FACT SHEET

Real Estate Investment Trusts

1. Background

1.1 The Hong Kong Housing Authority (HA) decided at a special meeting held on 24 July 2003 to divest its retail and car-parking facilities. HA plans to sell both the management and ownership rights of the facilities to a new company which will in turn make an initial public offering on the Stock Exchange of Hong Kong. The new company will be established in the form of a Real Estate Investment Trust (REIT). This fact sheet provides a brief introduction to REITs to facilitate Members of the Housing Panel in deliberating the issue.

2. Definition of a Real Estate Investment Trust

2.1 According to the Securities and Futures Commission (SFC) of Hong Kong, a REIT is "*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. 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*."[1]

2.2 A REIT can be perceived as a collective investment scheme that aims to deliver a source of recurrent income to investors through focused investment in a portfolio of income-generating real estate such as shopping malls, offices, hotels and service apartments. Investors are able to purchase units of REITs through the stock exchange. As REITs are listed on the stock exchange, they are subject to a corporate governance and disclosure regime that is on a par with that governing listed companies.

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[1] Hong Kong. Securities and Futures Commission. *Code on Real Estate Investment Trusts*, August 2003.

3. Development of Real Estate Investment Trusts

3.1 REITs were first introduced in 1960 in the United States of America (US). The primary aim was to make large-scale and income-producing real estate investments accessible to small investors. In 2002, there were about 180 REITs, with a total asset value of US$300 billion[2] (HK$2.3 trillion)[3], registered with the US Securities and Exchange Commission. More than two-thirds of the registered REITs are traded on the major US national stock exchanges.

3.2 In the US, to be a REIT, a company is legally required to pay almost all of its taxable income (at least 90%) to its shareholders every year. The REIT can deduct the dividends paid to the shareholders for the corporate tax bill, which implies only one level of taxation for investors. However, the REIT cannot pass any tax losses through to its investors.

3.3 There are three major categories of REITs in the US:

(a) equity REITs which own and operate income-producing real estate;

(b) mortgage REITs which own mortgages or mortgage-backed securities; and

(c) hybrid REITs which both own properties and make loans to real estate owners and operators.

3.4 In 2001, Japan became the first Asian country to offer REITs. Currently, there are six REITs being traded in Japan, two in Singapore, and three in Korea.[4] Other places studying the possibility of introducing REITs include Taiwan, India and Hong Kong.

3.5 In the fourth quarter of 2002, SFC began to initiate the discussion of the concept and viability of introducing REITs in Hong Kong. The objectives were to broaden the choice of investment products available to the public and reinforce Hong Kong's position as an international financial centre. In March 2003, SFC released a draft code stating the general principles and rules that would govern REITs in Hong Kong. Public consultation was then conducted, leading to the publication of the *Code on Real Estate Investment Trusts* (the Code) in August 2003.

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[2] Many REITs are not registered with the Securities and Exchange Commission in the US. Source: Web site of the National Association of Real Estate of Investment Trust. <http://www.investinreits.com/faqtext.cfm#4>.

[3] The average exchange rate of US Dollar to Hong Kong Dollar for 2002 was US$1=HK$7.799.

[4] DBS Vickers Securities. "Real Estate Investment Trusts", *Sector Focus*, 30 May 2003.

4. Features of a Real Estate Investment Trust in Hong Kong

4.1 Listed below are major features of a REIT authorized by SFC in that it should:

(a) invest in real estate in Hong Kong only[5];
(b) hold real estate for long-term investment purpose;
(c) provide regular detailed reports regarding its performance to investors;
(d) require both voting by unit holders and soliciting opinion of independent experts in the event of connected party transactions;
(e) limit the level of borrowing to 35% of the gross asset value;
(f) disclose material information on a timely basis;
(g) require an independent trustee to provide a layer of oversight over the operation of the scheme;
(h) be listed on the Stock Exchange of Hong Kong; and
(i) pay at least 90% of its after-tax income to investors in the form of dividends at regular intervals.

5. Operation of a REIT in Hong Kong

5.1 An SFC-authorized REIT should be structured in the form of a trust to ensure clear segregation of assets of the REIT. In this connection, a trustee responsible for overseeing the operation of the REIT and protecting the rights and interests of unit holders should be appointed. The trustee can either be a bank, a trust company of a bank or a banking institution or trust company incorporated outside Hong Kong which is acceptable to SFC. The trustee has the right to appoint and remove the management company and the property valuer of the REIT.

5.2 The management company of the REIT should be licensed under the Securities and Futures Ordinance (Cap. 571) and approved by SFC. The management personnel should include two officers each of whom has at least five years' track record in managing collective investment schemes, and at least one of the officers is available at all times to supervise the management company's business of regulated activity, including asset management. The management company should also maintain satisfactory internal controls and written compliance procedures which address all regulatory requirements. Conflicts of interests should be properly addressed to safeguard investors' interests. The names of persons holding 10% or more of the outstanding units of the REIT and their relationship with the REIT should be disclosed.

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5 The Securities and Futures Commission (SFC) requires that SFC-authorized REITs should only invest in real estate in Hong Kong. This focused approach helps facilitate better understanding of the new product by retail investors. As the REIT market becomes more developed, SFC believes that this geographical restriction could be removed. In that event, a task force would be set up to examine the minimum benchmarks for REITs to invest in overseas properties.

5.3 The management company should ensure that the assets of the REIT are valued in good faith once a year according to the market practice and in accordance with SFC-approved procedures. Mandatory rotation of the property valuer is required once every three years.

6. Regulatory Body

6.1 SFC is responsible for vetting the constitutional and offering documents and other product description documents during the establishment of REITs, and ensuring their compliance with the Code. The Hong Kong Exchanges and Clearing Limited is responsible for listing-related matters of REITs, including vetting the listing documents, supervising the conduct of the listing process, and monitoring the continuous compliance with the Listing Rules.

7. Advantages and Risks of Investing in REITs

7.1 According to SFC, REITs "*tend to offer better liquidity and allow investors to participate in quality large-scale properties which would otherwise be impossible without a very substantial investment outlay. They also offer the benefit of diversification arising from holding a portfolio of properties with different lease lengths and tenant types*."[6] However, SFC also stresses that the total return on REITs is subject to the performance of the property market, interest rate cycles, economic prospects and political outlook. The unit price of a REIT may go down if its underlying properties drop in value. Dividends may not be paid if the REIT reports an operating loss.

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[6] Hong Kong. Securities and Futures Commission. *Real Estate Investment Trusts, What You Have to Know*.

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1. Hong Kong. Housing Authority. *Information Note on Divestment of Housing Authority's Retail and Car-parking Facilities*, August 2003.

2. Hong Kong. Securities and Futures Commission. *Consultation Conclusions on the Draft Code on Real Estate Investment Trusts*, July 2003.

3. Hong Kong. Securities and Futures Commission. *Code on Real Estate Investment Trusts*, August 2003.

4. Hong Kong. Securities and Futures Commission. *Real Estate Investment Trusts, What You Have to Know*.

5. DBS Vickers Securities. "Real Estate Investment Trusts", *Sector Focus*, 30 May 2003.

6. Web site of the National Association of Real Estate Investment Trusts, www.nareit.com/.