

Research and Due Diligence for REITs

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The impact of listed securitized real estate in development markets like Australia and the US cannot be understated. REIT pricing is now affecting real estate pricing. From the property professional perspective, an open and transparent REIT market has also created many opportunities to sell services.

In an Asian context, recent developments in Japan, Singapore and, albeit to a lesser degree, Hong Kong, indicate that these markets too will be impacted by this emerging asset class.

Paul Hart of Knight Frank Petty is a chartered surveyor with a broad base of experience. He works extensively with investment banks in Hong Kong, China, and Singapore. In his address, Paul will explore the impact of REITs in developed and emerging real estate markets and how they have and are impacting the services that property professionals provide.

An update on the Regulatory Environment for Real Estate Investment Trusts

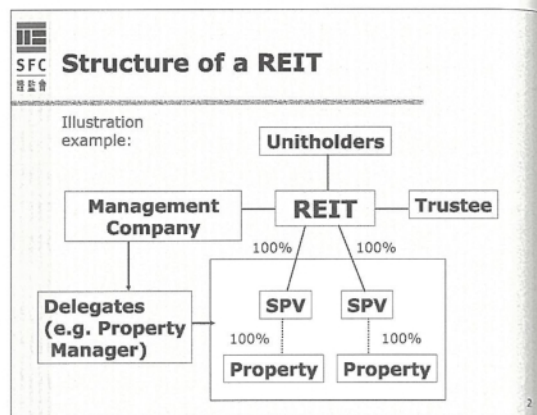
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An update on the Regulatory Environment for Real Estate Investment Trusts

Peggy Yang
Associate Director
Investment Products
Securities and Futures Commission
15 July 2006



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Regulatory Requirements of REITs (1)

- REIT manager licensed by the SFC
 - ✦ Fit and proper requirement
- Establishment of a trust
 - ✦ Trustee safeguards assets and provides oversight on the acts of the REIT manager
- Due diligence
 - ✦ REIT manager conducts due diligence to ensure proper legal title and control on the properties
 - ✦ Listing agent conducts independent due diligence

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Regulatory Requirements of REITs (2)

- Full and accurate disclosure in the offering circular
 - ✦ All material information should be contained in the offering circular to enable investors to make informed investment decision
- Timely disclosure of information
 - ✦ Announcement should be made to the public on a timely basis
 - ✦ No selective disclosure of information or leakage of price sensitive information

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Management Company – Qualification Requirements

- Licensed under Part V of SFO and approved by the SFC to manage CIS (Type 9 regulated activity)
- Possess sufficient financial, human, technical and organizational resources to carry out its duties
- Satisfactory internal controls and written compliance procedures
- 2 responsible officers each with at least 5 years of experience in investment management and/or property portfolio management
- Responsible officer must be readily contactable by the SFC

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Management Company – Responsibilities (1)

- Professionally manage the REIT in accordance with its investment objectives and policies, and in the sole interests of holders
- Maintain risk management controls and compliance mechanism in accordance with Compliance Manual
- Assess the suitability of a REIT's investments
- Conduct due diligence work
- Ensure that the REIT has proper legal title to its real estate

An update on the Regulatory Environment for Real Estate Investment Trusts

SFC Management Company – Responsibilities (2)

- Delegation – selection and replacement of property managers and delegates, audit trails, on-going supervision of delegates
- Disclosure of interest
- Maintain proper books, records and financial statements of the REIT
- Appoint an auditor for the REIT
- Implement appropriate measures to oversee and supervise overseas entities, if any

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SFC Trustee – Qualification Requirements

- REIT must be constituted as a trust and governed under the laws of Hong Kong
- A REIT must appoint a trustee which is either:
 - ❖ a licensed bank;
 - ❖ a trust company being subsidiary of a bank; or
 - ❖ a bank incorporated outside HK and acceptable to SFC
- Trustee must be independent of the management company
- Trustee must have paid-up capital and reserves of at least HK\$10 million

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SFC Trustee - Responsibilities

- Ensure that assets of the REIT are properly segregated
- Take reasonable care to ensure that investment/borrowing limitations set out in the trust deed are complied with
- Annually report to holders whether in its opinion the management company has managed the scheme in accordance with the trust deed
- Take reasonable care to ensure that a scheme has proper legal title to its real estate assets

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SFC Property Valuer – Qualification Requirements (1)

- Every authorised REIT must appoint a Principal Property Valuer ("PV") to value a REIT's properties once a year
- PV must be a Hong Kong qualified valuer with sufficient financial and human resources
- PV must be independent of the REIT, its Management Company and its Trustee

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SFC Property Valuer – Qualification Requirements (2)

- PV may engage an overseas agent to conduct the valuations on overseas properties but the PV must certify the relevant valuation reports
- Retirement of the PV after 3 consecutive years, and the same valuer may only be reappointed after another 3 years


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SFC Property Valuer - Responsibilities

- To value all real estate held by a REIT once a year and produce a valuation report on specific real estate as and when required, such as a property to be acquired or sold, or when new units are offered by a REIT
- To adhere to and consistently apply the valuation methodology in the guidelines published by the Hong Kong Institute of Surveyors or International Valuation Standards
- PV is ultimately responsible for the valuation for all properties held by a REIT


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An update on the Regulatory Environment for Real Estate Investment Trusts

 **Property Valuer – Content of a Valuation Report**


- Basis of valuation and assumptions used
- Valuation methodologies adopted
- Market research and study
- Particulars of property
- Independent status of valuer
- Justification of valuation methodology adopted and assumptions used
- Rationale for choosing particular methodology if more than one method is adopted

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 **Listing Agent – Qualifications and Responsibilities**


- Must possess experience and expertise in conducting and managing IPOs in Hong Kong
- Responsible for the overall management of the IPO of a REIT
- Conducts its own due diligence in an independent manner
- Joint listing agents may be engaged and such agents are jointly and severally responsible and liable for their work
- Where more than one listing agents is appointed, one of them must be designated to communicate with the SFC

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 **Auditor – Qualifications and Responsibilities**

- Must be qualified under the Professional Accountants Ordinance for appointment as an auditor of a listed company
- Must be independent of the management company
- Must apply same accounting principles in auditing a REIT, regardless of whether they invest locally or overseas
 - ❖ either complies with HKFRS or IFRS

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 **SFC authorised REITs – Special Product Features**

- Management Company has to comply with the general principles in the Code of REITs
- Examples are:
 - ❖ Remuneration of Management Company paid in REIT Units
 - ❖ Additional layers of SPVs
 - ❖ Interest rate swaps
 - ❖ DPU guarantee
 - ❖ Distribution entitlement waiver
- Must demonstrate these arrangements are deployed in the interests of unitholders
- Must clearly communicated to investors by disclosure in the offering documents

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Valuation Approaches to Assessing the Fair Value of New REIT Issues

Kam-Hung Yu
FHKIS, FRICS, RPS(GP), FHIREA

What is Fair Value?

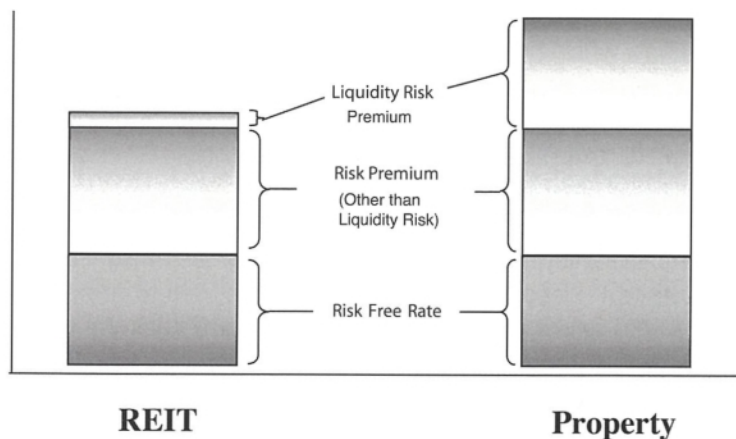
The expression "Market Value" and the term "Fair Value" as they commonly appear in accounting standards are generally compatible, if not in every instance exactly equivalent concepts. Fair Value – an accounting concept – is defined in International Accounting Standards and other accounting standards as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. Fair Value is generally used for reporting both Market and Non-Market Values in financial statements. Where the Market Value of an asset can be established, this value will equate to Fair Value. Where the Market Value of an asset cannot be established, its value is arrived at using a term such as Depreciated Replacement Cost (DRC).

Fair Value of Property vs. Fair Value of REIT

In property valuations individual assets are appraised and valued separately by a qualified real estate surveyor who deals solely on the net asset worth. REIT valuations cover the value of the whole business entity, including the intangibles that go along with the business, and this is commonly assessed by investment bankers, financial analysts or any qualified business valuer. The Fair Value of properties may not be equal to the Fair Value of the REIT that holds the properties.

On liquidity, REIT investments are more liquid than property investments. Therefore, property valuations are considered to have a higher liquidity premium when compared to REIT valuations (see figure below).

Discount Rate



In Hong Kong, the REIT Code limits the loan ratio to 45% of the total asset value. This is much lower than the typical loan ratio for commercial properties of 50% to 70%. This fact affects the risk and thus should be taken into consideration when deciding the discount rate to be adopted in the valuations applying the methods as introduced below.

In brief, risks (i.e. lower loan ratios) and liquidity profiles of a REIT are different from its underlying properties.

Valuation Approaches to Assessing the Fair Value of New REIT Issues

The discount rates applied for REIT valuations should not be the same as those applied to property valuations. Adjustments to the latter have to be carefully made to reflect the actual situation.

REIT Valuation Methodologies

Typical and popular methods utilized in valuing individual properties such as the direct market comparison approach and the depreciated replacement cost cannot be relied upon because, in REIT, you are valuing a business entity and not an individual property or fixed asset. In addition, and assuming that all other things are equal, e.g. loan ratios, these methodologies do not recognize superior management abilities, do not consider the effect of diversification of the whole portfolio, and fail to measure intangibles such as, but not limited to, distribution networks, supreme managerial power, monopoly/oligopoly, implied call option for additional assets, etc.

The two most appropriate methodologies in valuing REITs are the Dividend Discount Method and the Free Cash Flow Method: both are derivatives of the Income Approach.

In the Dividend Discount Method, expected dividends are discounted using an appropriate discount rate. In Hong Kong, the REIT Code requires at least a 90% payout ratio. As dividends become highly predictable, it makes sense to use this method of valuation.

The Free Cash Flow (FCF) Method discounts the free cash flows rather than the dividends with an appropriate discount rate. It is normally expected that the difference between dividends and the FCF for a REIT should be small. However, the REIT Code requires that the payout ratio be based on the earnings, not on the FCF. In case that the FCF is higher than the earnings, the management of the REIT may opt to retain the excess portion.

Unlike in property valuations, which normally isolate each asset and ignores intangibles such as superior management skills, the above two methodologies can be applied to the whole REIT and reflect the superior cash flows due to superior management skills. In addition, the cash flows should be projected to reflect factors due to other intangible assets.

An alternative methodology in REIT valuations, the Yield Spread Analysis, should also be considered. Yield Spread Analysis compares the yields of REIT with other financial investments, such as yields of government bonds, corporate debentures, etc. This method is used to compare yield spread, rather than the values. A REIT is like a bond but with growth potential. We can use the Yield Spread Analysis to compare a REIT and a bond, and the yield spread may be positive or negative, depending on whether the growth potential can offset the risk differential.

Feedback Effect to Property Market

A lot of institutional investors such as funds and insurance companies are originally restricted from directly investing in real estate. Through the REIT structure, however, these investors can now tap their funding into the property market. In fact, a high demand for REITs has already rippled through the property market. In Japan, the yield of the high-end properties dropped gradually following the introduction of REIT in the country. This was probably due to a number of investors rushing to acquire properties, perhaps with the purpose of forming REITs in the

Valuation Approaches to Assessing the Fair Value of New REIT Issues

future. With the higher valuation of REITs compared to the property valuation, we envisage that the same process is likely to occur in Hong Kong.

Snapshot of major holdings by North American & European Institutional investors

| Market | Institution name | Origin | REIT name | % holding | Date |
|--------|---------------------------------------|---------------|---------------------------------|-----------|-------------|
| HK | The Children Investment | UK hedge fund | The Link REIT | 18.35% | 8/12/ 2005 |
| HK | Deutsche Bank | German bank | The Link REIT | 5.05% | 7 /12/ 2005 |
| HK | Stark Investment | US hedge fund | Prosperity REIT | 8.05% | 23/12/ 2005 |
| HK | Prudential Plc | UK insurance | Prosperity REIT | 4.89% | 23/12/ 2005 |
| Japan | The Bank of New York | US bank | Japan Retail Fund Investment | 2.25% | 31/08/2005 |
| Japan | AIG Star Life Insurance | US insurance | ORIX JREIT | 2.50% | 31/08/2005 |
| Japan | AIG Star Life Insurance | US insurance | Japan Retail Fund Investment | 1.99% | 31/08/2005 |
| Japan | AIG Star Life Insurance | US insurance | TOKYU REIT | 3.26% | 31/1/2005 |
| Japan | AIG Star Life Insurance | US insurance | Japan Prime Realty Investment | 1.93% | 30/6/2005 |
| Japan | American Life Insurance Company GAL | US insurance | Japan Retail Fund Investment | 0.91% | 31/08/2005 |
| Japan | American Life Insurance Company GAL | US insurance | ORIX JREIT | 2.09% | 31/08/2005 |
| Japan | American Life Insurance Company GAL | US insurance | Nomura Real Estate Office Fund | 2.31% | 31/10/2005 |
| Sing | The Capital Group Companies, Inc. | US | Suntec REIT | 6.14% | 15/11/2005 |
| Sing | The Capital Group Companies, Inc. | US | CapitaCommercial Trust | 10.23% | 23/11/2005 |
| Sing | T. Rowe Price Associates, Inc. | US | Mapletree LogisticsTrust | 5.97% | 21/12/2005 |
| Sing | Schroders Investment Management Group | UK/US | Fortune REIT (Singapore) | 7.25% | 24/11/2005 |
| Thai | Lehman Brothers Securities, (HK) | HK/US | CPN Retail Growth Property Fund | 0.48% | 08/11/2005 |
| Thai | Laxey Partners | UK | CPN Retail Growth Property Fund | 0.48% | 08/11/2005 |

Source: Company disclosure, CBRE Research. Note that the list only captures the holders of the REITs on a particular date and is not a complete list of overseas institutional investors in REITs.

JAPAN – REIT Transactions

MAJOR REIT-RELATED ACQUISITIONS IN 2005

Exchange Rate: US\$1 = JPY118.03

| REIT / Buyer | Property | Approximate Price US\$ | Sector |
|----------------------|---------------------------------------|------------------------|-----------------|
| JRE | Ginza Sanwa Building | 158,000,000 | Office / Retail |
| Nippon Residential | Portfolio of 7 residential properties | 190,900,000 | Residential |
| New City Residence | Portfolio of 9 residential properties | 122,200,000 | Residential |
| Tokyo Reit | Picasso 347 (60% ownership) | 138,200,000 | Retail |
| JRE | Jusco City | 115,600,000 | Retail |
| JRE | Kitanomaru Square | 719,300,000 | Office / Retail |
| Global One | TK Minami Aoyama Building | 308,700,000 | Office |
| Global One | Ginza First Building | 114,300,000 | Office |
| Nippon Building Fund | Yamato Semei Building | 538,000,000 | Office |

Valuation Approaches to Assessing the Fair Value of New REIT Issues

SINGAPORE – REIT Transactions

MAJOR REIT-RELATED ACQUISITIONS IN 2005

Exchange Rate: US\$1 = S\$1.66

| REIT / Buyer | Property | Approximate Price US\$ | Sector |
|-------------------|---------------------------------------------------|---------------------------|-----------------|
| Suntec REIT | Park Mall | 140,200,000 | Retail |
| CapitaCommercial | HSBC Building | 92,700,000 | Office |
| CapitaMall Trust | Sembawang Shopping Centre | 47,600,000 | Retail |
| Ascendas (A-REIT) | Pacific Tech Centre | 37,800,000 | Retail |
| Ascendas (A-REIT) | Telepark, Kim Chuan | 192,900,000 | Industrial |
| | Telecommunication Complex, Ka Centre, KA Place | | |
| CapitaLand | Parco Bugis Junction | 343,700,000 | Retail |
| Prime REIT | Wisma Atria (74%), Ngee Ann City (27% stake) | 771,000,000 | Office / Retail |

HONG KONG – REIT Transactions

MAJOR REIT-RELATED ACQUISITIONS IN 2005

Exchange Rate: US\$1 = HK\$7.76

| REIT / Buyer | Property | Approximate Price US\$ | Sector |
|--------------------|-------------------------------------------|---------------------------|------------|
| Macquarie Goodman | Dynamic Cargo Centre | 83,800,000 | Industrial |
| Macquarie Goodman | Fountain Set Building 1 and 2 | 59,310,000 | Industrial |
| Macquarie Goodman | Tsuen Wan International Godown | | |
| | Lung Wah International Godown | 12,200,000 | Industrial |
| Macquarie Goodman | Evergain Plaza, Kwai Chung (62% stake) | 146,100,000 | Industrial |
| Macquarie Goodman | Wilson Logistics Centre, Kwai Chung | 30,700,000 | Warehouse |
| Macquarie Goodman | Global Gateway (Lower Portion) | 73,500,000 | Industrial |
| Mapletree Logistic | Ever Gain Building, Shatin (54% stake) | 37,580,000 | Industrial |

Valuation Approaches to Assessing the Fair Value of New REIT Issues

Conclusion

Although REITs comprise of property portfolios, they are in fact corporate entities, and thus require considerable thinking of its business features when doing REIT valuations. The traditional property valuation methodologies are considered unusable and as such have limitations when trying to arrive at an opinion of the Fair Value.

REIT can improve liquidity of property assets and tap the additional funding from capital markets to property markets. This in term affects the Fair Value.

Overall, the intangible values of a REIT are worth the attention of REIT investors.



A Building Surveyor's Role in REITs

Raymond Chan

FHKIS, FRICS, RPS(BS), Authorised Person

Recently, Real Estate Investment Trust (**REIT**) becomes a very hot investment product in Hong Kong. Popular REITs like "The Link REIT" and "Prosperity REIT" have been launched in the local stock market for nearly half a year and are welcome by both local and oversea investors. REITs are also of interest to those listed property companies and funding companies. Many large property developers are planning to set up REIT by re-organizing some of their owned properties.

REIT generates income mainly through rental income from a sizable property portfolio. The property portfolio in REIT may comprise of various kinds of properties including commercial buildings, residential buildings, shopping malls, car parks, industrial buildings, etc. In order to maintain a reasonable income and return for investors, a professionally-managed property portfolio in REIT is requisite. To achieve this, professional input in the following tasks are required for REIT:

- Setting up REIT and Properties Acquisition
- Value Enhancement
- Running and Operation

Building Surveyor, a building professional for both new and existing buildings, takes important roles in the above tasks for REIT.

Setting up REIT and Properties Acquisition

Acquisition of quality properties with relative high yields is one of the critical elements for the success of REIT. Every acquisition in REIT must be gone through a "Due Diligence" process by professional advisors so as to minimize the risks to its investors. What is meant by "Due Diligence" in the process of property acquisition? Simply speaking, it means the diligent checking carried out by some professional advisors before acquisition so as to determine that the conditions of the property conform to what has been said by the sellers and of good title. The professional advisors can be lawyer, accountant, surveyor, engineer, etc.

During the "Due Diligence" process, Building Surveyor acts as a building expert and professional advisor to perform the following professional works in property acquisition in REIT:

(I) **Property Title** - Acquisition of properties with good title is important and otherwise the transaction may subject to dispute or legal proceeding. Building Surveyor, who familiar with the local building control system and statutory requirements, can carry out on-site inspection to check the building "diligently" in respect of the following:

- Any existence of unauthorized building works against the latest approved building plans and structural plans;
- Any non-compliance of usage against the occupation permit, outline zoning plan, lease conditions, DMC, latest approved building plans, etc.
- Any non-compliance of current regulations in force.

Building Surveyor can compile a professional report summarizing the findings and recommendation on the remedial actions, priority and time and cost involved for the legal advisor and the REIT operator's decision making in the acquisition process.

A Building Surveyor's Role in REITs

(II) Building Condition - A building of poor condition may involve big money for repair and maintenance cost which should be considered during the acquisition process. Building Surveyor here acts as a "Building Doctor" to carry out condition survey to the targeted building and identify defects like structural cracks, building settlement, water seepage, roof leakage, window detachment, debonded tiles and other defects of building services installation, etc. and review all maintenance record and relevant available documents. The REIT operator should be alarmed for those defects of prime concern to public safety.

Again, the Building Surveyor can compile a condition survey report summarizing the findings and recommendation on the repair/remedial works, priority and time and cost involved for the REIT operator's decision making in the acquisition process.

(III) Building Measurement - The seller's area figures for property transaction is unclear and inconsistent in the local market and the system for standardization is still subject to further discussion currently. Building Surveyors are expertise in building measurement by their professional knowledge of the definition of different areas categories which are commonly recognized like gross floor areas, saleable floor areas, lettable floor areas, etc.

Building Surveyor can carry out site measurement to the properties so as to verify the sellers' area figures. This in fact affects the acquisition price if a significant difference noted after the site verification on the seller's area figures.

(IV) Boundary Survey - Building Surveyor also can coordinate with Land Surveyor to carry out boundary survey of a building lot to check any infringement to its adjacent lot or crown land. Remedial actions with time and cost involvement can be suggested for REIT operator's decision making in case of any infringement identified in the survey.

During the "Due Diligence" process as mentioned above, Building Surveyor takes important roles in assisting REIT operator's decision making in acquisition of property.

Value Enhancement

Another critical element to the success of REIT is how to enhance the value of properties in the portfolio and hence increase the income to its investors. Some buildings may be under value at the time of acquisition. Their value can be significantly increased after some "changes".

Building Surveyor, a "Cosmetician" of existing buildings, can make the "changes" through applying his professional skills in the following aspects:

(I) Renovation/Fitting-out Works - Comprehensive renovation and fitting-out works can upgrade the image and class of the building and hence enhance its value. Many success cases like shopping malls of Telford Plaza and Tuen Mun Town Plaza which have been treated with renovation and fitting out works so as to upgrade their image and class and hence increase the rental income. The Link REIT also planned to carry out comprehensive renovation and fitting out works to their shopping malls in the near future in order to increase the rental value of its property portfolio.

A Building Surveyor's Role in REITs

(II) Enhancement of Efficiency/Space Planning - Re-planning of the building layout and space is also paramount in value enhancement. For example, improvement of vertical circulation, rearrangement of the internal corridors and re-sizing of shop areas in shopping mall may enhance the customer flow and hence increase the rental value. For some properties with surplus plot ratio because of height restriction or other reasons at the time of development, additional floor areas may be obtained through formal submission of alteration and addition works proposal to Building Authority for approval.

(III) Change of Use - The property market changes rapidly and some types of building may be under value due to lack of demand. However, these buildings may be "reborn" after change of its existing use to a new use that caters the market demand if relevant statutory requirement can be complied for such change of use. Mong Kok Computer Centre is one of the successful examples. Recently, due to the economic reform in Hong Kong, the conversion of office building into hotel to meet the demand of increasing traveler from Mainland China to Hong Kong is another typical example. Such change of use can prolong the economic life and enhance the value of a building.

(IV) Improvement of Accessibility - The value of building may also be affected by its accessibility. The rental value of a shopping mall situated on top of a MTR station must be higher than a similar one which can be accessed by bus or minibus only. To promote the convenience and accessibility of a building, improvement works such as connection works to nearby MTR or KCR station, linkage to nearby bridge and tunnel, etc. can be an alternative way to enhance the building value.

Building Surveyor can tailor-make renovation/improvement plans, carry out feasibility studies, recommend investment cost and payback period, prepare detailed time schedule, phasing of works, etc. and then implement the renovation/improvement plans from inception to completion.

Running and Operation

Since REIT is a long-term investment product, the property portfolios in REIT need to be run and maintained in a good state. In order to maximize the income for investors, the REIT must keep its running cost and maintenance cost that are value for money. Here Building Surveyors can apply their skills in the following professional works:

(I) Energy Saving Schemes - Building Surveyor can give professional advice on various energy saving schemes by reviewing the energy consumption of existing lighting installation, air-conditioning system, lift and escalator installation and other building services installations in order to reduce the electricity cost. Feasibility study on the "before" and "after" electricity cost and payback period on the investment cost of energy saving schemes, and implementation of those adopted schemes can be executed by a Building Surveyor.

(II) Planned and Preventive Maintenance Program - To maintain the building elements and building services installation of the property portfolio in REIT in a good state and minimize the maintenance cost, Building Surveyor is the expert in preparing and implementing planned

A Building Surveyor's Role in REITs

and preventive maintenance program designed for those properties in REIT. The program should include the routine maintenance works and planned maintenance works in respect of the maintenance cycle of building elements and building services installations. With a well-planned maintenance scheme, the physical life of building can be prolonged. Those unnecessary maintenance and repair works can also be avoided.

The Challenge and Opportunities Ahead

With the economy is experiencing upturn in Hong Kong, the REITs market shall grow and become more mature in the near future. Building Surveyor, a building professional and expert for both new and existing buildings, should well prepared for the challenge and opportunities ahead.

What makes a successful REIT and Why is Asset Management Important

James Clark
National Director

Property Asset Management, Jones Lang LaSalle

REIT and Success
The Importance of Asset Management

15 July, 2006

JONES LANG LASALLE

Some discussion topics with a focus on Hong Kong and PRC

- Successful REIT's
 - Greater China...how are we tracking
 - Australia...a little bit of history
- What makes a successful REIT
 - Yield or share price
 - A or B grade assets
 - What class of asset
- Why is Asset Management so important
 - Different way of thinking
 - Are we managing for the investor
 - Where are the investors coming from
 - What do they expect
 - What happens if it all goes wrong

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How are we going in Hong Kong

- Current state of play
 - Current performances
 - Is it good to have a high share price or a high yield....Why
 - Investment Criteria
 - Have we enough education ?
 - What type of education do we need and who needs this education ?

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The Australian Market (a little history)

- We all must start somewhere
- Mid 1970s
- Currently over 40 LPTs trading on the ASX, capitalized at over AUD\$50b. Grew from AUD\$11b in Dec 1994
- 2nd largest REIT market in the world (not for long)
- G.P.T (first LPT....3 assets ...AUD 6million)...now approx AUD 7 billion
 - Share price on IPO = AUD 1\$...as at end of June AUD 4.07...Yield 8 to 11 % Total Return

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The Australian Market

- Weight of Money:
 - Australia's managed fund are approx A\$800b and are forecast to grow to about A\$1.5trillion by 2015.
 - Australian managed funds pass \$1 trillion mark
Helen Westerman
The Melbourne Age June 20, 2006
- Sectors
 - Investment in alternative sectors such as tourism and aged care will grow.
- Offshore
 - Superannuation money and a limited domestic market will see the push to invest offshore continue.
 - As Asian property markets mature and become more transparent, demand from Australian investors will grow. This as we know is already well underway

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The Australian Market

- Population
 - Australia's ageing population will see a continued desire for highly liquid, high yielding investment vehicles.
- Population Australia
 - 20 Million, currently 9% Superannuation (MPF) is compulsory
- Returns
 - 7 - 11% total return

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What makes a successful REIT and Why is Asset Management Important

REIT and Success

1. Key issues
2. Role of promoter, trustee & regulator
3. Evaluating & pricing risk
4. Gearing
5. Asset Management
6. Assets



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1. Key issues

Background

- Asian markets now generally sustaining post 1997 recovery
- Inconsistent transparency, ownership and access
- Real estate markets maturing from local business to regional and in some cases ones with global dimensions
- Dynamic start to Asian REIT markets
- Investors seeking professional and indirect access to growth markets
- Cross border REITs now launched and trading
- More coming
- Issues and difficulties



The Development of REITs

- **Drivers**
 - Opportunity to sell and re-inject capital
 - Inadequate listed sector for this type of product
 - Success and growth of early Asian REITs
- **Perceived advantages**
 - Provide all (or most) benefits of real estate investment to the shareholders
 - Access
 - Diversification effects
 - Competitive yields ?????
- **Challenges**
 - Inconsistent regulations and legal system
 - Management in overseas property market
 - Multiple sets of professionals and cross-border coordination (legal & tax advisors, investment bankers, auditors and other due diligence professionals)
 - Tax system sophistication
 - Currency instability



Solutions

- Matching of listing currency and operational currency
- Strong sponsor backing
- Potential investor education
- Experienced asset management
- Tax exemption & tax transparent



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2. Role of promoter, trustee & regulator

What makes a successful REIT and Why is Asset Management Important

Promoters

- Critical to success
 - Increasing number of global and regional players
 - Credibility and confidence to owners
-
- Confidence and experience to solve legal and tax issues
 - Integration of real estate to financial markets
 - Articulate REIT return and risk to other asset classes



Trustees

- Part of a sales / marketing vehicle
 - Track record
 - Administrative oversight in less transparent markets
-
- Confidence that delegation of duties appropriate
 - Oversight of investment (and re-investment) strategy
 - Operational integrity



Regulators

- Experience / speed / certainty
 - Minimize administrative burden in authorization and IPO
 - Balance interests of trustees and fund managers
-
- Permits flexibility
 - Specific protections (eg leverage)
 - Balancing transparency, disclosure, conflicts and good corporate governance



Regulators

- Beware of REIT rumours
- Due caution: The Securities & Futures Commission advises investors to read the announcements of real estate investment trusts or listed companies before making an investment decision.
- Some media reports on real estate investment trusts contain unconfirmed information, the Securities & Futures Commission warns, adding that investors should always read the announcements of the real estate investment trusts or the listed companies before making an investment decision.



SFC raises bar on reit applications

Avoid concerns over market manipulation, watchdog places stricter conditions on firms seeking to tap demand for trusts

SFC has issued a new set of rules for REITs, requiring applicants to provide more detailed information on their business plans and financials. The rules also require REITs to have a track record of at least two years in the real estate market before applying for listing.

The SFC is also requiring REITs to have a minimum net asset value of HK\$1 billion at the time of application. This is a significant increase from the previous requirement of HK\$500 million.

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3. Evaluating and pricing risk



What makes a successful REIT and Why is Asset Management Important

Real Estate Issues

Geographical (logistics)

- Pricing market inefficiency and non-transparency
- Lack of local experience
- Lack of reliable data and comparative transactions
- Currency risk

By asset class (eg Hotels)

- Management control and standards
- Branding
- Sector specific volatility and non real-estate risks (eg SARS)



Real Estate Issues (con't)

- What types of assets
 - Growth potential in rentals
 - Asset enhancement opportunities
 - Well positioned in the specific market place
 - Lease profile
 - Capital expenditure items...need to manage
 - Under rented space
 - Change of use to increase returns
 - Allows for tenant expansion if required
 - Operational and Financial risk management



Why is Asset Management so important

- Strong REIT Management = Stability of the trust
- The Waterfall affect
- The trust is led from the top down
 - Strategies from the Chairman, CEO's, deputy CEO's etc
 - Acquisitions
 - Sales
 - Capital Structures
 - Growth areas
 - Other asset classes
 - Distributions
 - Reporting schedules etc



From the CEO to the Asset Management team

- Asset Manager (AM) drives the strategy passed on by the Chairman / CEO especially at the property level
- The assets must be worked and reworked month after month to extract the maximum returns
- AM now needs to deliver the strategy through people, processes and systems
- Good Asset Management = Good Property management
- Good Property management = Good Asset Management = Delivery of the Strategy



Examples of Policies and Procedures for good Asset Management

Asset and property management expertise

- Continuous professional training to staff
- Creation of high quality and professional service culture
- Use external consultants, advisors and service providers as appropriate if in interests of Unitholders
- Monitor / benchmark performance to international standards.
- Due Diligence process
- Open Market valuations
- Market research
- A complete understanding of the markets the trust is working within



Examples of Policies and Procedures for good Asset Management

Pro-active management and leasing

- Disciplined and efficient cost control
- Pro-active retail and commercial leasing
- Continual review of tenant mix and facility layout
- Delivery of high quality services to tenants and customers
- Active marketing / promotion - seeking additional revenue
- Efficiencies and effectiveness in staffing levels



What makes a successful REIT and Why is Asset Management Important

So why is Asset Management so important

- Pre IPO
 - Exciting
 - Road Shows
 - A job well done
 - Success
 - International Interest
 - Sale completed
 - Allocations
 - WHAT NOW



Post IPO vs. Pre IPO

- Post IPO
 - Exciting.....Long term hard work
 - A job well done.....a job well done for the life of the trust
 - Success.....not guaranteed....markets can fluctuate...how do we manage this risk
 - International Interest....need to report back to shareholders
 - Sale completed.....more coming ?
 - Reporting schedule
 - Forecasting returns
 - Managing risk



Working on Behalf of investors

- The assets now has thousands of owners so a change of thinking is required
- They want a distribution
- They rely on Asset Managers to look out for them and act in their best interest
- How much of the investment dollar is attributable to pension or superannuation funds
- Put yourself in the investors shoes...would like to invest in a stable dividend stock or a volatile stock and have to ride the market even at retirement age



Working on Behalf of investors

- Asset managers act on behalf of unit holders and must do their very best to drive the yield to enhance the distributions
- Regulators will keep an eye on proceedings
- Trustees will also monitor the manager
- Transparency is paramount
- The trust must be able forecast returns and risks through the management processes and take action to mitigate
- Asset managers carry the trust after IPO



What happens if it all goes wrong....even in a mature market



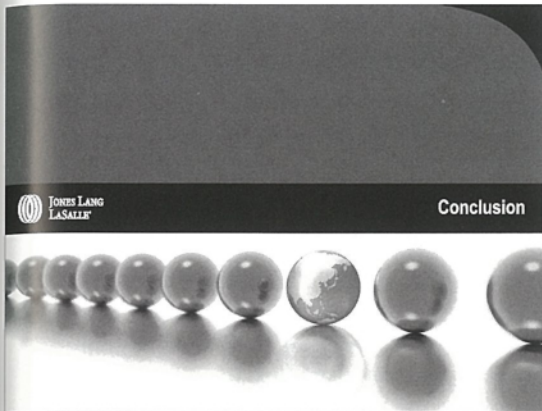
THE AUSTRALIAN

Investors burnt by asset sale loss
Paddy Manning April 25, 2006

- INVESTORS in a property syndicate managed by xxxxxx Services - Sydney - stand to lose two-thirds of their money or more than \$21.3 million after the xxxxx asset sold at a loss last week.
- In its letter xxxxxx said the poor sale price was "a result of continued issues with the tenant profile of xxxx centre, the current poor trading performance of the centre, high vacancy rates and tenant volatility and a general negativity towards the bulky goods market".



What makes a successful REIT and Why is Asset Management Important



Success Pre and Post IPO

- Right assets
- Right Capital Structure
- Right management structure
- Right position
- Good tenants
- Manageable lease expiry profile
- Transparency
- Good Asset management = Good Property management
- Must think like an owner
- Always act in the best interests of the unit holder

JONES LANG LASALLE

Future of REITs

- Global proliferation to continue
- Aging demographics
- Increasing real estate allocation
- Increasing Asian allocation



JONES LANG LASALLE

Features of Real Estate Investment Trusts, their Performance Evaluation and Distribution Policy

Richard Ho

Partner and China Industry Leader of the Real Estate and Construction Practice Deloitte Touche Tohmatsu

Features of REITs

Real Estate Investment Trust ("REIT") is, as stated in the Hong Kong's Code on REITs, a collective investment scheme constituted as a trust that invests primarily in real estate with the aim to provide returns to holders derived from the rental income of the real estate. Moreover, funds obtained by a REIT from the sale of units in the REIT are used in accordance with the constitutive documents to maintain, manage and acquire real estate within its portfolio.

There are several advantages of using REIT as a mode of real estate financing. REIT may be listed on the stock market through which funds of the general public are gathered together for specific real estate projects. Real estate projects are normally and most probably disposed of by the original owner to the REIT at values very close to the market values at the time of listing. Moreover, units in a REIT are listed securities tradable in the stock market providing liquidity to both the financial assets of the securities and the underlying physical assets of the properties. Under certain circumstances, the original owner may retain control and management rights of the real estate projects even after disposal of the properties to the REIT. There are usually preferential tax allowances for REITs in certain countries that result in higher asset return performance.

Listed real estate companies are ordinary public companies with their shares listed on a stock exchange. There are broadly two types of real estate companies. The first type comprises of property investment companies that acquire or develop properties and then retain them for rentals and capital appreciation. In other words, they invest in income-producing properties. The rental income is used to cover running costs and interest charges and to pay dividends. The market price of its shares should theoretically reflect the value of the underlying properties. The second type comprises of developers-traders that construct or acquire properties and then sell them for profits. As a result, such companies' shares tend to be priced according to their expected earnings growth.

Many people would wonder what are the differences between a REIT and a listed real estate company. They apparently appear very similar because both are engaged in real estate projects with funding that can be raised publicly through capital market. Some of the above-mentioned advantages apply to both of them. Nevertheless, if one investigates further into the nature of REIT and listed real estate company, their respective governing regulatory framework and other circumstantial conditions surrounding their operations, it would not be difficult to see that there are actually many significant differences between them.

Listed real estate companies need only to comply with listing rules of the stock exchange on which the companies' shares are traded whilst REITs have to comply with, in addition to listing rules, the Code on REITs that imposes many restrictions on, just to name a few, investing, financing and distribution policies of the REIT.

Just like other public companies, management of a listed real estate company is empowered to determine and exercise property investment and development decisions. However, management of a REIT is under very tight restrictions, as imposed by Code on REITs and its own constitutive documents, on investing merely in real estate projects providing steady returns to unit-holders,

Features of Real Estate Investment Trusts, their Performance Evaluation and Distribution Policy

on not involving significantly or even not allowed investing in real estate development ventures, and on specific categories and locations of real estate projects.

A REIT is allowed, under the Hong Kong's Code on REITs, to borrow for financing investment or operating purposes but the aggregate borrowings shall not at any time exceed 45% of its total gross asset value. A listed real estate company normally does not have any borrowing limit imposed on it other than sometimes by its own lenders.

Management of a listed real estate company also has the absolute discretion to determine the company's dividend policy - they may declare a high or a low dividend payout ratio. It has recently been reported that Hong Kong's listed real estate companies on average pay out 40% of their net profits (before property revaluation gains). On the other hand, REITs are required to pay out a significant portion of their profits to the unit-holders. As required under the Hong Kong's Code on REITs, not less than 90% of a REIT's audited annual net income after tax needs to be distributed. Because of this requirement, returns to unit-holders of a REIT are normally more steady and at a rate of 2% to 3.5% above government bonds, whilst returns to investors of a listed real estate company will fluctuate.

In countries like the United States in which REITs play an important role in real estate financing and investment, a REIT may elect, as permitted under local tax laws, to qualify for becoming a pass-through entity that distributions to its unit-holders almost of its profits and capital gains generated from disposal of its properties. The REIT does not pay taxes on its profits, but the distributed profits do represent dividend income to unit-holders and are taxed accordingly. To qualify as a REIT for tax purposes in these countries, there are usually certain asset, income and distribution requirements. However, no preferential tax allowances are usually given to listed real estate companies and therefore "double taxation" can be resulted as taxes have to be levied on both the profits generated at the company level as well as when they are distributed as shareholders.

An independent trustee is required to be appointed for a REIT. The trustee shall exercise all due diligence and vigilance in carrying out its functions and duties and in protecting the rights and interests of the unit-holders. Such appointment should be able to achieve a higher standard of corporate governance through effective oversight of the work performed by the property management by the trustee. On the other hand, major shareholder of a listed real estate company very often controls composition of the board of directors and thus functioning of the management - this may sometimes affect interests of the minority shareholders.

Performance Evaluation

There are 3 performance evaluation measures normally adopted for listed real estate companies. One may compare the market price of a listed real estate company's share to its net asset value ("NAV") per share. NAV is the total value of the assets of a company as determined by valuation of the properties minus the value of its liabilities. In general, real estate company shares trade at a discount to NAV, and the average discount to NAV varies over time as does the discount of individual companies. Possible reasons for such discount to NAV include asset management fees, taxation effects, agency costs incurred due to separation of asset ownership and management, excess

Features of Real Estate Investment Trusts, their Performance Evaluation and Distribution Policy

volatility from stock market noise arising from uninformed trading in shares and the stock market's lack of confidence in the real estate company management. The concept of trading at a discount to a real estate company's share is essential for performance evaluation of listed real estate companies because the lesser the discount be, the lesser the amount of the costs as set out above.

Someone may consider that a value should be assigned on land bank reserve possessed by real estate companies. To assess the adequacy of a real estate company's land bank reserve, one may calculate the ratio between the value attributable to the areas that will be subject to development in the near future and the market value of the company. The larger this ratio to be, the more land bank reserve the company has relative to its size.

Since real estate developers require significant sum of fund to develop their property projects, their gearing ratio is normally higher than companies engaged in other businesses. The existing high interest rate environment would certainly affect the performance of those highly-g geared real estate companies; accordingly, rising interest rate trend definitely hinders some of those highly-g geared from further expansion.

When we come to evaluate REITs, the NAV, the land bank reserve and gearing ratio may not be appropriate because of the nature of and restrictions on REITs. We have to bear in mind that the REITs are restricted by trust deed or investment guideline on level of borrowings, dividend payout ratio and other areas. When we compare the gearing ratio, it will be meaningless as the gearing ratio does not in fact represent the financing performance of a REIT but actually reflects the financing restriction imposed on it. These characteristics make us focus on different attributes of the REITs to evaluate their performance.

One of the most commonly adopted performance measures is "funds from operations" ("FFO"). Under a REIT, the dividend payout ratio is fixed in the trust deed and the investors concern on the cash flows available to the REIT for the dividend payout. When we look at the accounting profit, the ability of dividend payout may be distorted by certain non-cash income and expenses, which include depreciation and amortization of fixed assets, revaluation gain or loss on properties, and other items. The FFO is thought by some to approximate the recurring cash flows available to pay dividends. FFO can be viewed as the net operating profit earned by the REITs after adjusting for the non-cash items. The higher of the FFO represents the higher the amounts of cash on hand available for distribution to the REIT unit holders. The FFO is able to demonstrate the dividend payout capability of a REIT and it is regarded as a better and more meaningful performance measurement for REITs.

Another measure to evaluate the performance of REITs is the "dividend discount". One of the defining characteristics of REITs is the relatively large portion of the return to the investors that is accounted for by dividends, rather than through price appreciation of the units. In US, research has shown that the proportion of return provided via dividends for US REITs is approximately 65% of the total return. Price of a REIT unit can be estimated by a simple dividend valuation model with reference to the variables of dividend payout by a REIT, expected return rate demanded by the investors and the expected growth in the dividend. The investors can compare the current

Features of Real Estate Investment Trusts, their Performance Evaluation and Distribution Policy

market price against the estimated price worked out by the investors and see whether the REIT is well-performed over the expectation of investors.

Other than above, we should also consider other qualitative factors for performance evaluation of a REIT or a listed real estate company. For example, the portfolio of properties (by location and type of properties), experience of the management, and percentage of the lease maturities in any given year. These factors may indicate the future growth of a REIT or a listed real estate company and the stability of the income/dividend generated from such investment. These qualitative factors are vital for investors to evaluate the future performance of a REIT or a listed real estate company.

Distribution Policy

Management of a listed real estate company has the absolute discretion to determine the company's dividend policy - they may declare a high or a low dividend payout ratio. REITs are however required to pay out a significant portion of their profits to the unit-holders. As set out in the Hong Kong's Code on REITs, not less than 90% of a REIT's audited annual net income after tax needs to be distributed.

There have been four REITs listed in Hong Kong since the Code on REITs was issued about three years ago by the Securities and Futures Commission, and they are the Link REIT comprising of retail space and parking areas of public housing estates in Hong Kong, the Prosperity REIT owning office and industrial properties in Hong Kong, the GZI REIT holding commercial properties located in Guangzhou, the PRC and the Champion REIT owning prime office properties in central Hong Kong.

Under the trust deed of each of these REITs, distributable income is defined as the audited net profit after tax of the REIT adjusted to eliminate the effects of certain adjustments which have been reflected in the REIT's net profit. After eliminating these adjustments, distributable income may be different from the net profit prepared under Hong Kong's accounting standards.

The Link REIT's distributable income is the net profit after tax, adjusting for (1) unrealized property revaluation gains (including reversal of impairment provisions), (2) recognition of negative goodwill, (3) realized gains on disposal of properties, (4) deferred tax charges/credits arising from property valuation movements, (5) fair value gains on financial instruments, and (6) other material non-cash gains.

The Prosperity REIT's distributable income is the net profit after tax, adjusting for (1) unrealized property revaluation gains/losses, (2) impairment loss of goodwill/recognition of negative goodwill, (3) realized gains on disposal of properties, (4) deferred tax charges/credits arising from property valuation movements, fair value changes on financial instruments and tax depreciation allowances claimed, (5) differences between cash and accounting finance costs, (6) IPO costs, (7) management fees paid by issue of fund units, and (8) other material non-cash gains/losses.

The GZI REIT's distributable income is the net profit after tax, adjusting for (1) unrealized property revaluation gains (including reversal of impairment provisions), (2) realized gains on disposal of

Features of Real Estate Investment Trusts, their Performance Evaluation and Distribution Policy

properties, (3) fair value gains on financial instruments, (4) deferred tax charges/credits arising from property valuation movements, (5) expenses paid in connection with issue of new fund units, and (6) any adjustments in accordance with Hong Kong's accounting standards which increase those recorded under the PRC's accounting standards on which the accounts of cash available for distribution is based (including reversal of depreciation charge on investment properties), and (7) other material non-cash gains.

The Champion REIT's distributable income is the net profit after tax, adjusting for (1) unrealised property revaluation gains/losses (including impairment provisions and reversal of impairment provisions), (2) impairment loss of goodwill/recognition of negative goodwill, (3) differences between cash and accounting finance costs, (4) realised gains on the disposal of properties, (5) fair value changes on financial instruments, (6) deferred tax charges/credits in respect of property valuation movements, fair value changes on financial instruments and commercial building allowances/capital allowances and other tax deductions claimed, (7) management fees paid by issue of fund units, (8) IPO costs, and (9) other material non-cash gains/losses.

When these lists of adjustments are compared, it would not be difficult to spot that most of the adjustments relate to non-cash items like property revaluation gains/losses, treatment of goodwill, fair value movements of financial instruments, and deferred tax impacts resulted from non-cash items recorded in net profit. All of these adjustments are required mostly because of the new accounting standards (like HKAS 39 Financial Instruments: Recognition and Measurement and HKAS 40 Investment Property) became effective at the beginning of 2005. Most of these new accounting standards require fair value measurement on balance sheet items and the resulted changes in fair value between reporting dates be reflected as income or expenses in the income statement.

One notable adjustment necessary for the GZI REIT is the accounting standard differences between Hong Kong and the PRC. Since all properties of the GZI REIT are located in the PRC, it is obvious that the property holding vehicles need to follow the PRC's accounting standards for preparation of their statutory financial statements, which determine the amount of cash available for distribution to unit-holders. Accordingly, this adjustment has to be included for the GZI REIT whilst it is not necessary for the other three REITs which were established solely with Hong Kong properties.

Because of the perceived significant impacts from the non-cash items like property valuation gains/losses on the reported accounting profit, ones have to study the adjustments required on the accounting profit to arrive at a REIT's distributable income as set out in its trust deed in order to understand the amount of cash generated from operations which is available for distribution to unit-holders.

About this publication

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Creating Value from Real Estate Investments in China

Vivian Lam and Raymond Li
Partners
Hong Kong, Paul Hastings

The combination of China's rapid economic development and urbanizing population makes property an attractive industry for foreign investors. Broad challenges, however, such as high taxes, tenancy registration, clarity of land title and scrutiny over repatriating rental income and other funds for distribution, have discouraged some investors from buying physical real estate assets. At the same time, the central government in Beijing has clamped down on property-related lending, in a bid to cool the sector.

As a result, developers and investors alike have been looking for new and legally-robust ways to participate in the market and generate capital from PRC real estate assets.

A Pioneering Transaction

The recent and successful launch of Hong Kong's first real estate investment trust (REIT) made up solely of PRC properties has created a novel template for investors to tap the value in commercial portfolios in the country, while enjoying the benefit of the liquidity associated with investing in a listed vehicle.

After innovative legal structuring, property developer Guangzhou Investment Company (GZI), a Guangzhou municipal government entity, packaged four prime shopping and office buildings into a REIT for listing. GZI REIT Asset Management Limited, the manager, then set up a Hong Kong holding company to acquire the properties held through British Virgin Islands (BVI) special purpose vehicles and devised an asset holding structure suitable for listing via an initial public offering in Hong Kong. The listing vehicle raised US\$230 million in the process.

GZI, which sold the properties to the REIT, can use the funds to lower its gearing and increase cashflow to contribute to existing and future projects. The REIT can be used as a vehicle for divestment and GZI may offer to the REIT any suitable properties from those that GZI is developing over the next few years, helping the REIT to further expand its portfolio and investor base.

With GZI REIT as the benchmark, several similar deals now in the pipeline will help this new asset class to evolve in China.

Equally significant, by clearing various regulatory hurdles in both Hong Kong and the PRC to secure the necessary government approvals, GZI REIT has also shown other types of real estate investors in China how to minimize general risks from uncertainties over PRC tax, foreign exchange and land title issues.

Regulatory Comfort

The key to GZI REIT was creating an entirely new legal structure to overcome a range of onshore and offshore issues and comply with the requirements of PRC, Hong Kong and BVI law.

The Hong Kong Securities and Futures Commission (SFC) had revised its rules only a few months earlier to allow locally-listed REITs to invest in overseas properties. And because the test case involved China, the regulator was meticulous in examining every aspect of the transaction, leading to lengthy negotiations. (The SFC was aware that many PRC developers are keen to follow the

Creating Value from Real Estate Investments in China

GZI REIT example so wanted to set a precedent it would be comfortable following in the future.)

Satisfying the various regulatory authorities in the PRC was equally complex. For example, the structure involves unique approvals from the State Administration of Foreign Exchange for remitting distributions of funds to the foreign property holding companies. Ultimately, the regulator's sanction allows each of the four buildings in the REIT to convert their renminbi-denominated rental income into foreign currency, so that rental income from the properties can be repatriated offshore in Hong Kong dollars without undue delay, as the SFC required.

Further, to tackle potentially problematic regulatory issues concerning land title, discussions with the PRC Land Bureau were essential to ensure the timely transfer of the property titles to the offshore property holding companies and the completion of the reorganization for GZI REIT's required asset holding structure.

Meanwhile, because each property in the REIT is directly owned by an offshore BVI company, and because foreign property owners are not allowed to have any operations onshore for PRC tax reasons, an onshore PRC company had to be appointed to collect and remit rentals, and to operate and manage the buildings.

New Opportunities

While it is common for government-run entities to set market precedents in China, the various approvals granted for the inaugural China REIT will have particularly far-reaching implications on the attraction of PRC real estate for the private sector. In particular, the lessons learnt from working with both the SFC in Hong Kong and the various PRC authorities will help foreign investors negotiate with regulators on both sides of the border in a variety of property investments.

With the listing of GZI REIT, regulators and investors alike should be more comfortable that REITs with PRC properties can be structured to be sufficiently robust for foreign investors, thereby enabling more similar deals to come to the market. However, the lead time to preparing PRC property portfolios for listing remains much longer than for local property deals, and involves more intensive restructuring and overcoming more regulatory hurdles. As a result, notwithstanding keen market interests in the product, the anticipated pipeline of China REIT deals will not materialize this year, but the continued growth of the HK REIT market will come from PRC properties.

Bright prospects ahead for China REITs

Andrew Ness
Executive Director
CBRE Research, CB Richard Ellis

With the positive influence of a number of push-pull factors in play, including the credit-tightening measures targeted at the real estate market, strong interests of institutional investors and developers from local and overseas, coupled with the huge desire for income-stabilized investment products by the mainland investors, the burgeoning market of Real Estate Investment Trusts (REITs) consisting of Chinese properties is ready for take off.

Betting on further revaluation of the Chinese currency and the continued robustness of office and retail space demand underpinned by the ongoing liberalization of foreign investment rules, overseas investors have been flocking into China to snap up or develop yield-accretive commercial properties, for enhancement for their real estate funds or potentially to spin off as REITs in the overseas markets.

At the same time, the surge of overseas interests in China real estate market in effect has come to the aid of the local developers, who are under pressure to raise capital amid the restrictive credit policies adopted by the central government and are struggling to explore alternative funding source. As a result, REITs have emerged as the subject of some vigorous discussions in China recently, and many market players have advocated the establishment of a local REIT market to solve the current problems in the industry.

The Central Government has enforced stricter rules on bank loans extended to the real estate market since 2003 that began with the issue of No. 121 document, which stipulated that developers have to put in 30% of the total investment from their own capital prior to application for bank financing, a ratio that was lifted to 35% in the subsequent year. Further adding to the developers' financial difficulties were the hike in benchmark lending rate (for medium to long term loans of 1~3 years) by 27 bps to 5.76% in October 2004 as well as a new land use directive in 2005 requiring local authorities to levy tax for land that stays undeveloped for over one year. Moreover, the government may reclaim sites that remained idle for more than two years.

In spite of the market's enthusiasm toward REITs, the product has yet to find root on China's soil due to the limitations under China's present legal framework governing trust and securities products. Although the government has already promulgated the Securities Investment Fund Law back in 2003, the investment focus of onshore China funds established under the Fund Law are confined to securities traded in the stock market, and are prohibited to take positions in real estates directly.

Seizing the opportunities under the absence of a REITs framework, some trust and investment companies in China have sought to fill in this market gap by introducing REIT-like structures in the form of real estate trusts, or so-called quasi-REITs, products which proved quite popular amongst the yield-hungry retail investors, due to the lack of investment opportunities given the high stock market volatility historically and low deposit rates offered by banks with saving rate currently stand at 0.72%.

Unlike REITs, which normally invest in mature properties and pay out most of the net income in dividends, real estate trusts in China primarily are lending plays by nature, with some functioning as bridging loans to developers, and are usually tied to certain pre-identified investment project. Most

Bright prospects ahead for China REITs

of the schemes have short maturity that generally falls between 1 to 3 years. However, these real estate trusts are subject to some major shortcomings such as no more than 200 units be issued in any trust plan and suffer from low liquidity and the prohibition to advertise via public media in their offerings.

Due to the lack of proper legal infrastructure, the only viable route to set up a China REIT at present is to bundle a basket of properties for listing in overseas markets such as Singapore or in Hong Kong. The two cities are widely seen to be rivals to become Asia's regional REIT hub, with the latter having revised its regulation to allow REIT to incorporate overseas assets and raised the gearing limit to 45%; whereas the former has in last October revisited its Property Fund Guidelines, with the result of allowing partial ownership as well as easing the leverage limit further from 35% to 60% to boost acquisitions both locally and across borders.

These regulatory changes paved way for the GZI REIT, the first and the only of its kind as of today that securities China properties, being listed in Hong Kong in December 2005, which saw its share price rose 14% on the first trading date. The successful debut of the GZI REIT has set an important precedent and created a template for future China REIT listings, and expected to stimulate more followers. CapitaLand and Macquarie Bank are amongst the likely candidates to launch China REITs featuring mainland shopping malls over the short to medium term. The China Capital Holding Co., Ltd, a local asset management company, is also reportedly in the process of putting together three China REITs, with the first one involves the securitization of a RMB 6 billion-worth shopping mall which now looks to be ready to come online in 2006 at the soonest, according to the China Property Post. The company unveiled that it has engaged DBS as its underwriter and financier.

While it will be unlikely to see a true China REIT listed in the PRC over the short term horizon, it may not be a remote possibility either. The country's financial regulators are witnessed to be exploring this instrument and slowly putting in place the regulatory framework ready for the adoption of securitization in China, as highlighted by the issue of the first asset-backed securitization law, namely *The Administrative Measures on Pilot Projects of Credit Assets Securitization*, jointly issued by the People's Bank of China and the China Banking Regulatory Commission in April 2005. Although this rule has been drawn up specifically to facilitate the launch of the pilot credit asset securitizations by the China Development Bank and China Construction Bank and has its applications restricted to credit asset securitizations by financial institutions, it remains a significant milestone and permits the regulators to test water prior to approving REIT. Nevertheless, legal impediments aside, for REIT to develop and flourish in the mainland, the authorities has to revolve issues that continue to deter potential investors from entering the market such as market opaqueness, red tape, clarity of land titles, double taxation and the lack of skilled fund and property management that meet international standard. These issues, while complicated and takes time to resolve, are not insurmountable hurdles, and given the strong demand push we are witnessing at present, China REIT may no longer be a dream if the regulators recognizes the benefits it will bring to China, notably to provide an element of stability to both the securities and property market as well as to unleash jammed capital flows presently locked in the banks' savings deposits and on the developers' balance sheet.

REIT Structuring - Technical Due Diligence

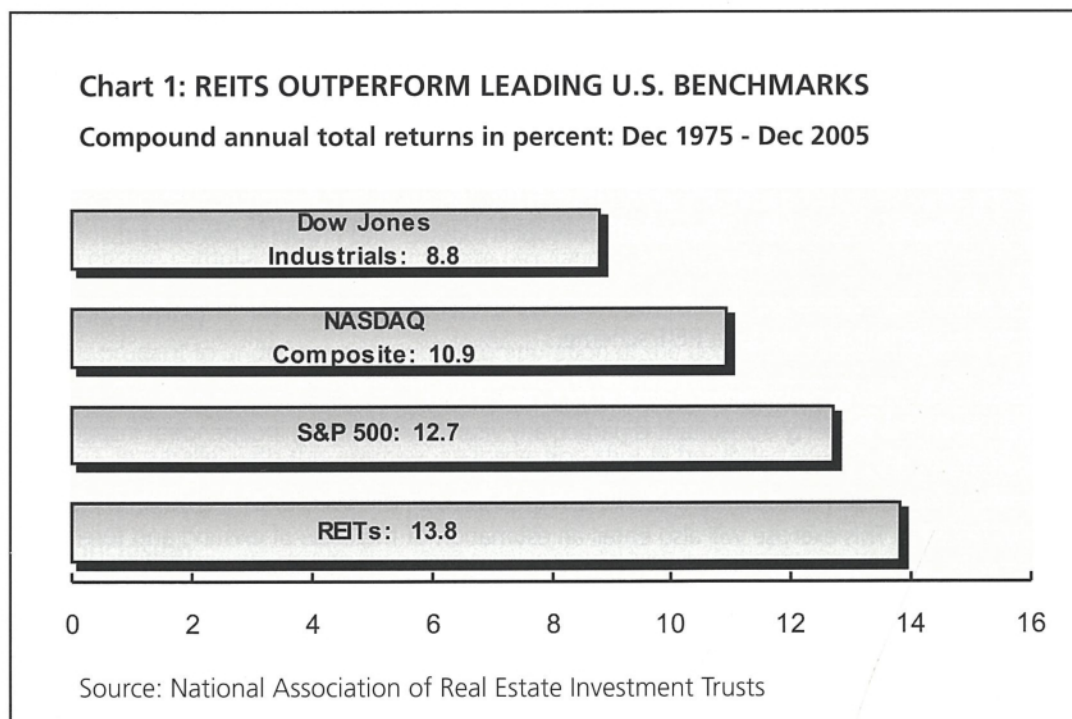
Kenny Suen
Managing Director
Vigers Hong Kong Limited

1.0 What is a REIT?

Real Estate Investment Trust (REIT) is a relatively new investment vehicle in Hong Kong which is essentially a collective investment scheme aiming to produce a source of recurring income through focused investment in a portfolio of income generating real estate assets such as serviced apartments, offices, shopping malls, warehouses, manufacturing facilities, hotels and recreational parks. There are several characteristics associated with a REIT initiative, which is often established with a clear and transparent investment strategy. The Trust pays out the majority of net income to investors by dividend distribution and there are borrowing limits and prohibitions from certain development activities.

2.0 Global REIT Market

In overseas markets, REITs have been around in the USA and Australia since 1963 and 1971 respectively. In the Asian market, the first REIT was assembled in Japan in September 2001 while that in Singapore was July 2002. In a mature market such as the USA, REITs offer attractive yields in the longer run when compared with other investment products in the securities market which can be demonstrated by Chart 1 below. The distribution of the REIT market value by countries with significant shares at the end of 2005 is illustrated by Chart 2.

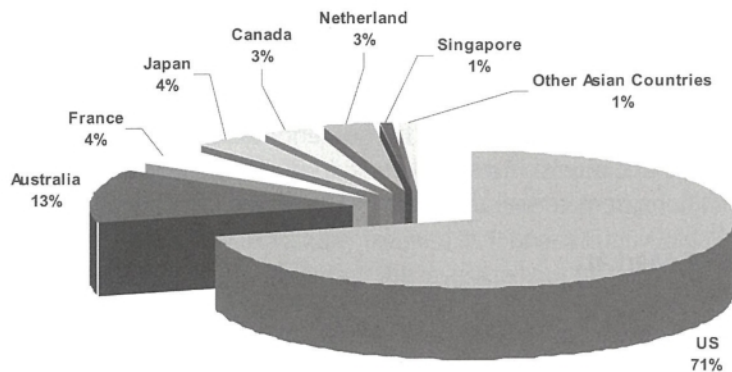


3.0 Development of REIT Market in Hong Kong

In Hong Kong, the Code on REIT was first published by the Securities and Futures Commission (SFC) in July 2003 and a subsequent revised Code was issued in June 2005. Authorized by the SFC, the "Link REIT" was the first REIT listed in the Main Board of the Hong Kong Stock Exchange in November 2005.

REIT Structuring - Technical Due Diligence

Chart 2: GLOBAL MARKET VALUE OF REIT BY COUNTRIES, 2005



The popularity of REITs as an investment product is increasing in the local market these days with investors' confidence much boosted by the impressive appreciation of the unit value illustrated by the Link REIT. In order to protect the interests of investors in publicly traded REITs and ensure that this new investment vehicle is properly regulated, the SFC has imposed a number requirements to achieve regulatory aims on listing, managing and operating the REIT. The skills and expertise delivered by the surveying profession is much needed to support the structuring and managing the REIT in the areas of offering professional services such as Market Consultant, Independent Property Valuer and Property Consultant.

The following focuses on the roles performed by Building Surveyors who are recognized as Property Consultants under a REIT scheme.

4.0 Roles of Building Surveyors - Property Consultant

The role of the Property Consultant is particularly vital in undertaking independent inspections, evaluations and assessments in relation to the physical condition of the buildings in order to confirm that there would be no material defect to impede the transfer of the target properties into the REIT. This exercise will also entail an estimation of the costs of existing and forecasted remedial works identified during the course of inspections. The disclosure of this information will enable the public investors to make an informed decision on their investments.

5.0 Technical Due Diligence

To fully appreciate the services delivered by a Property Consultant in either structuring a REIT or acquiring other assets in enlarging an existing REIT portfolio, the following outlines the most critical areas to be examined under a REIT assignment:

5.1 Structural Review

This is needed to ascertain whether there is any defect that will adversely affect the structural integrity of the building elements with reference to the Approved Structural Plans and Codes of Practice.

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5.2 Unauthorized Building Works (UBW) Scrutiny

The existing building will have to be examined to identify the presence of UBW or any other areas in contravention of the Buildings Ordinance. The use of the building has to be reviewed to ascertain any non-compliance against the approved usage allowed under the Occupation Permit.

5.3 Building Services Survey

All mechanical and electrical services have to be inspected to assess the current state of all plant and equipment against both the design and regulations requirements. Any existing and potential problem taken into consideration of life cycle analysis will have to be identified and reviewed carefully as the expenses associated with plant repair/replacement could be very costly. The completeness of all E&M manuals and maintenance records should be properly checked as the absence of such document will complicate the future maintenance management of the buildings.

5.4 Dilapidation Survey

All external facades, roofs and internal common areas should be inspected to establish their overall condition and state of repair. Following the examination, a record should be prepared to capture all defects, deficiencies on fire safety issues and evidence of deleterious materials in order to enable a remedial strategy to be developed and executed through a yearly rolling programme.

5.5 Environment, Health and Safety Compliance Check

An inspection should be conducted to assess environmental, health and safety risks associated with the current activities involved in the subject building and an audit should be carried out to ensure compliance with appropriate regulations and acceptable management practices.

5.6 Area Survey

It is prudent to undertake a thorough computation of the floor areas based on site verifications and available approved plans. This exercise will identify any discrepancy on the gross floor areas which needs to be ironed out and reaffirmed before transferring the asset into the REIT. In parallel with this exercise, an inspection should be undertaken to verify whether the subject building has encroached into the adjoining premises.

6.0 Conclusion

REITs have proved to be a successful instrument in overseas markets of higher maturity in terms of size, value and governing regulations. A large portion of property related issues can comfortably and adequately be resourced by the diversified skills of surveyors and we can all collectively develop the REIT sector into our niche market. The continuous participation of our profession will not only open up this window of opportunity for surveyors at a time when we are expanding our professional capabilities to meet the changing needs of our society, but will also underpin our market position in reinforcing Hong Kong as both a renowned fund raising and REIT hub in Asia to stay ahead of fierce competition from overseas markets.

Overcoming Hurdles in Acquiring Commercial Properties in China

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Property prices in China have soared significantly over the last ten years, despite the government trying various means to cool down the market from time to time. The benefits of enjoying liquidity through real estate investment trusts (REITs) in different jurisdictions, with high appreciation potential in the property market in China, have lured a lot of foreign investors to acquire investment properties, especially commercial properties, in big cities in China, including Beijing, Shanghai, Guangzhou and Shenzhen. In this article, we will analyze the possible major hurdles that might be faced by foreign investors in acquiring commercial properties in China and ways to overcome such hurdles.

Determining the Most Cost-Efficient Structure

There are several structural options for foreign investors to acquire and hold commercial properties in China. The most commonly adopted option is to set up a wholly foreign-owned enterprise (WFOE) in China and use it as an investment vehicle. This is the most straight-forward option and complies with the legal requirement that a formal entity has to be established in China for the operation of any business activities within China. However, it normally takes more than a month to establish a WFOE in China and as such is unfavourable to a foreign investor, especially when it is eager to obtain property which is under keen competition. Further, if a foreign investor wishes to establish separate legal entities to hold each of the properties to be acquired by it, this option becomes very costly. To resolve the time constraints hurdle, the foreign investor may adopt a second option by using an offshore entity to acquire the properties, and then use the properties as part of the capital contribution to be paid by it for establishing a WFOE in China. This is an expensive alternative as the foreign investor has to pay various taxes and duties twice since the acquisition and capital injection are regarded as two separate transfer transactions under Chinese law.

To overcome the shortcomings of the above-mentioned options, a third option has been adopted by a number of investors in China, that is, the investor will use its offshore entity to acquire properties in China and then appoint a qualified agent to manage the leasing of the properties. This option allows investors to avoid the time-consuming process of establishing a WFOE in China, and they only have to pay the taxes and duties once. The drawback of this option is, however, the investor would have to hand the management and control of the properties to an agent, and bear the related agencies' fees.

Remittance and Conversion of Foreign Currency

Whether foreign currency remitted to China as the purchase price for acquiring properties has to be approved by the State or Local Administrative Foreign Exchange Authority is a grey area. Some of the local administrative authorities believe that the foreign currency can be remitted to the operating account of the vendor, which can be converted into renminbi currency without separate approval. On the other hand, some of the local administrative authorities hold a completely different view and maintain that approval for converting the foreign currency into renminbi currency is required. However, such local administrative authorities may refuse to grant approval on the grounds that there is no clear law and regulation which gives them authority to grant approval.

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Although the party faced with this problem is the vendor, it is common that the vendor will refuse to proceed with the sale (on assumption that no legally binding agreement has been signed or there is an exit clause in the agreement) if such problem remains unresolved. In some of the cases, the parties are able to resolve this hurdle by obtaining informal confirmation from the State or Local Administrative Foreign Exchange Authority that all of the purchase prices can be remitted into the operating bank account of the vendor and the purchase prices in foreign currency can be converted into renminbi without formal approval.

However, the law is catching up in this area. In November 2005, a *Notice regarding Problems in Converting Foreign Currency Remitted for Sale of Onshore Properties by Domestic Companies* was issued by Shanghai Administrative Foreign Exchange Authority. Under the said Notice, approval should be obtained from Shanghai Administrative Foreign Exchange Authority for converting any foreign currency received for sale of onshore properties, which exceeds the threshold of US\$100 million. We believe that other local administrative authorities may follow the new policy, in line with the state policy to slow down property transactions in China. The foreign investor and its legal counsel should keep a close eye on the development of this area and communicate with the local administrative authority in advance to ensure that such will not become a deal breaker.

Tax Saving Mechanism


For purposes of determining market price of the properties to be sold, valuation reports will be prepared by the vendor in advance. However, there is still a risk that the "market price" as reflected in the valuation reports may be rejected by the taxation authority, especially when the purchase prices of the properties in the neighbourhood are substantially higher than the "market price" or purchase price of the properties in the contemplated transaction. To overcome such hurdle, a more comprehensive valuation report and advance communication with the taxation authority should be done at an early stage.

In addition to the one-off deed tax payable for acquiring properties in China, generally speaking, a foreign investor has to pay business tax, municipal properties tax and withholding income tax OR foreign enterprise income tax. The tax payment payable under withholding income tax is much less than the tax payment under foreign enterprise income tax. Therefore, in order to save tax payment to the greatest extent, the investor should consider choosing a structure which will not fall into any of the circumstances where foreign enterprise income tax is required.

Legal Title

Unlike Commonwealth countries, there is no perfect or secured system to ensure that the investor can obtain the legal title of the properties acquired by it after closing. The investor would face great hurdles in obtaining the certificates of title of the properties if the vendor disappears or is uncooperative after receiving the purchase price. One way to overcome such hurdles is to withhold part of the purchase price before closing and release same to the vendor after the investor obtains the legal title of the properties. However, this solution is unlikely to be accepted by the vendor and the investor does not have much bargaining power if there are several investors competing with one another for the same properties.

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The above issue will become more complicated if the vendor has to utilize a substantial part of the purchase price of the properties to discharge the mortgages from the mortgagee. There is always a risk that the vendor may use the purchase price for other purposes, instead of discharging the mortgages. Some of the banks are willing to resolve this problem by signing a three parties' agreement with the vendor and investor, confirming that the bank will use the purchase price credited into the vendor's bank account to discharge the mortgages over the properties. However, some of the banks are reluctant to undertake any additional responsibilities and refuse to provide any kind of cooperation. Further, even if the bank agrees to sign the three parties' agreement, risk remains that a creditor of the vendor may apply through court to freeze its bank accounts, rendering the vendor and the bank unable to use the purchase price credited into the vendor's bank account. Nevertheless, given that the property prices in China have soared significantly in the past years and the cash flow conditions of the vendors are much improved nowadays, the said hurdle would be overcome if the vendor can use its own funds to discharge mortgages over the properties prior to closing.

Encouraging Future

The number of foreign investors in the property sector in China keeps increasing. Equipped with more and more experience in resolving different kinds of legal or regulatory hurdles in property transactions, foreign investors should realize that there are always ways to overcome the hurdles and move forward.

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