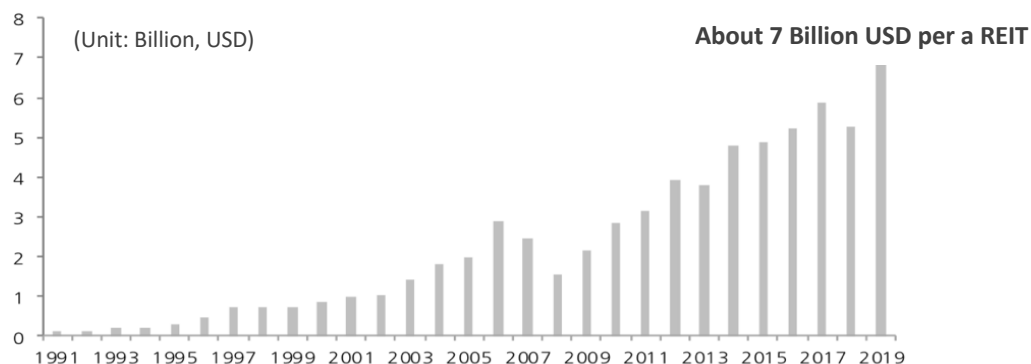


Figure 2-6 Aggregate value per REIT in U.S. in 2019

Source: (Hanwha Investment and Securities Research Center, 2020)

Table 2-7 Market Share by AUM Scale (based on number of REITs, 2019 Q4)

(Unit: billion, KRW)

<i>AUM Scale</i>	<i># of REITs</i>	<i>Market Share</i>	<i>AUM</i>
<i>Less than 10 billion</i>	27	10.8%	59.1
<i>10 to 49 billion</i>	44	17.6%	1,364.3
<i>50 to 99 billion</i>	43	17.2%	3,205.6
<i>100 to 199 billion</i>	55	22.0%	7,872.3
<i>200 to 299 billion</i>	30	12.0%	7,257.1
<i>Above 300 billion</i>	51	20.4%	31,803.5
<i>Sum</i>	250	100.0%	51,561.9

Source: (KAREIT, 2020)

One of the reasons behind the small AUM scale of a REIT in Korea is that most REITs in Korea are established as one REIT per property. When REITs were introduced in the market, Korean investors had a tendency to prefer profits from capital gains than from income flow. Thus, REITs were established on a small investment scale, one REIT per property, with a finite life of four to six years so that investors can make money from resale of property for capital gains. (Tae Ri Lee, 2015, p. 30)

Creating a REIT for just one property is not only unproductive in terms of cost and time, but it is not perpetual as the REIT is dispersed when that one property is sold. Also, there was no M&A to be found between REITs ever since their introduction in the market, which shows how closed the REIT market is and how limited in its expandability. In this sense, without the perpetuity, a REIT is like a Real Estate Fund that has a life equal to that of its property.

Under “The Real Estate Investment Trust Act,” a REIT must be in the form of a corporation, which can be a perpetual portfolio with multiple properties that can grow to continuously to make profit from income flow. A REIT must grow its size and be composed of multiple properties to be able to generate stable profit and build its track record to gain investors’ trust. Economy of scale is important for REITs to be perpetual. REITs should have enough scale to own and operate many properties in diverse areas to hedge the risk of defaulting on rental income and regional risks.

Listed REITs

As of 2019 Q4, the total AUM of K-REITs market is 52 trillion Korean won. From the total 246 REITs, 239 are non-listed REITs (96%) and only 7 are publicly listed (4%). The sizes of listed REITs differ dramatically from those of Japan and Singapore, countries that introduced REITs at a similar period as Korea. Japan has 64 listed REITs at market capitalization of around 175 trillion Korean won, and Singapore has 44 listed REITs at market capitalization of around 96 trillion Korean won.

Table 2-8 Status of Listed REITs in Major Countries (based on 2019 Q4, Unit: Tri, KRW)

Class	USA	Japan	Singapore	Korea
Introduction Year	1960	2000	2002	2001
# of Listed REITs	219	64	44	7
Market Cap.*	1,538.7	174.8	96.0	2.1
Dividend Yields (%)	4.1	3.6	5.4	All: 4.2, Listed: 7.7
Percentage to GDP (%)	6.8	3.2	24.0	0.11
GDP**	22,550	5,469	401	1,894

* Applied in exchange rate of major currencies against Korean won on December 31, 2019

** Based on 2018, applied in exchange rate (KRW 1,100.3/\$)

Source: (KAREIT, 2020)

The reason behind the small number of listed REITs is largely because Korean REITs were founded on Corporate-Restructuring REITs, which had no obligation to be publicly listed and to pay out dividends. Individual investors had no opportunity or reasons to invest in REITs. From 2013, the number of Corporate Restructuring REITs decreased and Externally-Managed REITs took over. Yet major pension funds and associations were exempt from public listing requirements when they acquired more than 30% of a REIT's share, allowing REITs market to grow mostly private.

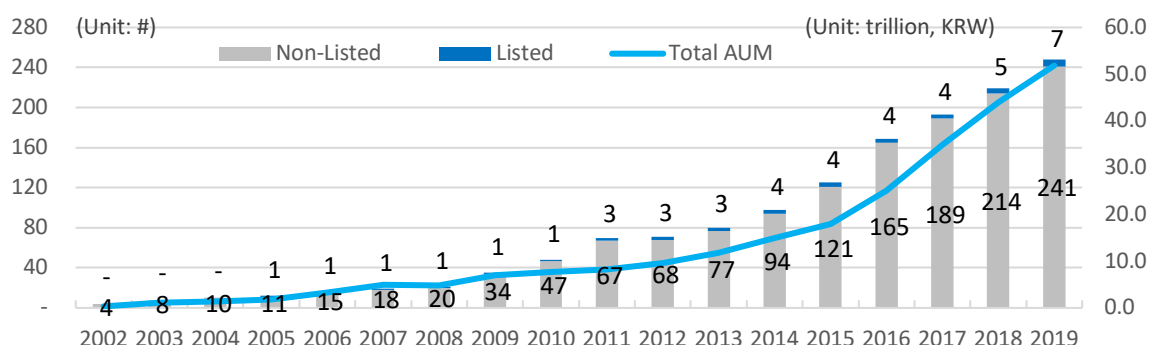


Figure 2-9 Number of listed vs. non-listed REITs

Source: (KAREIT, 2020)

2.1.2 Real Estate Fund

As of 2019 Q4, there are a total of 1,933 Real Estate Funds in Korea and total assets under management is around 101 trillion Korean won. The total AUM of real estate funds in 2004 was only 800 billion Korean won, 0.43% of market share within the total fund market in Korea. Since then the real estate fund market has grown steadily to AUM of 101 trillion Korean won, and market share of around 15.3% of Korean fund market in 2019. Traditional assets such as stocks and bonds took over nearly 64% of the market share in 2004, but currently their market share is around 36% of the Korean fund market. As you can see from Figure 2-10, stocks and bonds faced downturns during the global financial crisis from 2008 through 2011, but real estate funds have steadily increased their share even through the financial crisis.

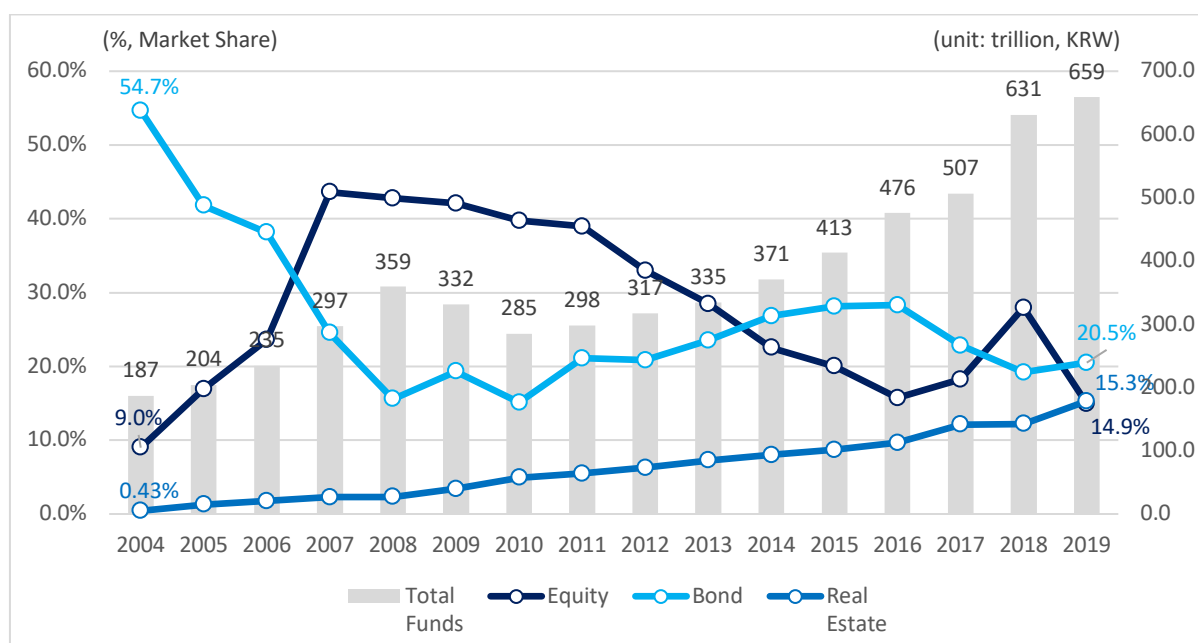


Figure 2-10 Market Share of Equity, Bond, Real Estate Funds

Source: (KOFIA, 2020)

Real Estate Funds were introduced later than Real Estate Investment Trusts, but their assets under management have grown rapidly. Currently, the REF market is two times larger than the REIT market. As interest rates decreased and stock prices fluctuated, large amounts of money were invested in real estate which were conceived to return higher yields than traditional investments such as stocks and bonds. Especially pension funds, associations, insurance companies, and large financial institutions started to grow their investments in real estate.

Table 2-11 Risk and return of asset types (Data: 2004 to 2018)

	<i>Asset</i>	<i>Average Annual Return</i>	<i>Risk (Std. Deviation)</i>
<i>Equity</i>	KOSPI	9.07%	24.59%
<i>Bond</i>	Treasury (3 yr.)	3.38%	1.27%
	Corporate (AA-)	4.07%	1.53%
<i>Real Estate</i>	Office	7.42%	2.32%
	Retail	7.14%	1.65%

Source: Bank of Korea, Korea Appraisal Board

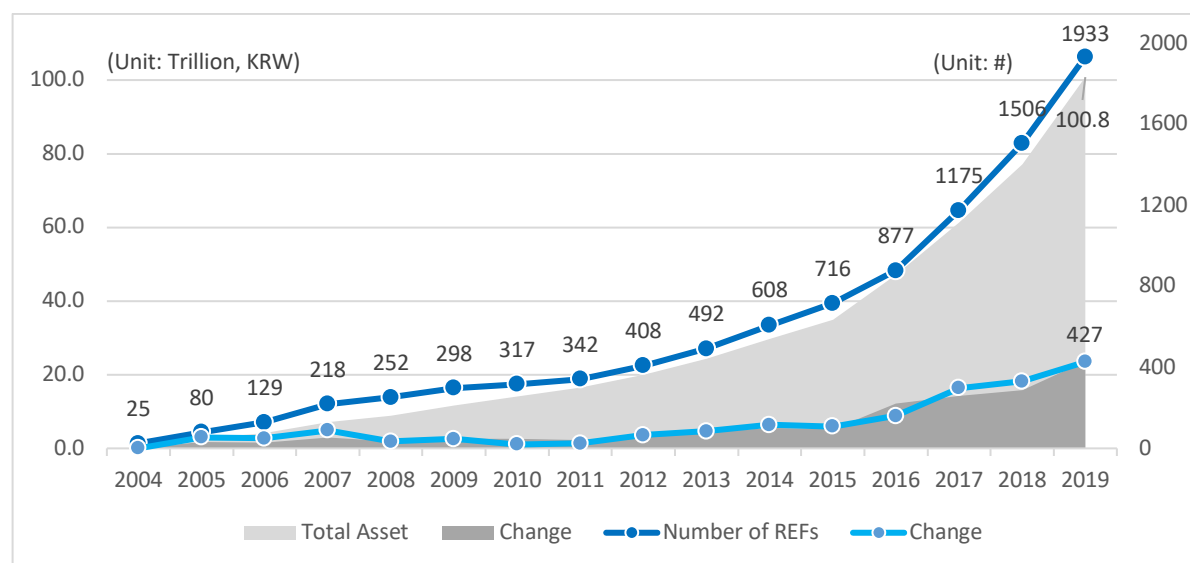


Figure 2-12 Total Assets and Number of REFs

Source: Korea Financial Investment Association, statistics portal

Behind the rapid growth of Real Estate Funds was the rise in institutional capital investing in real estate. As the low interest rate, low economic growth environment became a long-term trend, Korean institutional investors searched for new profit-generating assets, away from traditional investments such as stocks and bonds. Large investment capital from pension funds, insurance companies, financial institutions increased the need for customized asset management that caused an imbalanced private-to-public ratio within the real estate fund market. Additionally, establishing private funds are more efficient in terms of cost and time as they are not regulated under disclosure requirements, whereas public funds are.

Overseas Investments

According to Real Capital Analytic, Korean institutional investors invested the largest amount in overseas commercial real estate in 2019 among Asian countries. As investments from China and Hong Kong have decreased since 2017, Korean overseas investments have increased, recording 50% of Asia's overseas investment amount. (Korea Capital Market Institute, 2020) After the global financial crisis, Korean institutional investors expanded their investments to global real estate to diversify their portfolio and get higher returns. As of 2019 Q4, 55% of Real Estate Fund's total assets, estimated to be about 55.5 trillion Korean won, is invested in overseas real estate investment, which is about 19 times the amount in 2010, about 3 trillion Korean won.

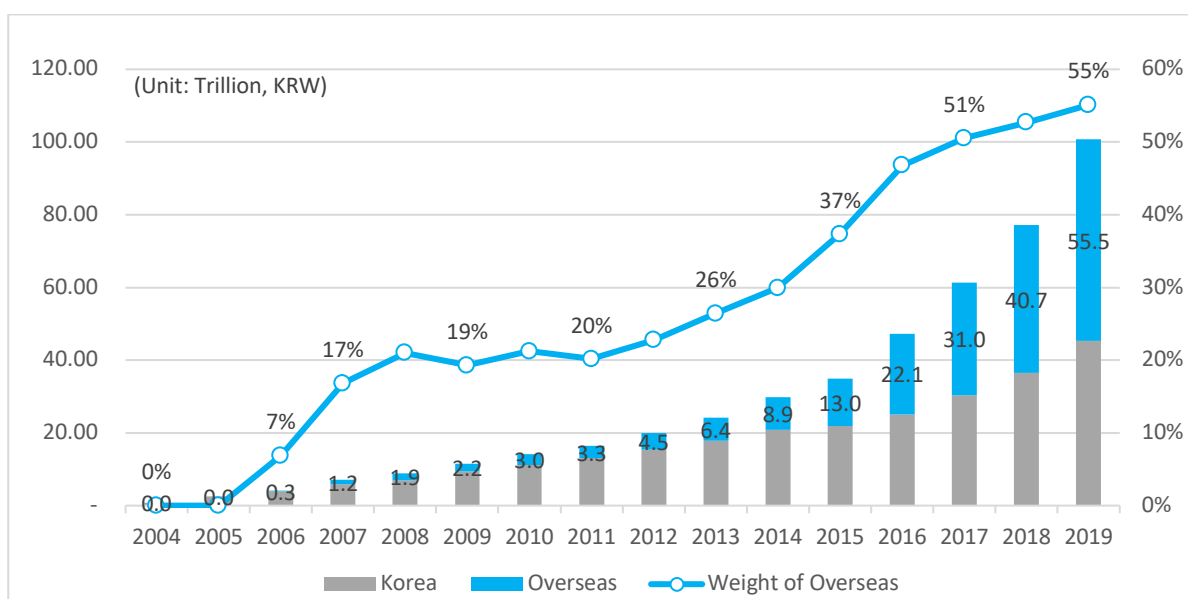


Exhibit 2-13 Real Estate Fund AUM invested Overseas vs. Korea

Source: (KOFIA, 2020)

According to KCMI, major Korean institutional investors have rather conservative investment preferences thus, their investments have been mainly focused on stable income producing assets in major cities around the world. The largest institutional investor in Korea, National Pension Service (NPS), has been securing stable income source through long term leases with core asset investments. Long term leases can reduce the volatility in reversion prices due to real estate market turnarounds and by investing in hands with the public sector and large corporations credit risk can be reduced. (Korea Capital Market Institute, 2020)

2.2 Sources of Fund

The two indirect real estate vehicles, real estate investment trusts and real estate funds, have been driven by private capital. One of the main reasons is because of the legal system of the two vehicles. Real estate funds have no obligation to be publicly offered so funds are customized to major investors, typically large institutions with big chunks of money. It is easier to manage few sources of funds than from many individuals so asset management companies have made products to suit their largest investors' needs. This goes against the purpose of the introduction of REFs, which is to provide opportunity for individuals to be able to invest in real estate with small amounts of money. As of 2019 Q4, AUM of 97.4 trillion Korean won is private, 97% of the real estate fund market. Only 3% of the market is publicly raised, with AUM of 3.4 trillion won in 48 real estate funds, making it difficult for individuals to participate.

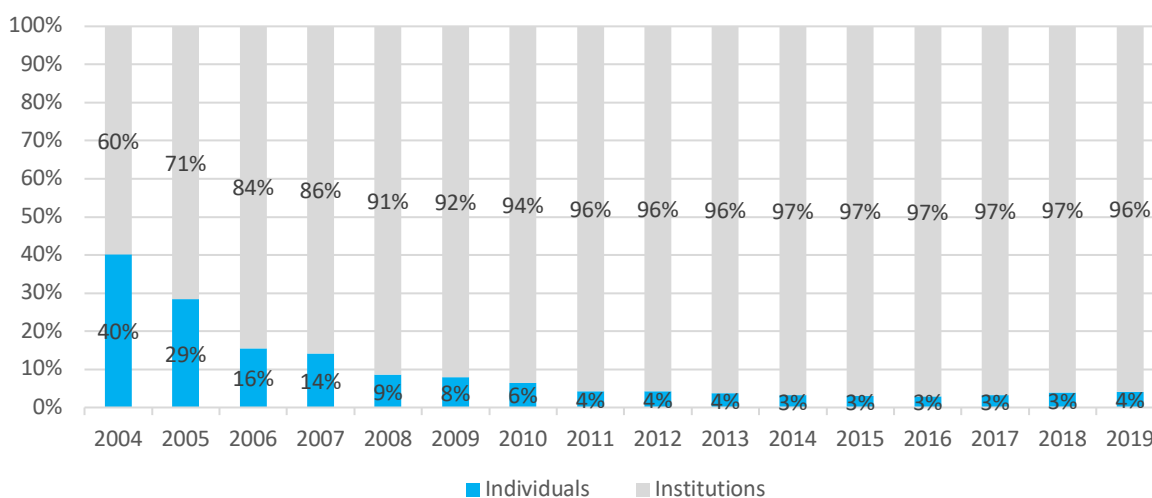


Figure 2-14 AUM per Investor Type by Weight

Source: (KOFIA, 2020)

In the case of REITs, data on investor type are not precisely collected: however, typically pension funds, banks, associations, insurance companies, private equity funds, and securities are the major investors and the number of individuals investing small amounts of money seems low. Additionally, there are only seven publicly listed REITs as of 2019 Q4, limiting the opportunity of individuals to invest in REITs. REITs were introduced in Korea to support corporate restructuring and enhance liquidity; thus, corporate-restructuring REITs did not have the obligation to be publicly listed. Government also alleviated listing requirements for large institutional investors, exempting them on public listing if they invest more than 30% of a REIT's asset, to entice large investors to size up the market so REITs had no driver to be publicly listed.

After the global financial crisis, large institutional investors started increasing their investments in alternative investments, especially in real estate. In the midst of a fluctuating economic environment, Korean pension funds and insurance companies sought new types of investment other than stocks and bonds to diversify their portfolio and aim for higher return. The largest players in the market are the four pension funds: National Pension Service, Teachers' Pension, Government Employees Pension Service, and Military Mutual Aid Association. In the following paragraphs, trends and status of real estate investments of the four pensions funds will be studied.

Table 2-15 shows a trend in AUM of alternative investments per each of four pension funds. Alternative investment includes real estate, infrastructure, and others. All pension funds have increased their investment amounts in alternative investments and expanded the size of alternative investments within their total portfolio. National Pension Service has the largest asset under management, about 90% of the total investment amount of the four pension funds. The fastest growing alternative investment pension funds are Government Employees Pension Service and Teachers' Pension and they both have announced publicly to increase the proportion of alternative investments, especially to increase distribution amount of overseas real estate investments. Annual returns of all four pension funds have been on average 4% to 8% over the last four years, marking alternative investment as a stable investment sector within the portfolio.

Table 2-15 Alternative Investment AUM of Four Major Pension Funds (Unit, Trillion, KRW)

<i>Pension Fund</i>		2016	2017	2018	2019
National Pension Service	Alternative	63.7	66.8	76.6	84.3
	% in Total	11.4%	10.8%	12.0%	11.5%
	Annual Return	8.8%	4.5%	11.8%	9.6%
Teachers' Pension	Alternative	2.2	2.5	3.1	3.9
	% in Total	15.8%	16.1%	19.6%	21.2%
	Annual Return	6.1%	4.7%	8.3%	10.4%
Government Employees Pension Service	Alternative	0.9	1.1	1.5	1.6
	% in Total	13.6%	15.6%	19.5%	20.1%
	Annual Return	3.8%	4.4%	8.1%	8.3%
Military Mutual Aid Association	Alternative	4.5	4.5	5.0	5.4
	% in Total	46.0%	43.0%	46.6%	46.5%
	Annual Return	3.2%	1.3%	6.0%	5.4%

Source: (NPS, 2020), (TP, 2020), (GEPS, 2020), (MMAA, 2020)

National Pension Service (NPS), the largest capital source in Korea, has invested 63.7 trillion Korean won in alternative investment and of the amount, 37% of it is invested in real estate as of 2019 Q4. Within the real estate sector, 24% is invested in Korea and other 76% overseas. In Korea, NPS typically invests in core assets in central business district of Seoul, mainly in office and commercial retail in the form of equity investment or debt, or hybrid of two. However, over the years, assets in CBD have been in fierce competition between institutional investors, driving asset sale prices higher. According to Savills Korea, the cap rate of office in CBD of Seoul was 4.6% in 2019, which has been decreasing steadily over the past few years. (Savills Research, 2020) As for overseas investments, NPS is investing in core assets overseas that can provide stable income for the long term. Their top overseas investment types are real estate securities and commercial real estate. NPS plans to expand its horizon to new investment sources to achieve higher yield, diversify their portfolio and hedge risks.

The other three pension funds are also seeking to find new types of assets for diversification. Teachers' Pension fund achieved the highest annual return among the four funds in 2019. It has invested 35% of their overseas alternative investment portfolio in real estate, focusing on value-add and opportunistic real estate mostly in the US. Investment asset types were logistics and multifamily, in the form of real estate debt. (TP, 2020)

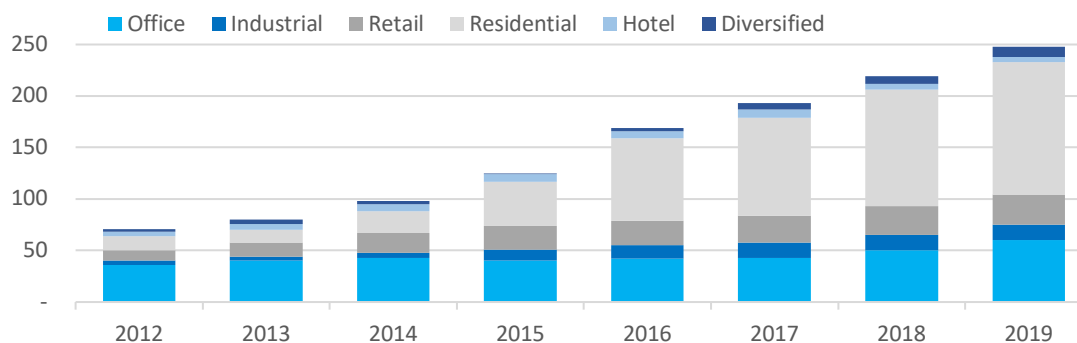
2.3 Investment Asset

2.3.1 REITs

Indirect real estate investment assets can be largely categorized as real assets and debt. REITs in Korea cannot invest in debt; thus, all assets of REITs are real assets. As of 2019 Q4, REITs in Korea are investing in office, industrial, retail, hotel, and diversified. The largest asset type is residential, 129 REITs in total, which is about 52% of total number of REITs. However, most residential REITs are driven by government policies for public purpose, so it is hard to say that they are naturally driven by the private market. Yet residential REITs are continuously growing in numbers. In early stages of the REIT market, office in CBD of Seoul was the predominant asset type, because they were the only assets that had stable income stream and could be subject to valuation by financial institutions. From 2013, concentration in office dispersed to other types such as industrial and retail. Compared to the US REIT market, asset types of K-REITs are very limited to traditional assets. US REITs invest in a wide variety of asset types from typical office to free standing, data centers, movie theaters, self-storage, infrastructure, healthcare, and timbre. There are only seven listed REITs in Korea, two of which invest in office, two in retail, one each in hotel and residential, and the last one diversified. Having a wide variety of investments can diversify investments, lower risk, and contribute stability, making REITs a healthy investment.

Table 2-16 Performance by Property Sector (CR & EM REITs)

<i>Sector</i>	<i># of REITs</i>	<i>AUM</i>	<i>Market Share</i>	<i>Yields (Avg.)</i>
<i>Office</i>	60	11,847	23%	5.8%
<i>Retail</i>	29	5,381	10.4%	10.7%
<i>Industrial</i>	15	950	1.8%	19.4%
<i>Lodging</i>	5	289	0.6%	8.4%
<i>Residential</i>	132	31,774	61.6%	0.7%
<i>Mixed</i>	9	1,321	2.6%	5.1%
<i>Total</i>	250	51,562	100%	3.4%



Source: (Korea Association of Real Estate Investment Trusts, 2020)

2.3.2 REFs

Asset types can be categorized in many ways, but because the market is driven by private equity and private funds don't have the obligation to publicize their information, it is difficult to collect good data. Alternatively, data will be collected from Fund Doctor, the largest fund assessment company in Korea. Fund Doctor categorizes Real Estate Funds into five categories: real estate development, real estate loan, real estate lease, global real estate, and global REITs. Because not all funds are disclosed, the total number of funds may be different than the actual. Nonetheless, this data will be used for analysis as the pool is big enough to analyze general market trends.

Figure 2-17 shows the proportion of newly authorized funds per real estate fund type. Right after the adoption of real estate funds into "The Capital Markets Act," real estate lease and real estate loan were the two largest investment types, 45% and 41% of the total number of newly authorized funds respectively. Real estate lease is a fund that invests in income-producing real estate where revenue is generated from real estate rent to give back to investors. At the end of a fund's life, additional dividend can be distributed from capital gains from sale. Real estate loan is a fund that lends money to real estate owners and operators through loans to profit from interest to give back to its investors.

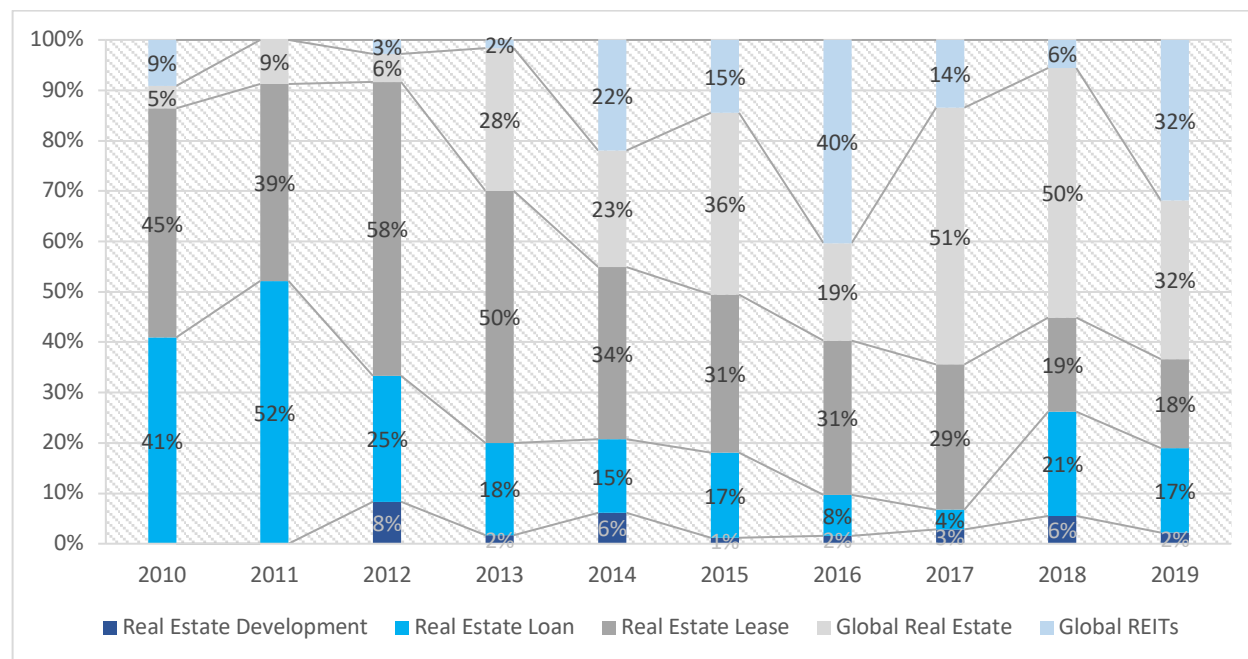


Figure 2-17 Number of newly authorized REFs by weight

Source: (KG Zeroin, 2020)

Looking at the trend, there was a decrease in real estate loan funds from 2011. This was due to an economic downturn when the number of developments looking for project financing decreased and market demands for stable income from real assets increased. Additionally, returns of real estate funds during this time show that returns for real estate loan funds have continued to drop whereas real estate rental funds have kept their returns relatively stable. The number of real estate lease funds increased in 2012 and continued to be the largest weighted type until 2014. From 2013, real estate loan funds entered a stagnant period. Since 2013, the number of global real estate funds started to increase rapidly due to large investment capital from institutional investors looking for new investments outside the country to diversify their portfolio and hedge portfolio risk.

A real estate development fund is a fund that develops the property by itself and gains profit by lease or reversion. When real estate funds were under the jurisdiction of “The Indirect Investment Asset Management Business Act,” a real estate fund could not invest more than 30% of total assets in developments so development funds were rare. After 2009 when real estate funds were absorbed into “The Capital Markets Act,” development funds were no longer subject to the limit. Even so there were few development funds established in the market. Since 2017, asset management companies began to establish development funds, which can be interpreted that the market competition for investment assets is high and investors are in search for diverse means to invest their money.

Chapter 3. Possible Market Improvements

From the market analysis of the previous chapter, the Korean indirect real estate investment market has limits and a number of obstacles to clear to become a healthy and vibrant market. Especially, Korean REITs can be said to be still in their early stage of development as the listed REITs market is yet to be activated and achieve its purpose as a stable means of investment in real estate. In this chapter, the development growth of REITs in Asia will be traced, countries that have successfully activated REIT sector in their market. These markets will be examined to see what were the driving forces of a REIT development, market obstacles, and characteristics of REITs that have made vibrant REIT sectors in their respective markets. Finally, possible market improvements for the Korean indirect real estate market will be discussed.

3.1 Real Estate Investment Trusts in Japan and Singapore

REITs were introduced in Asia in the early 2000s with Japan in the lead with two J-REITs launched in 2001 and followed by Singapore that launched its first S-REIT in 2002. Both countries have introduced REITs at a similar time as Korea, but have been more successful in activating REITs in their markets. As of December 2019, Japan has 64 J-REITs listed on the Tokyo Stock Exchange and 43 S-REITs listed on the Singapore Exchange, whereas Korea has only 7 REITs listed on the Korean Exchange.

3.1.1 Japan

History

Japan introduced REITs in September 2001 with its first J-REITs, Nippon Building Fund and Japan Real Estate Fund on Tokyo Stock Exchange and ever since, it has grown to be the second largest REITs market in the world. As of December 2019, total market capitalization of 64 listed J-REITs is around 182 trillion Korean won, which is about 79 times the size of the Korean listed REITs market, only 2.3 trillion Korean won. As it was in Korea, the financial crisis in 1997 caused the real estate market downturn in Japan and triggered the introduction of REITs. REITs were to provide liquidity and new capital to stabilize the troubled real estate market. (Joseph T. L. Ooi, 2006) In 2002, the tax system was revised and REITs were incorporated into the MSCI index, which increased the participation of institutional investors. From 2003, the establishment of REIT-Fund Of Fund was allowed and this led to an increase in the individual investor pool. J-REITs market was on a rise as asset prices increased and REITs generated higher yields than the low interest in Japan. Banks and institutional investors acknowledged REITs as stable means of investment and REITs rapidly became an active vehicle in Japan. Due to the impact of the global financial crisis, J-REITs market was on a downturn. Many corporations filed bankruptcy and so the government

alleviated regulations to allow REITs to invest in foreign assets and enable M&A to enlarge the size of REITs and improve their financial structure. Foreign real estate enabled J-REITs to diversify their risk and returns and M&A allowed REITs to improve the profit structure and financial fundamentals. Behind the rapid development of J-REITs was the strong legislative support from the government. The government's drive to activate the vehicle made J-REITs to grow even from the market downturn after the financial crisis.

In Japan, the indirect real estate market can be divided into equity and fixed income. Equity investments are then categorized into private equity funds, private equity REITs, and publicly listed REITs. Vehicles are clearly categorized according to their fund character and fund life. Private equity funds are finite-life vehicles whereas private equity REITs and publicly listed REITs are infinite-life vehicles. As shown in Figure 3-2, investment purposes for real estate funds and J-REITs differ and thus, having a clear distinction between the vehicles make no confusion in the market and lets the indirect real estate investment market to grow healthy and balanced.

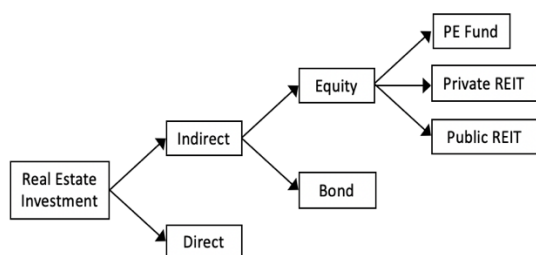


Figure 3-1 Real Estate Investments in Japan

Source: Ministry of Land, Infrastructure and Transport, KB Securities

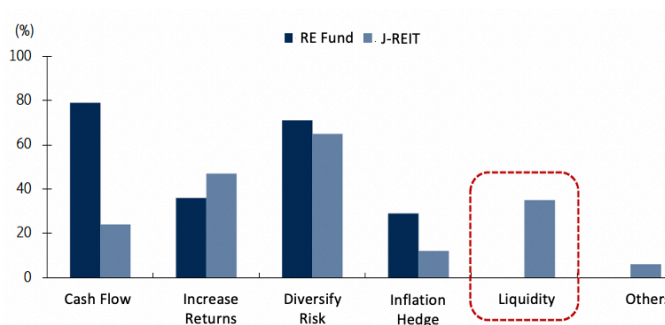


Figure 3-2 Real Estate Investment purpose of a Japanese Pension Fund

Source: ARES, KB Securities

J-REITs are allowed in the form of a corporation or a trust, but for listed REITs, if a corporation owns the asset but entrusts asset management operations to an external management company, it can be exempt from corporate tax. J-REITs enjoy this conduit tax treatment and earn revenue from rental real estate, and can only be externally managed. Furthermore, J-REITs are not allowed to conduct development by themselves, which is considered risky.

Sponsored REITs

One of the most distinctive characteristics of J-REITs is that all listed REITs are in the structure of sponsored REITs. A sponsor is an entity that forms and operates the conduit by managing the asset management company and sourcing investment assets in the pipeline. Sponsors of J-REITs are usually large real estate companies that own and develop real estate for business. They may not be the major shareholder, but they act to support REITs in providing investment assets, procuring funds, managing asset and property management companies to enhance stability and credibility of REITs. The top ten J-REITs that account for approximately 45% of total market capitalization are sponsored by major real estate developers such as Mitsui Fudosan, Mitsubishi Estate, and Nomura real estate development.

Case Study: Advance Residence Investment Corporation

In Korea, there are 132 residential REITs and the majority of them are rental housing REITs driven by the government for public purpose. Rental housing REITs in Korea have not been successful as they are formed one REIT per property, which makes a REIT short lived, susceptible to risks, and unsustainable. Japan has used REITs to effectively invigorate the rental housing market and make rental housing REITs into a stable and sustainable vehicle for people to invest in. The case of a major residential J-REIT, Advance Residence Investment Corporation, will be studied to see how it is structured and operated.

Advance Residence Investment Corporation was established in 2010 and has the largest portfolio of assets among all residential REITs in Japan. As of April, 2020, the corporation owns 271 properties, 21,415 leasable units, with total assets of 456.4 billion Japanese yen. Advance Residence Investment Corporation targets small households who have the financial ability to rent housing in city centers, especially the center of Tokyo. This is due to the expectation of high demand in rental housing from the increase in the population of Tokyo. Most housing types are single and compact housing since they are in high demand, are more efficient in management, and have higher yields. The average occupancy rate of all properties is 97.5% as of March, 2020.

The main sponsor of Advance Residence Investment Corporation is ITOCHU Group, which has an 80.6% stake in the REIT. The REIT entrusts its asset management to AD Investment Management, an asset management company owned by ITOCHU group. AD Investment Management entrusts property and leasing management to the property manager and it again outsources building management and leasing marketing to third parties. Thus, Advance Residence Investment Corporation and its asset management is dominated by ITOCHU group.

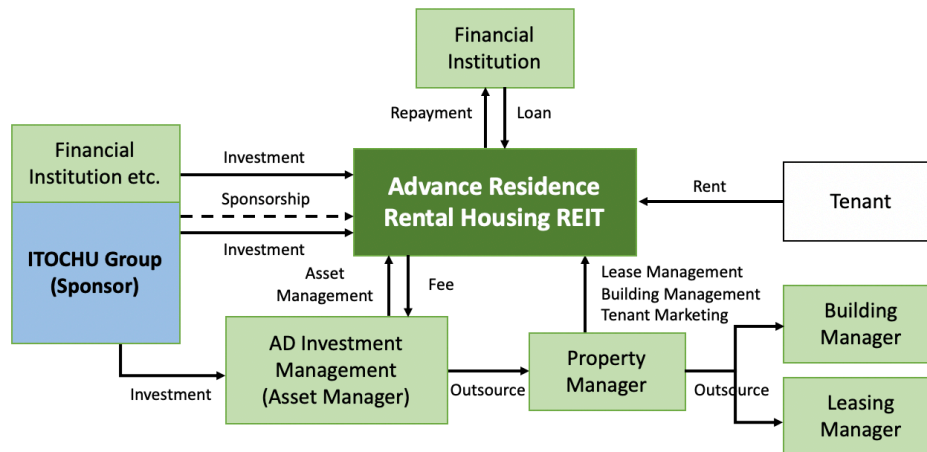


Figure 3-3 Structure of Advance Residence REIT

Source: (Advance Residence Investment Corporation, 2020)

The main advantage of a sponsored REIT is that the REIT and its asset management company can fully utilize ITOCHU group's support line companies to enable steady growth over the long term. ITOCHU support line companies, which have a wealth of real estate development know-how, plan and develop properties and offer AD Investment Management the first option to acquire their real estate. This secures AD Investment Management a preferential opportunity to acquire properties of sustained quality from ITOCHU group. The group and AD investment management also exchange information of the market such as market and tenant demand trends to develop quality properties that generate maximum profit.

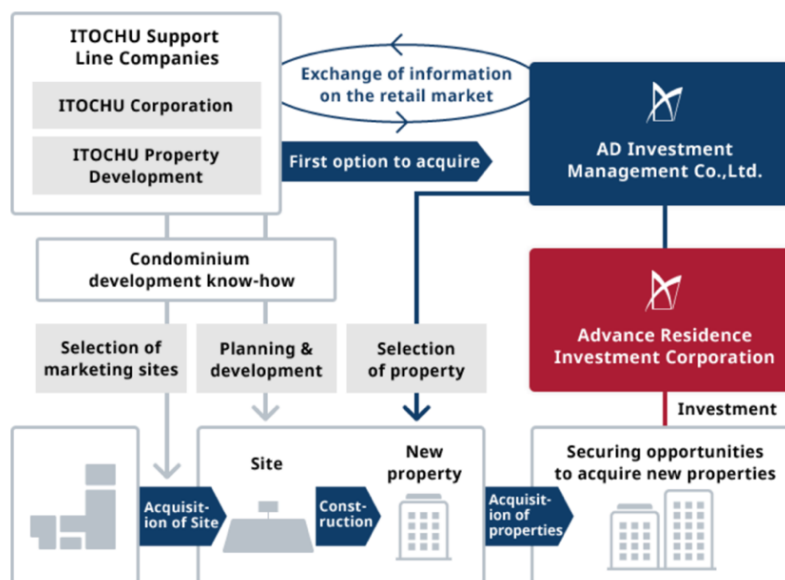


Figure 3-4 Acquisition of Properties from ITOCHU Support Line Companies

Source: (Advance Residence Investment Corporation, 2020)

Advance Residence REITs use a branding strategy to be competitive. It has created a brand called “RESIDIA” to utilize in property operations and management. This brand promotes sustained quality and efficient customer service by operating a 24-hour, 365-day tenant call center, waiving brokerage fees if the tenant moves between RESIDIA properties, providing goods for all emergencies, and ensuring certain levels of housing service quality. This strategy has been very effective in standardizing and maintaining the high quality of rental housing assets.

The case study shows that sponsored REITs can sustain the long-term management of a REIT by providing a well-functioning cycle to benefit both the sponsor and the asset management company and eventually investors of REITs. By selling its assets to REIT, ITOCHU group can ensure its sales and can reinvest the income earned to develop diverse asset types to build up its portfolio. Advance Residence REIT can benefit from a continuous supply of new assets developed by ITOCHU group and under ITOCHU’s professional management, it can enhance investors’ trust and enable continuous fund procurement.

3.1.2 Singapore

Singapore introduced REITs in 2002 with its first S-REIT, “Capital Mall Trust” by CapitaLand, which was listed on the Singapore Exchange. As of December, 2019, there are 44 REITs with total market capitalization of approximately 96 trillion Korean won. The percentage of REITs within the Singapore Exchange is about 12%, which is the largest among all global stock exchanges. Unlike Korea and Japan, the impetus for introduction of REITs in Singapore did not stem from the financial crisis, but REITs were introduced to enlarge the country’s capital market, grow the local fund management business, and benefit other areas of the financial sector. Furthermore, REITs were to provide alternative sources of funding for the capital-intensive real estate sector. REITs were an attractive vehicle to realize immediate gains and scale down their balance sheet. The structure allows them to maintain control of the properties and create a fee-based income business from managing the trust. (Joseph T. L. Ooi, 2006)

Over the years Singapore’s legislative framework has evolved to provide a pro-business and supportive regulatory environment that is well balanced between rigor and leniency. Monetary Authority of Singapore (MAS) has been very careful in setting guidelines for REITs to protect investors and unit holders while giving flexibility to new entrants with new ideas or asset classes. Upon introduction of S-REITs, they were not set up to be pass-through vehicles, which meant that funds would be taxed at a corporate level and again at the shareholder level when income is distributed. Lack of tax incentives made

REITs unappealing in Singapore as property investment yields were very low and, without tax benefits, yields would be lower. After failing the first REIT listing attempt, Inland Revenue Authority of Singapore granted tax transparency status to listed REITs. (Mapletree, 2015) In 2003, to enhance the development of the S-REIT market, MAS eased the borrowing limit for S-REITs from 25% to 35% if all their borrowings were made with a credit rating of above a single A credit. It also reduced the withholding tax on S-REIT distributions to non-individual unit holders from 22% to 20%, which was further reduced in 2005 to 10% on earnings for five years. In 2005, to develop the S-REIT market as Asia's hub, MAS introduced new guidelines to give more flexibility to asset managers. The global financial crisis was when the strength of S-REITs was shown, with their ability to deliver at least 5% of yields even during the crisis. This was largely due to the sponsorship of strong and stable companies such as Ascendas, CapitaLand, Mapletree, and Frasers. In 2015, the government introduced amendments to ensure that Singapore remains the hub for REIT listings in Asia. They included an increase in leverage limit from 35% to 45% and an increase in development limit from 10% of deposited property to 25%. MAS has also improved governance structure to protect interests of unit holders in cases of conflict. Singapore's government has developed regulations that ensure transparent management of REITs and protection of its investors to be well regarded by both domestic and international investors. The S-REIT framework has facilitated an attractive investment for foreign capital flow, because Singapore does not levy dividend income taxes on both the domestic and international investors.

Like Japan, Singapore has also utilized sponsored REITs to grow its market. S-REITs are sponsored by Government Linked Companies such as Capitaland, Ascendas, and Mapletree, large companies that every Singaporean knows of and their participation in S-REITs made REITs trustworthy and stable vehicles to invest in. Furthermore, these REITs incorporated iconic assets in the urban center with low vacancy rate and high rental income to provide stable yields. Sponsors of REITs can be categorized in five types: developer sponsors, fund manager sponsors, financial sponsors, government-related sponsors, and non-property corporate sponsors. (Tae Ri Lee, 2015) Using sponsored REITs, Singapore has rapidly grown to be Asia's REIT hub.

3.2 Possible Market Improvements

From the analysis of indirect real estate investment market in Korea, there are areas that can be improved to enhance the efficiency and vibrancy of the market. I suggest possible market improvements based on the market analysis and lessons learned from markets of comparable countries.

3.2.1 Clear Division between REITs and REFs

Market analysis has shown that REITs and REFs are similar in their economic essence, but differ in their character as REITs are more of a public-purposed vehicle made to provide stable means of investment to the public and REFs are purposed for real estate market activation. This difference in character make them subject to different authorities and legislative frameworks. Because of its public character, a REIT is subject to a more restrictive regime under “The Real Estate Investment Trust Act,” that is to protect the wealth of all shareholders including individual investors. On the other hand, a Real Estate Fund is under the regime of “The Capital Markets Act,” which is less restrictive and allows flexibility in a fund’s legislative framework.

Because REITs in Korea have been usually private, non-listed REITs, REITs and REFs have been competing to attract the same type of investors and assets. However, under different legislation, asset management companies have preferred to establish real estate funds since they offer greater flexibility. This has caused the REF market to grow much faster and larger than the REIT market, creating an imbalanced investment market. In order to activate the real estate investment market, the two vehicles should be differentiated from each other with clear roles in the market. In financially mature countries like the US and Japan, REITs and REFs are clearly divided in their roles. For example, in Japan real estate funds are private funds that have a finite life, whereas REITs can be both public and private, but have infinite fund life. Although REITs in Japan can be private, all REITs in Japan are listed to act as a public vehicle. With a clear division of roles of the two vehicles, REITs and REFs can grow in two ways to have distinctive characters that can benefit the investors, managers, and real estate market.

3.2.2 Activation of listed REITs market

The main purpose of a REIT is to provide individuals the opportunity to invest in core real estate assets with small amounts of money and to enforce the relationship between the capital market and the real estate market to raise stable funds. However, REITs in Korea have yet to achieve their purpose. Looking at the market developments of Japan and Singapore, the main driver of a successful public listing market is the support from governing authorities for deregulation of tax rules. Tax benefits are crucial in

attracting investors both domestically and internationally to grow a healthy investor pool and eventually enlarge the REITs market. To activate the public REITs market, tax benefits should be differentiated between public and private REITs. The level of tax benefits for listed REITs should be differentiated from those of private REITs and real estate funds to incentivize firms to list their REITs. In the development of J-REITs and S-REITs, government played a crucial role in activating the public REITs market by alleviating tax standards. Furthermore, diverse benefits should be provided to ease the process of mergers and acquisitions between REITs and scaling up the size of REITs.

3.2.3 Larger REITs

In order for REITs to effectively sell their story, they should be large enough to retain a portfolio of numerous and diversified assets to generate stable rental income. Different from a real estate fund, a REIT is a corporation that can easily increase its size by issuing new stocks. According to Jin and Kim (Changha Jin), larger REITs have operational efficiency in which general and administrative expenses are reduced, thus improving their profitability compared to medium firms. Furthermore, larger REITs can gain public recognition as a sound investment vehicle for individual investors. REITs with large asset bases are also attractive to institutional and foreign investors who invest above a certain asset size base.

One of the success factors of J-REITs was that listed REITs in the early stage of J-REIT market development were large in size with the support of great sponsors. Additionally, there was government support in sizing up REITs. After the global financial crisis, some of the REIT sponsor corporations experienced financial difficulties and to prevent them from defaults, Japanese government encouraged mergers and acquisitions between REITs by simplifying the process of M&A. Current listed REITs in Korea have a small asset base and they are mostly very dependent on a core asset. This can make a REIT exposed to risk as it is easily impacted by market risks, regional risks, and asset risks. REITs should continuously bring in assets that can disperse the income base to hedge risks and this eventually builds trust in the market to become a stable means of investing money.

3.2.4 Sponsored REITs

A REIT is an investment that is committed for mid- to long-term; thus, credibility is much more important than when investing in stocks. As a relatively new vehicle compared to stocks and bonds, REITs face a challenge differentiating against existing real estate stocks and real estate funds that have already been established, are more diversified and have established track records. By having credible companies as REIT sponsors, REITs can be shown to individual investors as credible long-term

investment vehicles backed by trustworthy companies. The main roles of a sponsor in REITs are sourcing funds, forming REIT investment policies and managing external asset management companies. Having a sponsor makes the fund-raising and asset acquisition process easier and, with readily established credibility with financial institutions, funds can be raised in relatively better conditions.

Singaporean REITs and Japanese REITs both are in the form of sponsored REITs and they have been the driver of a fast-growing REIT market. In Singapore, REITs are led by Government Linked Companies which provides their assets at the first of right offer, acts as a source of credit when financing, and contributes to fund-raising when issuing new stocks. Korea is a country that is led by large conglomerates. It is safe to say that they run most of big businesses that own large amounts of real estate that can provide core assets to the pipeline of REITs. Most conglomerates in Korea own securities, insurance, construction, or asset management companies, so they can use their branches to implement their know-how in managing REIT assets. With their strong brand recognition, conglomerates as sponsors can easily attract individual investors to REITs. The problem of market transparency of conglomerates and asset management companies that are 100% owned by the conglomerates can be solved by requiring a broader range of disclosure and strict policies in protecting the rights of shareholders.

4. Conclusion

Focusing on the indirect real estate market in Korea, this paper has shown that the market is still immature compared to its global peers. The current low interest rate environment and rise in housing prices due to the high level of speculation trigger the need to introduce alternative real estate investment vehicles to individual investors in Korea. From the market analysis, the two main vehicles of indirect real estate investments, Real Estate Investment Trusts and Real Estate Funds, are mostly private, customized to the need of institutional investors, limiting the participation of public capital. To divest the large amount of floating money in the market, indirect real estate investment vehicles should act as a stable and credible investment vehicle. In this point of view, market status and history of REITs and REFs are studied and, in the process, this thesis attempts to find areas for possible market improvements.

Market analysis shows that the impetus of introduction of REITs and REFs was from the financial market downturn in Korea, in an effort to provide ways of restructuring troubled corporations and providing liquidity. Policies and legislative frameworks developed from this view and thus, indirect real estate vehicles did not play a role in providing investment alternatives for individual investors. Currently REITs and REFs both exist for the private capital, their roles somewhat unclarified from each other. Between the

two, REFs are less restrictive in their legislative regime, allowing the investment entity to be incorporated into diverse forms, subject to fewer restrictions, but have tax benefits similar to REITs. Therefore, asset management companies preferred REFs over REITs since they are flexible and also more cost- and time-effective. All domestic and foreign institutional investors were attracted to REFs, converging the market towards real estate funds.

There is no doubt about the impact of a well-functioning indirect real estate market in a financial market, how it can contribute to building wealth of individuals, growing healthy industries, activating the real estate market and creating jobs. Furthermore, in the case of Korea, it can redirect the speculation amount put in apartments in Seoul to commercial real estate and reduce the amount of household debt.

To activate the indirect real estate market in Korea, there are several ways the market can be improved. First, the roles and characters of real estate investment trusts and real estate funds should be clearly defined and differentiated from each other. Real estate funds should be for the private market, as finite-life funds. Real estate investment trusts can be public and private, but should be focused on the listed market, providing easy access for individuals to invest in commercial real estate with small amounts of money. Secondly, the listed REITs market should be activated. Looking at REITs of advanced countries, the main driver of the successful listed REIT market was the government support, providing tax benefits and deregulating to give flexibility to asset management companies, but also balancing the market to protect the shareholders' interests. Benefits should be differentiated between private and public REITs to incentivize firms and investors to invest in listed REITs. Thirdly, the asset base of REITs should be larger and more diversified. A REIT should be perpetual, developing its income base by acquiring new assets to divide their income sources. A REIT should not depend on an asset or a certain type as a REIT can become susceptible to market risks. Because a REIT is a mid- to long-term investment, building a portfolio with diverse assets that can give back a stable flow of income is important in building its track record and brand recognition. Lastly, sponsored REITs can be used to build a sustainable management cycle of REITs. Sponsors can source the asset pipeline and raise funds for REITs and sponsors can have a definite source of revenue and reduce the burden in their financial statement.

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