Investing in Sri Lanka's Changing Skyline: Introducing REITs

Globally, Real Estate Investment Trusts have become a lucrative investment opportunity for individual and institutional investors, providing greater access to commercial real estate projects.

A recent survey[1] identified that a majority of Sri Lankans prefer to invest in real estate as opposed to the stock market or bank savings, given the long-term appreciation for real estate assets. The survey further revealed that 58% of respondents anticipate property prices to consistently increase in the future. Demographic and lifestyle changes, increase in tourist arrivals, growing interest from foreign investors, and overall optimism on the future of the property market, were identified as key factors propelling interest in investing in this sector.

While investing in real estate appears to be a popular choice, the rising cost of property poses a significant challenge to individual investors, who typically resort to loans in order to finance such investments. The Sri Lanka House Price Index[1] indicates a 16% increase in apartment prices and a 14% increase in housing prices in 2015 compared to 2014.

Financing real estate investments can be a considerable challenge to middle- income individual investors. As the sector grows, offering lucrative gains, this class of investor needs an alternative opportunity to gain from attractive returns these assets offer over time.

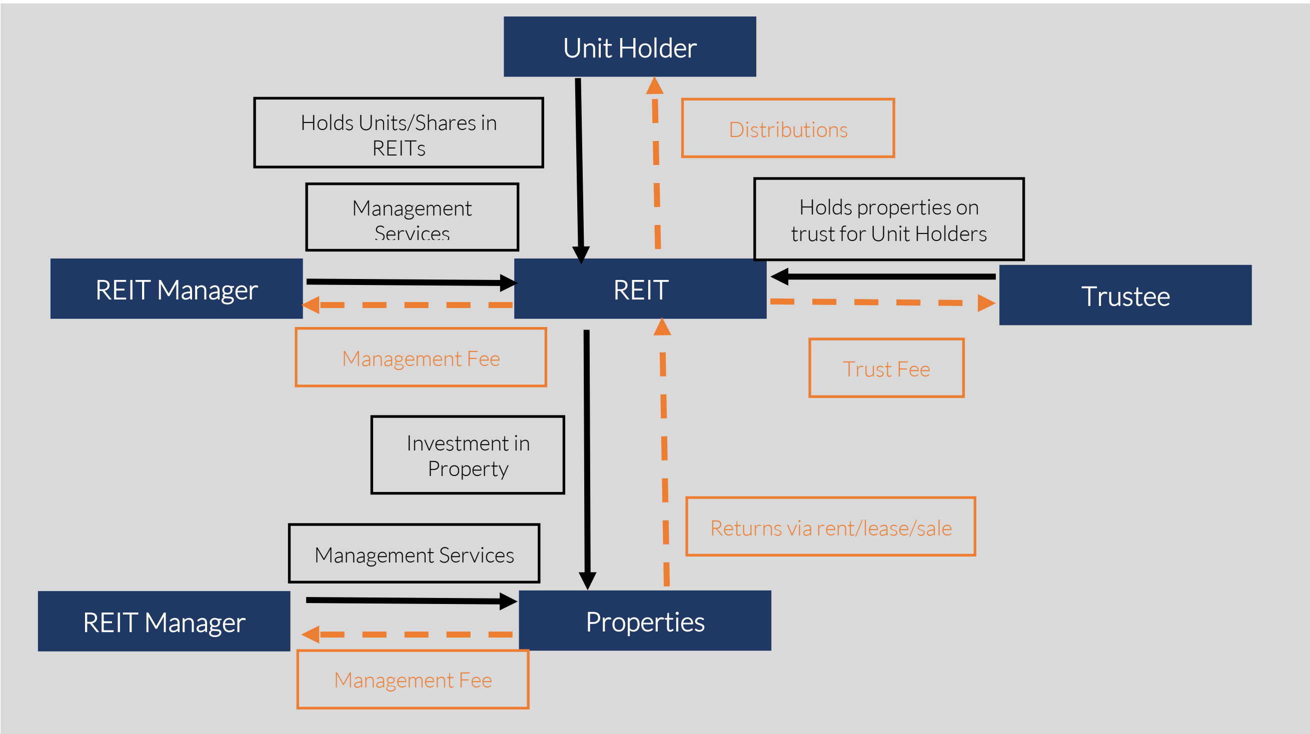
Democratizing Real Estate Ownership through REITs

Real Estate Investment Trusts (REITs), first introduced in the United States in 1960 under the guidance of President Eisenhower, created a mechanism for individual investors to generate income through investing in large commercial real estate. Commonly referred to as REITs, this unique mechanism provided the opportunity for a greater number of individuals to invest in commercial assets which were previously open only to large financial institutions and significantly wealthy individuals.

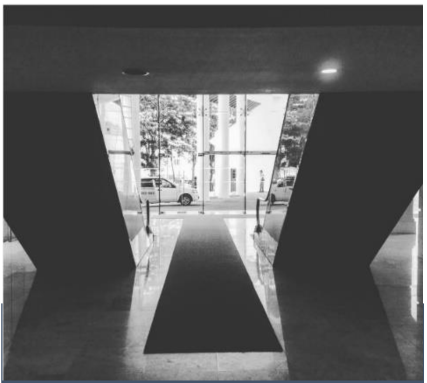
A REIT can be defined as a company that acquires, owns, and operates, income producing real estate assets. Assets owned by a REIT typically include apartments, office buildings, shopping malls, hotels, resorts, warehouses, self-storage facilities, mortgages, and loans. Figure 1 below demonstrates the structure of a REIT and its key stakeholders.

REITs require external funding as its key source of capital and are most often listed on a country's stock exchange. A unit holder would be able to purchase shares of the REIT through an initial public offering or on an exchange. The funds thus collected are invested in a diversified pool of professionally managed real estate and the unit holder would own a portion of the pool of properties. Income generated through renting, leasing or selling these properties are distributed directly to the unit holders. The REIT manager is in charge of operation and management of the properties thus invested and the Trustee would hold the properties on trust for the unit holders.

Figure 1 – Structure of REITs and its Stakeholders



Investing in REITs: Benefits to Individual Investors



For an individual investor, REITs present an ideal opportunity to invest in assets that are typically considered beyond their means.

1. Enables retail investors to make a diversified play in real estate, which they cannot do as individual investors. It can give them the option to subcontract asset selection to a professional management company.

2. A secure and stable stream of income due to multiyear rental contracts of real estate assets

REITs offer investors a relatively stable income stream given that real estate rental contracts are for multiple years. Not only does this provide a stable source of income for a comparatively long period, but it also equips the investor with the ability to plan ahead and make informed decisions.

3. Swift entry and exit opportunities for investors

Given that REITs are listed on stock exchanges, investors have the freedom to invest and divest with ease, which would not have been granted when directly investing in property. REITs essentially take an illiquid asset class – real estate – and make it liquid. The greater freedom afforded and the substantially lower transaction costs make REITs particularly attractive compared to direct investment in real estate assets.

4. Returns through appreciation of real estate assets

REITs have historically performed well due to the steady long-term appreciation of real estate assets. While just like equity stocks, listed REITs are also traded and therefore their value will be determined by market forces, the important difference is that the value of the underlying assets are less susceptible to changes in the business cycle

Investing in REITs: Benefits to the Economy

1. More jobs, better economic growth

Apart from making the real estate industry transparent and more accessible, REITs have a significant impact on job creation and positive contribution to the economy. Employment opportunities are created throughout the lifecycle of the real estate asset. A study conducted by PwC (2012) identified that work hours were generated during the construction phase (42%), major asset enhancement (29%), light refurbishment (25%), and during extension work (4%) contributing to better engagement and opportunities to the work force. Additionally, REITs benefit adjacent industries through the requirement of legal services, accountants, and real estate service groups. According to the Association for Real Estate Securitization (ARES) (2012), REITs contributed to 0.3% of the Japanese economy between the years of 2001 and 2011, with 300,000 employment opportunities being created during that period.

2. Increased tax revenue

Tax authorities are generally weary about the benefits of REITs and have concerns about losing out on taxable revenue due to the exemptions granted at certain stages of the investment to avoid double taxation. The preferential treatment at a REIT level does not create a net loss in tax revenue, rather it makes REITs a more competitive investment in comparison to direct property investments. In fact, the various economic activities and increased number of tenants occupying the properties contribute to tax revenue indirectly and outweigh the losses of exempting REITs from certain taxes.

3. A catalyst for foreign investment

REITs additionally provide a platform for much needed foreign investment, without transferring ownership of land to the foreign investor. Current restrictions on foreigners owning land in Sri Lanka have been a considerable obstacle to the flow of foreign capital into real estate in the country. If necessary regulations are enacted, REITs can circumvent these obstacles by enabling the foreign investor to invest in a REIT, without directly transferring the title of the property to the foreign investor.

The benefits of REITs are not limited to individual investors alone. The subsequent ripple effects of developing this sector can benefit the government and the economy as a whole.

4. Improved investor confidence through increased transparency

A significant benefit of introducing REITs would be the increased transparency created through the disclosure requirements of the stock exchange set for listing entities. Real estate assets have been notorious for its ambiguity as an asset class, especially in terms of valuation, the structure and operation of REITs creates greater transparency and thereby improves investor confidence.

This in turn helps improve the dynamics of property markets and provides better access to information when planning, underwriting and monitoring investments. In 2015, Pakistan became the first South Asian country to launch a REIT, the 'Arif Habib Dolmen City REIT'. This had helped it improve its ranking in the 'Global Real Estate Transparency Index' – an index compiled by global real estate management firm Jones Lang Lasalle - from 'low' from 'opaque' in 2016. The index quantifies transparency based on 139 variables relating to transaction processes, regulatory & legal frameworks, corporate governance, performance measurement and data availability. Table 1 below reflects how countries with established REIT markets rank higher in terms of real estate transparency.[12]

*Table 1 – Real Estate Transparency Index**

	Country	Level of Transparency	Composite Score	2016 Composite Rank
Established REIT markets	Singapore	Transparent	1.82	11
	Hong Kong	Transparent	1.89	15
	Japan	Transparent	2.03	19
	Taiwan	Transparent	2.14	23
	Malaysia	Transparent	2.35	28
	Thailand	Semi-Transparent	2.65	38
	South Korea	Semi-Transparent	2.66	40
REITs Legislation in Progress	Philippines	Semi-Transparent	2.78	46
REITs adoption under consideration	China - Tier 1	Semi-Transparent	2.52	33
	India - Tier 1	Semi-Transparent	2.61	36
REITs adoption not considered	Sri Lanka	Low	3.49	69

Notes: *Transparency scores rank from 1 (most transparent) to 5 (least transparent)
Source: Jones Lang Lasalle Transparency Index 2016

REITs in the Asian Region

REITs have been quite prominent in Asia. After the early introduction of REITs in the early 2000s, Asia now accounts for a market worth over US$ 180 Bn, 75 times more what it was when it was introduced in 2000 (APREA, 2014). Japan, Singapore and Hong Kong have been successfully established as market leaders in Asia. Much of the driving forces behind the emergence of REITs was largely due to the need of injecting much needed liquidity to revive the real estate sector.

This sector had been severely affected by large economic and financial reforms, and also from the protracted recession in Japan in 1997. This urged regulators in Asia to attract much needed capital, both local and foreign, to boost growth and performance in real estate and banks, which was burdened with high non-performing loans. Additional support from real estate and even non-real estate sectors established favorable regimes for the enactment of REITs in Asia.

Noteworthy success stories in the region have given confidence to Sri Lanka in considering launching REITs. In 2012 Singapore's US$ 38Bn REIT market was deemed the best performing market in the world surpassing leading markets such as U.S., U.K. and Japan[3]. This growth was led by increased asset acquisition and rental appreciation with total rental revenue increasing 5.8% annually from 2008 and 2011. Closer to home, Pakistan surpassed India in launching South Asia's first REIT in June 2015, at a premium of 10% to the offer price. Dolmen City, the company that launched the REIT, expects a net income of US$ 21.9 Mn during the first year and dividends are expected to at US$ 20.7 Mn[4].

Meanwhile, in India, in June 2016 the Securities and Exchange Board eased rules to allow REITs to invest in construction assets and provide access to a larger number of sponsors. Industry experts state that the introduction of REITs would draw in much required liquidity in the real estate sector with expected investment from retail and institutional investors.[5]

Way Forward For REITs in Sri Lanka

To foster a conducive climate for REITs in Sri Lanka, there are some key areas that must tackled, particularly the establishment of a suitable legal and regulatory framework and a suitable tax regime.

Legal and Regulatory Framework

A crucial hurdle for REITs in getting into new markets is to ensure that it receives support from local regulatory bodies and authorities in formulating a supportive legislative framework for its operations. Many authorities tend to throw skepticism at REITs, claiming that it may be used to bail out owners of poor performing properties at the expense of ill-informed citizens. As a result, establishing a REIT market can be cumbersome, but can be combated through lobbying, consultation and consideration for with various stakeholders.

Enabling REITs under the Unit Trust code has been widely recommended as a first step towards providing a supportive regulatory foundation for the operation of REITs in Sri Lanka. Providing for the operation of REITs under the Unit Trust codes exempts the need for drafting new legislature which is costly and time consuming process.

Tax Regime

To ensure that REITs can be successfully implemented, an efficient and stable tax regime must be kept in place to instill confidence in investors. Several countries have had the issue of granting tax incentives for REITs because of concerns over the loss of tax revenue, even though several studies have shown that the socioeconomic benefits that REITs provide outweigh the losses in tax revenue. Setting effective tax policies and setting supportive policies can encourage investments not only from local citizens, but also foreign investors – whose participation is crucial to setting a successful REIT market.

The government can consider certain limited tax concessions in order to help maximize yields and make REITs more attractive. For instance, a concession on stamp duty on the transfer of immovable property to a special purpose vehicle like a REIT is essential to fostering REITs in Sri Lanka. For this, Provincial Councils would need to make amendments to their financial statues to exempt REITs from stamp duty.

Conducive Climate

To ensure that REITs can operate feasibly in the long run, authorities and regulators must focus on setting up a conducive environment to allow greater company and investor participation. Investors often misunderstand REITs with real estate stocks, and associate the returns of a REIT to shares, which then leads to poor investor participation. Strong corporate governance and increasing transparency can help the investor community and regulatory bodies to assess the viability and quality of projects, which can help to protect customers and allow for greater dissemination of information to customers.

References:

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[2] Average Prices are based on property ads published on LankaPropertyWeb.com until the stated period. The prices have been taken from a sample of around 15,000 property ads.

[3] Market Realist, "REITs: Everything Investors Need to Know,", Aug 24, 2015. Retrieved from http://marketrealist.com/2015/08/advantages-disadvantages-investing-reits/

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The third Strategic Insights edition is based on work done by the National Agenda Committee (NAC) on Finance & Capital which has taken the implementation of REITs as a key action item.

The sub-group on REITs of the NAC on Finance & Capital has developed a proposal for introducing REITs, including the features of robust REITs and their regulatory requirements. The sub-group is working collaboratively with sector regulators and relevant government agencies to push this agenda forward.

The NACs are thought-leadership groups appointed by the Ceylon Chamber of Commerce to develop the foremost insights on key strategic economic themes. They are multi-stakeholder in nature, and are working together to challenge conventional thinking, develop new insights, and put forward innovative solutions. Five NACs have already been set up and have begun work - the NACs on Investment Climate; Infrastructure; Finance and Capital; Logistics and Transport; and Innovation Eco-system.

Prepared by Economic Intelligence Unit (EIU) Ceylon Chamber of Commerce

Authors:
Shenali de Silva, Research Associate
shenali@chamber.lk

Dinuka Malith, Research Intern
dinukamalith71@gmail.com