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Trusting in REITs

It's been a rocky year for real estate investment trusts but industry experts are upbeat on the alternative long-term investment scheme. By Celine Tan

Real estate investment trusts (REITs), collective investment schemes invested in a diverse portfolio of real estate or real estate related assets, were touted to be able to improve the stability of a portfolio as well as help maximise returns. But, for the one-year period ended last Dec 31, the market capitalisation of individual REIT markets in Asia had fallen by 41% from US$84.5 billion to US$48.23 bilion.

"The past year has been an extremely difficult period for REITs. REITs were sold down as they were associated with financial and property stocks, which lost favour with investors," says John Lim, group CEO of ARA Asset Management Ltd. "Uncertainty arising from impending debt refinancing, particularly due to the vanishing commercial mortgage-backed securities (CMBS) market, compounded the situation. This is in

Things to consider when investing in MREIT

1 Pay attention to "hard numbers", says Chrisanne Chin, a capital markets industry consultant-cum-entrepreneur in corporate strategy and investment education. "The fundamentals of REIT include the pricing of the properties and rental incomes. Look for a REIT that has long-term tenancies to ensure that long-term income is locked-in."
Look for the leverage factor and sectors that the REIT are in, adds Chin. "One can also do sensitivity analysis [a way to predict the outcome of a decision if a situation turns out to be different compared to the key predictions] and look at variables like discounted cash flow and price to NAV [net asset value]."

2 Scrutinise the quality of the management and look at its track record, says Lim Yoon Peng, CEO of Am ARA REIT Managers Sdn Bhd. "Ensure that the REIT is in the hands of capable professionals. Look at how the managers take initiatives to further improve yields and values of the real estates. For example, by looking at how they recover late rental."

A slowdown in the real estate industry allows MREITs participants to take a breather and re-examine their strategy and directions, says John Lim, Group CEO of ARA Asset Management Ltd. "It is a healthy evolution of a maturing MREIT [Malaysian REIT] market. MREIT managers will emphasise good asset management, as most will have limited capacity to make acquisitions. However, a golden opportunity exists for the stronger MREIT to acquire properties at attractive valuations." Given the challenges that the industry is facing, MREIT with robust and diversified income streams and whose capital

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sharp contrast with the past few years, in which REITs were in favour because investors viewed them as an income stock and as an avenue to participate in the property market upcycle."

While most equities have rebounded quickly since April, Malaysian REITs (MREITs) have lagged behind. "In a downtrend, REITs will fall in line with the equity market while in an uptrend, they will not recover as fast," says Chrisanne Chin, a capital markets industry consultant-cum-entrepreneur in corporate strategy and investment education.

Despite this, the investment experts that *Personal Money* interviewed are bullish on MREITs as a long-term prospect. Why is this so?

Opportunities in MREITs?

REITs face further headwinds in the form of a weaker economy and tight credit. But there are lots of value in MREITs, as last year's selldown was overdone, says Ong Chee Ting, REIT analyst at Maybank Investment Bank. "Certain MREITs, especially those with foreign shareholdings, suffered on the perception that MREITs face similar liquidity crunch and economic contractions like in Singapore, Hong Kong and Australia." In Singapore last December, the market capitalisation of SREIT had fallen to US$9.1 billion from US$21.6 billion a year ago, compared with MREITs that had fallen to US$1.2 billion from US$1.6 billion in the same period. "Malaysian banks proved to be relatively resilient. The banking system is flush with liquidity and the current low-interest environment will help boost MREITs' profits due to lower interest expenses. With the exception of Al-Aqar REIT, by our estimates, current share prices of MREITs are factoring a 5% to 29% drop in property prices," says Ong.

"With the current low interest-rate environment, we think property price correction is unlikely to exceed 15% over the next two years," he adds. "Malaysia is relatively insulated from falling property prices compared with the rest in the region, as a property bubble did not really take place. The high-end property sector in Singapore, however, was less resilient and has fallen drastically," says Sherilyn Foong, associate director of Newasia Capital Sdn Bhd. With lower prices, yields have risen. Foong, the author of *Road to Riches with REITS*, elaborates that with a

JOHN: An opportunity to participate in the recovery of the property cycle

CHIN: Asset quality is a concern

JOHN (GROUP CEO OF ARA ASSET MANAGEMENT), CHIN (PATRICK GOH/THE EDGE)

positions are stronger will be in a better position to reward their investors with a higher level of returns going forward, he adds.

3 Track regional REITs to find the trend of MREITs, says Sherilyn Foong, associate director of Newasia Capital Sdn Bhd. "MREITs tend to be laggards compared to other asset classes, but are similar to regional REITs since MREITs are relatively young."

4 Invest in REITs in which the shareholding of its holding company is substantial. "MREITs are relatively resilient compared to REITs in the region because the amount of stock that the managers are holding is big," says Chin. "If the ownership is substantial, 40% to 50%, this can be a good sign. When the holding company has a sizeable stake, efficiency in the operation profits can be usually ensured and the MREIT price is unlikely to experience high volatility."

5 Focus on REITs that pay stable and high-income distribution, says Foong. Yoon Peng adds that though there is no fixed payout policy as regulated by the SC, generally, MREITs follow global practices and pay out at least 90% of their income. In addition, if REIT managers do not distribute at least 90% of their income, unitholders will be subjected to the usual 25% tax as shareholders of listed property companies. In Singapore, REIT are required to pay out at least 90% of their distributable income to shareholders. "Most managers elect to pay out 100% of the distributable income but given the credit crunch, some managers may elect to conserve cash and reduce the payout ratio," says John.

6 For more savvy investors, go for listed MREITs, says Foong. "For the less-savvy investors who do not have sufficient resources to do the homework to pick the right REIT, go for unit trusts that invest in REITs." Some of the unit trust funds that invest in REITs are MAAKL Asia-Pacific REIT and Public Far-East Property & Resorts. ■

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FOONG: With the lower entry, your dividend yield is a lot higher now

ONG: iREIT is an option

YOON PENG: [Go for] REITs that have underlying property assets in different sectors

REITs

Company	Dividend yield (%)		Gearing level (%)
	2008A	2009F	
Al Aqar REIT	9.0	9.0	33.2
AmanahRaya REIT	9.9	11.3	33.6
AmFirst REIT	8.3	10.7	39.6
Atrium REIT	13.5	13.7	24.7
Axis REIT	11.9	12.9	31.7
Boustead REIT	10.7	10.5	11.2
Hektar REIT	10.8	12.3	40.8
Quill Capita	9.2	10.0	37.2
Starhill REIT	9.6	10.8	11.1
Tower REIT	10.3	10.3	19.7
UOA REIT	10.2	10.2	23.4

SOURCE: BLOOMBERG CONSENSUS, MAYBANK INVESTMENT BANK

lower entry now but with the same income in absolute amounts, your dividend yield is a lot higher now. "The risk of further capital losses is also minimised," she says.

But what is the outlook on future dividends? In theory, a slowdown in real estate will put pressure on rental rates and vacancies, and impact, distributable income in the future.

"Fortunately, in Malaysia, rental rates have not been spiking up, unlike its regional peers. In fact, most of 2009's renewal rates reflect tenancies signed in 2006, when rental rates were lower. So, instead of getting 2008's rental rates, owners will have to be satisfied with lower rates [but still higher than 2006's]," says Ong.

Overall, MREITs' debt-to-asset ratio averaged 26.3%, which is manageable and provides room for further gearing to buy new properties for growth, says Ong. "REIT players have less competition now compared with 2007-08." The Securities Commission guidelines state that MREITs can only raise their gearing to 50% of their total assets. Once the statutory limit is reached, the MREITs can only go into the capital market to raise equity because at least 90% of their profits before taxation must be distributed as dividends to be tax-exempted, leaving little for expansion. In fact, REITs offer you the opportunity to participate in the recovery of the property cycle, says John. "Government stimulus packages have softened the fallout of the global economic slowdown by providing relief to the various sectors of the economy. To a certain extent, these measures have helped, whether directly or indirectly, to support the property market."

Ong is of the view that the government's stimulus packages and fiscal policies will have an indirect impact on REITs, as they will help spur economic activities and shore up market and business confidence. In a development announced in July, foreign REIT operators may now own up to 100% of the MREIT managers [this was previously increased to 70% last August]. With this, the MREIT sector can spring to life, says Ong. "Foreign-based operators like CapitaLand [for its retail and hospitality divisions], Frasers Hospitality, and ARA [an affiliate of Cheung Kong Group] can stand to gain from the Foreign Investment Committee (FIC)'s liberalisation rules. Upon formation, the REIT managers can export their property management expertise, create fresh demand for commercial properties in Malaysia and eventually list these properties in Malaysia via the REIT structure to benefit from its attractive tax structure."

MREIT also received a boost in

FOONG AND YOON PENG (KENNY YAP/THE EDGE), ONG (LEE LAY KIN/THE EDGE)

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Historical price performance (Jan 1, 2008 to March 20, 2009) (%)	Type
-8.2	Hospital
-27.3	Diversified
-6.7	Commercial
-38.0	Industrial
-31.4	Commercial/Industrial
-27.7	Plantation
-42.7	Retail
-36.8	Commercial
-20.7	Hotel/Retail
-36.2	Commercial
-30.4	Commercial

Budget 2009 where the withholding tax on dividends for foreign institutional investors was halved to 10% while the rate for individual Malaysian investors was cut to 10% from 15%. In an environment where sentiment and fear reign, however, this advantage has minimal impact on investors, notes Foong.

The risks

For the next 12 to 24 months, volatility still reigns supreme due to MREITs' equity characteristics, says Foong. "As you increase your risk appetite towards MREITs, you need to have the holding power to withstand short-term volatilities. You need to make a judgment call in the risk of capital loss." She encourages investors to hold the investment for a time frame of at least three to five years. "Also, liquidity can be a risk since MREITs have a lower daily trading volume."

Deflation and devaluation can hinder the performances of REITs, fears Foong. "If that happens, managers have to write down the property values, resulting in the portfolio not being worth as much as what it was initially." Similarly, Chin, who has 15 years' experience in investment banking, equity stock brokerage and equity research, says asset quality is a concern. "Unlike regional REITs, MREITs can contain just two buildings and name it a REIT. If one of the asset's quality deteriorates, it will significantly affect the entire portfolio."

On the other hand, says Ong, the key risk lies with the going concerns of their tenants.

Lower REIT prices are in a way impeding growth through acquisition, says Ong. "MREITs will find it difficult to go out to the market [in this current environment] to raise equity as there will be risk of immediate dividend yield dilutions." ARA Asset Management's John adds that acquisition activities will be subdued as any acquisition is unlikely to be yield-accretive since current REIT distribution yields exceed those of property. "In addition, the limited availability of credit will hamper the ability of REITs to complete acquisitions."

Local banks started charging higher credit spreads late last year to compensate for the perception of heightened business risks, says Ong. "Despite Bank Negara Malaysia (BNM)'s 150bps OPR cut [since last November] to 2% a year, MREITs did not fully benefit from the lower interest rates as the cost of finance reduction will be offset by higher spreads when their facilities are renewed."

Since financing costs have gone up, going forward, that can be a drag on dividend rate, says John. "MREIT managers will have to work their assets harder to protect the topline while facing higher cost of debt." Nevertheless, most MREIT managers are beginning to talk to banks about the matter, observes Foong.

Lim Yoon Peng, CEO of Am ARA REIT Managers Sdn Bhd, concurs that MREIT managers have started to lock in certain rates before the financing rates start to climb.

Which sub-sector(s) to look at?

The yield expectation of MREITs will depend on the individual REIT that you are looking at. "In view of the state of the economy, sectors that are looking good are those that have defensive qualities like hospital and plantation [in view of the commodities boom], and underweight in office and retail. I am neutral on the industrial segment," says Foong. Chin is also of the view that the office segment will possibly experience a downtrend given that by 2011, Petaling Jaya and the Golden Triangle in KL, will see a 10% increase of commercial buildings. "So, with oversupply, managers are bound to get lower rental income than they expect."

REITs that have underlying property assets in the different sectors will help your investment portfolio mitigate the disparity in the downturn, says Yoon Peng.

Ong thinks that the economic slowdown affects all subsectors but that has been priced in. "At current prices, we like exposure in Quill Capita Trust and Tower REIT [office], Axis REIT [industrial / office], and AmFirst [office/ retail/ hotel]."

Foong is bullish on Islamic REITs (iREIT). "This will be a competitive edge for MREITs and I see the potential in Malaysia coming up with global iREIT issues, comprising not just Malaysian properties but global properties." Ong shares a similar view. "With the global economy going through a challenging period and the financial markets shying away from issuing credit, iREIT is an option for those seeking to raise funds or looking for alternative investments that normally offer steady returns with a moderate risk profile." ■