

Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts



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2013

EXECUTIVE SUMMARY

Real estate investment trust (REIT) is a valuable investment alternative for investors in many markets. Being home to many world-class property developers and Asia's financial hub, Hong Kong has all the criteria to grow a thriving REIT market. In light of the explosive growth of real estate market in Asia-Pacific and the need for asset securitisation products from investors such as pension funds, the REIT market is poised for growth in the coming decade.

The birth of Hong Kong REIT (H-REIT) market came with the enactment of the Hong Kong REIT Code in 2003. But in the decade since, only ten¹ H-REIT offerings have taken place, substantially lagging the growth of other REIT markets in the region. Failure in capitalising on the REIT market growth potential is largely due to the relative restrictiveness and lack of incentives of the H-REIT regime. From the lack of tax incentives to investment restrictions and takeover hurdles, H-REITs are facing a much tougher operating environment than regional markets such as Singapore and Malaysia, which are more proactive in growing their REIT markets by addressing issuer and sponsor concerns and facilitating market reforms.

Development of the international financial industry is robust and rapid. Hong Kong must strengthen its advantages in view of the rapid growth of wealth, the need for investment products to cater to the growing retirement savings market in Asia and other market developments in the region. In most REIT regimes, regulatory changes and tax incentives have proven to be effective tools to grow the market. It is imperative that Hong Kong enhances its REIT regulations to align itself with market changes and international norms, thereby securing its role as an international asset management centre and global capital formation centre for REIT listings. These changes, if adopted, would increase employment in Hong Kong and assist in growing Hong Kong's economy.

¹ RREEF China Commercial Trust had since entered a process of liquidation

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SECTION 1 INTRODUCTION

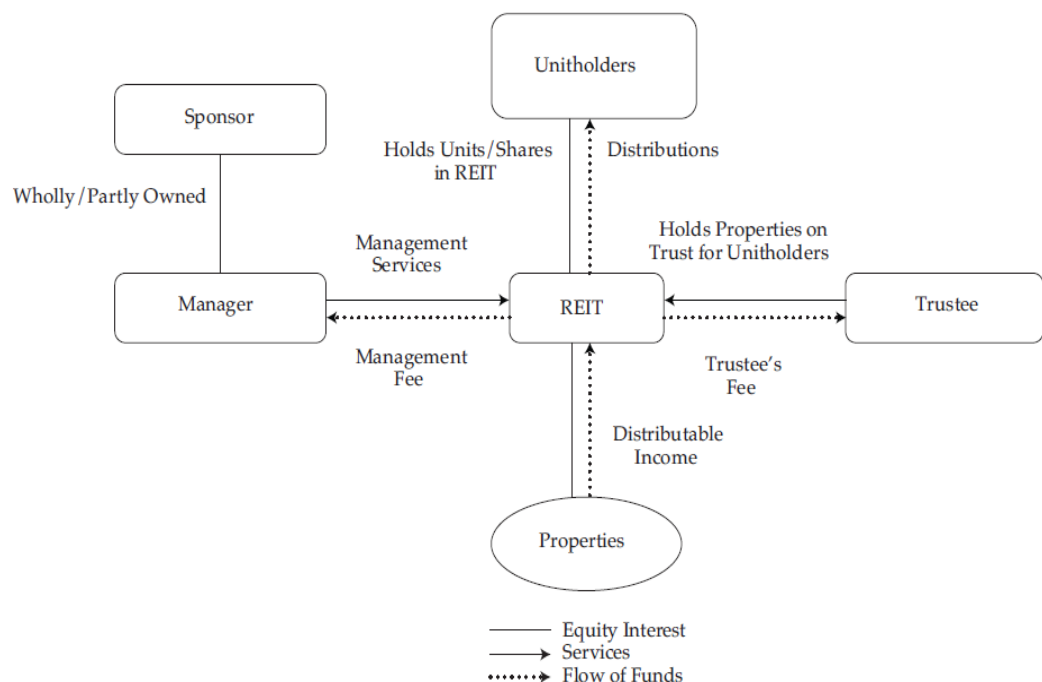
1.1 WHAT IS A REIT

DEFINITION

REITs are listed trusts or companies that own and actively manage portfolios of high quality income-producing real estate. They are listed on their respective stock markets and their shares or units are publicly traded like other stocks. Major income stream for REITs is the rental income from their real estate portfolios, most of which is distributed to investors due to REITs' high dividend payout ratios. Thus, REITs are considered hybrid investments offering the liquidity of the stock market as well as secure income stream that comes from tenants' leases. Retail investors in particular are drawn to REITs given the smaller investment size, much higher liquidity and ease of transaction relative to buying physical real estate. In addition to gaining real estate market exposure, overseas retail and institutional investors are attracted to REITs due to their "flow through" tax status, as most REIT regimes outside of Hong Kong allow for zero tax leakage at the REIT level.

STRUCTURE OF REITs

FIGURE 1: TYPICAL REIT STRUCTURE IN HONG KONG AND SINGAPORE



Trustee. The trustee is responsible for holding the properties in trust for unitholders, with a duty to oversee the functioning of the REIT manager and ensure the REIT manager is performing in line with the trust deed and relevant laws. The trust deed is an agreement between the REIT manager and the

trustee that governs the way the REIT is legally organized and managed. It describes the duties and responsibilities of the REIT manager and the trustee, as well as the rights and interests of unitholders. The trustee, typically a bank or its subsidiary, is paid a fee based on a percentage of the REIT's underlying asset value.

REIT Manager. REITs can either be externally or internally managed.

- **External management.** The external management structure is most common in Asia. The trust's assets are managed by an external REIT manager that carries out all the management duties, such as operations, financing, and property management. Investors buy units in the trust, and the units trade independently of the REIT manager, who may or may not be a listed company. In exchange for services, the REIT manager charges a management fee that can include a base fee and a performance fee that are typically based on the net income, net asset value, relative share/unit price of the trust and/or other performance benchmarks. It may also charge the trust such additional fees as acquisition and disposal fees and property management fees if such services are not outsourced to other companies.
- **Internal management.** In an internally-managed REIT, the trust owns both the assets and the REIT manager. Under this structure, unitholders own units in the REIT, which also wholly-owns the REIT manager, while the separate functions of the trustee and the REIT manager remain the same as an externally-managed REIT. An example of internal management is stapled securities, where REIT management duties are carried out by an internal management company that is "stapled" to the trust. This structure gives investors one unit in the trust and one share in the REIT manager, which are effectively stapled and traded together on the exchange.

Sponsor. The REIT sponsor plays an important role in the Asia-Pacific REIT market. The sponsor is the entity that divests its properties initially to the REIT at the time of listing to recycle capital and raise funds. The sponsor is typically a participant in the real estate industry, such as an owner of properties, property developer or fund manager.

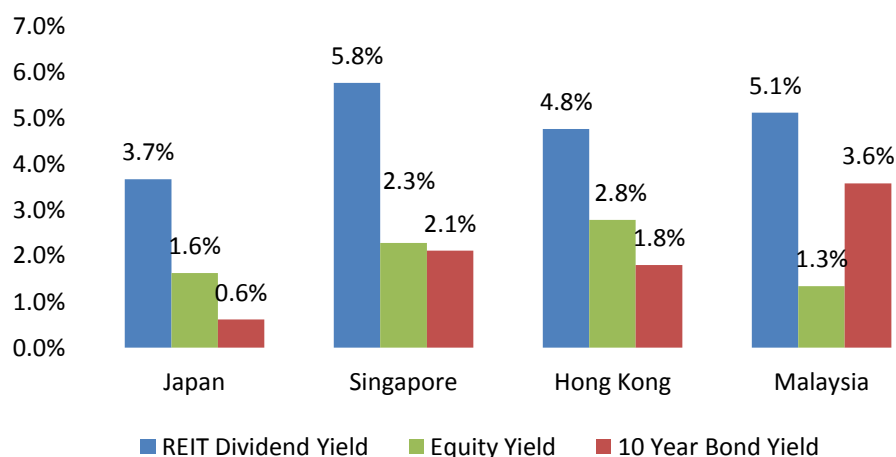
Despite divesting its properties into the REIT, the sponsor often retains a large holding in the REIT, giving it significant control and interest in the underlying cash flow of the properties. Although the REIT is a completely separate listed entity, the sponsor often maintains control over the operations of the REIT as well, since the REIT manager and property manager are commonly subsidiaries of the sponsor. Therefore, the sponsor also captures the fee stream paid by the REIT to the manager.

INVESTOR BENEFITS

High liquidity and diversification. Compared to direct investment in property which are relatively illiquid and require more substantial investment size, REITs provide investors lower barrier to entry and higher marketability and liquidity. Investors consider REIT as an investment alternative to purchasing properties and investing in property-related stocks, allowing them to diversify their portfolios and capitalise on the growth of the real estate market.

High yield with lower risk. Investors benefit from the relatively stable cashflow stream from REITs which have high payout ratios that are either mandated in REIT regulations or incentivised by taxation requirements. REITs typically are conservatively managed, with low to moderate gearing and high quality real estate portfolios managed by professional managers. Investors, especially those seeking annuity-style performances at low to moderate risks, are drawn to REITs by their relatively attractive yields compared to government bonds and equities.

FIGURE 2: YIELD COMPARISON BETWEEN REITs, GOVERNMENT BONDS AND EQUITIES



Source: Bloomberg, data retrieved 28 October 2013

Taxation benefits. REITs are usually structured to meet certain requirements under various tax laws so that investors can benefit from “flow-through” taxation. Such benefits allow the REIT to be free from tax on its income, so that tax is paid only once in the hands of investors. This tax advantage is not available to REITs in Hong Kong.

GLOBAL REIT MARKET

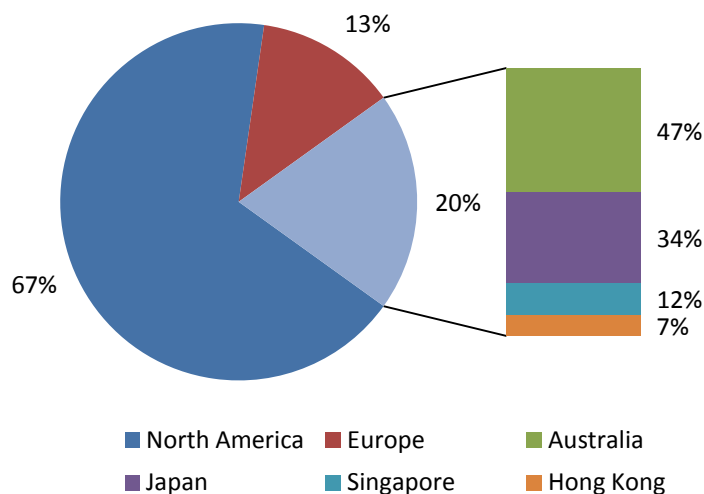
The U.S. REIT market is both the largest and the oldest market globally, dating back to 1961 when the first REIT was listed on a U.S. stock market. The Netherlands in Europe was next to establish a REIT market in 1969, followed by Australia in 1971. The global REIT market has experienced significant growth in the past 20 years, with over 20 countries adopting REIT legislations. In Asia, Japan established its REIT market in 2001, followed by Singapore in 2002, Hong Kong and Malaysia in 2005. Currently several countries, including Thailand, India and China, are considering setting up REIT markets, as is the Philippines,

which has legislation in place but is waiting for final governmental approvals before REITs can officially list.

GLOBAL REIT MARKET CAPITALISATION

Market capitalisation of North American REITs contributes approximately 67% of the global REIT market. Europe and Asia Pacific contributes the remaining 33%. Australia has the largest REIT market in Asia Pacific, followed by Japan and Singapore. Hong Kong is relatively small at less than 2% of the global REIT market.

FIGURE 3: GLOBAL REIT MARKET CAPITALISATION, SEPTEMBER 2013



Source: Data from FTSE EPRA / NAREIT Developed REIT Index

1.2 HISTORY AND REGULATORY REFORMS OF REIT MARKETS

EVOLUTION OF THE U.S. REIT MARKET

The U.S. REIT market has changed dramatically over the decades since its initial formation in the 1960s. Two cycles in 1970s and 1980s saw small increases in the number of U.S. REITs, which had an aggregate market capitalisation of just US\$1.5 billion in 1971 (representing 34 REITs) and was still under US\$10 billion in 1990. It was not until the early 1990s that the sector experienced explosive growth and wide acceptance among investors.

The Tax Reform Act in 1986 was important for the development of U.S. REITs in two ways. First, it reduced the potential for real estate investments to become tax shelters, thus gave property owners an incentive to spin off their holdings. Second, it allowed U.S. REITs to own, operate and manage their property investments, integrating property management into the organisation, facilitating U.S. REITs to grow through acquiring, developing and managing real estate as well as through ancillary businesses.

In 2001, the REIT Modernization Act allowed the formation of taxable REIT subsidiaries (TRS). A TRS, which is taxed at the corporate level, can engage in non-rental, ancillary business activities, such as property management, leasing,

or development. All of these activities contribute to a REIT's earnings. Today, a U.S. REIT can own 100% of the stock of a TRS.¹

EVOLUTION OF THE AUSTRALIAN REIT ("A-REIT") MARKET

General Property Trust, now known as GPT Group, was the first A-REIT in April 1971. At the time, General Property Trust was externally managed with Lend Lease acting as the responsible entity. Subsequently, the listed A-REIT sector grew steadily and by the end of 1980s, companies such as Westfield and Stockland had become listed entities. However, it was after the commercial property collapse in the early 1990s that the A-REIT sector gained momentum. The crash highlighted the pitfalls of holding direct property, with institutions left holding illiquid assets, without the ability to quickly access their equity, in an environment where valuations lagged the market. As a result, institutions looked to securitise their property portfolios to increase liquidity into what was traditionally a direct-exposure asset class. With the increasing popularity of securitisation, A-REIT market boomed in the late 1990s, with approximately 60 REITs listed on the ASX. This growth was supported by both institutions and private sponsors.

The A-REIT market then went through a wave of consolidation with cross border mergers that gave emergence to A-REITs with international exposure and the increase in popularity of the stapled security.

In 2008/09, the A-REIT sector undertook a phase of recapitalisation. This was due to a combination of historically high gearing levels, falling property values and dislocated credit markets. A-REITs were forced to initiate large dilutive equity raisings, cut distributions, or sell assets at discounts to book value. By 2010/11, A-REITs have refocused on the source of earnings with many A-REITs scaling back to Australian-centric operations, while large cap growth-oriented A-REITs have looked offshore and towards improving return on capital employed and assets under management.

EVOLUTION OF THE JAPANESE REIT ("J-REIT") MARKET

Debuted with the IPOs in September 2001, the first two J-REITs (Nippon Building Fund, Japan Real Estate) were listed on the Tokyo Stock Exchange in September 2001 with a combined market cap of around ¥260 billion. By the end of March 2007, the number of listed J-REITs had grown to 41 with a market cap of ¥6.3 trillion. In just around five years, the market ballooned to 24 times its initial size.

Regulatory reforms had much to do with this rapid growth, such as the tax reforms in 2003 which lowered the rate on capital gains and dividends from 20% to 10%. A change in July 2003 to allow funds-of-funds targeting REITs also had a positive effect. A track record of stable dividends among listed names promoted J-REITs as an attractive investment. New types of REITs emerged added to the diversity of J-REITs on the market, targeting investments outside the greater Tokyo area or other asset types such as logistic facilities and hotels.

After peaking around mid-2007, J-REIT market entered a downtrend. Following the Lehman crisis and bankruptcy of certain J-REITs, financial market confusion complicated the funding environment for J-REITs, leading to significant stagnation in share prices. At that point, it became necessary for officials to act quickly with policies aimed at abating J-REIT credit risk and bringing back some normalcy to the market. Steps taken to improve the fundraising environment for J-REITs in 2008/09 included a facility established to provide funding via the Japan Development Bank, the central bank accepting J-REIT bonds as collateral for credit, and a fund set up to stabilize the real estate market. The tax reforms in 2009 also enabled J-REITs to retain negative goodwill arising from merger (a non-cash item) and not to be distributed as dividend. Since 2010, the J-REIT market has consolidated as a number of mergers were completed.

EVOLUTION OF THE SINGAPORE REIT (“S-REIT”) MARKET

CapitaMall Trust, sponsored by CapitaLand, was the first S-REIT listed in July 2002 with an initial portfolio size of less than S\$1 billion and a market capitalisation of S\$746 million. The initial growth for the S-REIT market was rather slow with only seven REITs listed as of end 2005. After introducing the policy of stamp duty remission in 2005, the sector took off in 2006 with the number of REITs more than doubled to 15 and market cap surged to S\$23 billion by the end of 2006. Whilst most of the S-REITs listed during the earlier period are domestic focused, S-REITs with regional/overseas exposure proliferated as assets from China, Japan, Australia and India sought listing in Singapore.

The Global Financial Crisis in 2008 brought tight credit conditions, declining share price and high cost of capital. 2009 marked the first year where S-REIT asset values were significantly written down. The sector moved into a deleveraging phase where S\$4.7 billion of equity capital was raised to retire debt. By end of 2009, the sector was significantly de-levered with gearing lowered to close to 30%.

Since 2009, the S-REIT market has slowly and steadily returned with a number of portfolios being spun off and acquisitions gradually increasing. Since 2010, with a significant amount of market being securitised, S-REITs increased its overseas exposure. Amongst the overseas markets, China, Australia and Japan are the top three countries of exposure. Currently, the sector has a total of 28 S-REITs with aggregate market capitalisation of US\$44 billion, representing 6.2% share of the SGX market.

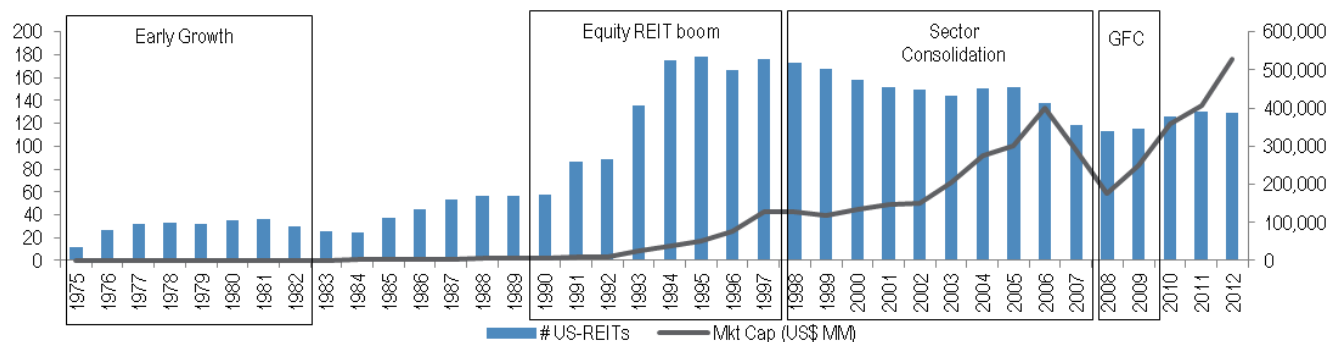
DIFFERENT PHASES OF EVOLUTION OF OVERSEAS REIT MARKETS

The histories of US-REIT, A-REIT and S-REIT markets all exhibited similar developmental phases. They all started with a slower “early growth” period, moving towards steeper growth during “internationalisation” period, then experiencing a “sector consolidation” period. It is important to note that the regulatory changes in the U.S. in 1986 and in Australia in 1998 have directly or indirectly accelerated growth of the sector. Securities regulators should be

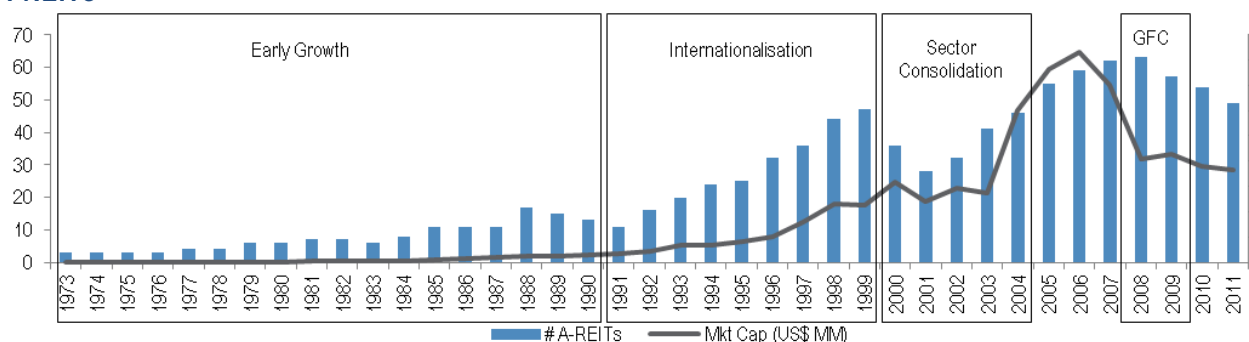
constantly reviewing REIT regulations to ensure they evolve alongside the market and sufficient provisions are available to pave way for sector consolidation which is meaningful for market development.

FIGURE 4: MARKET EVOLUTION OF OVERSEAS REIT MARKETS

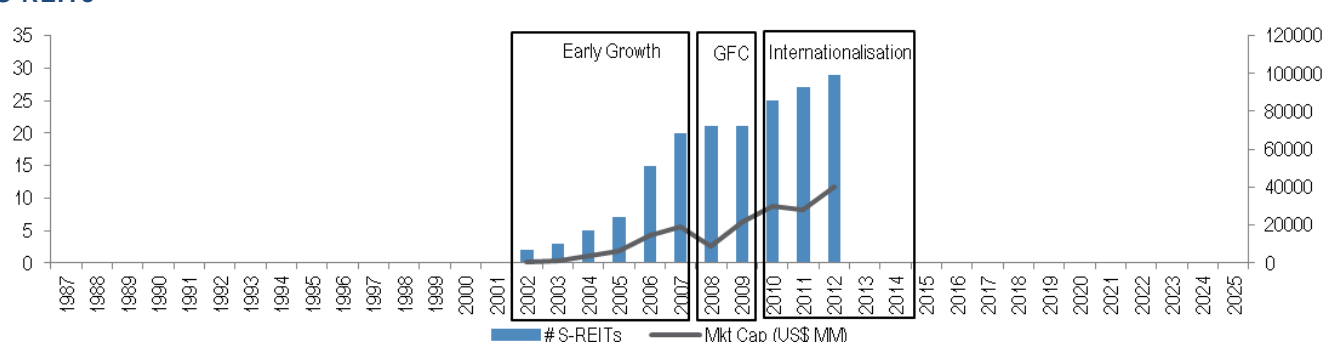
US-REITs



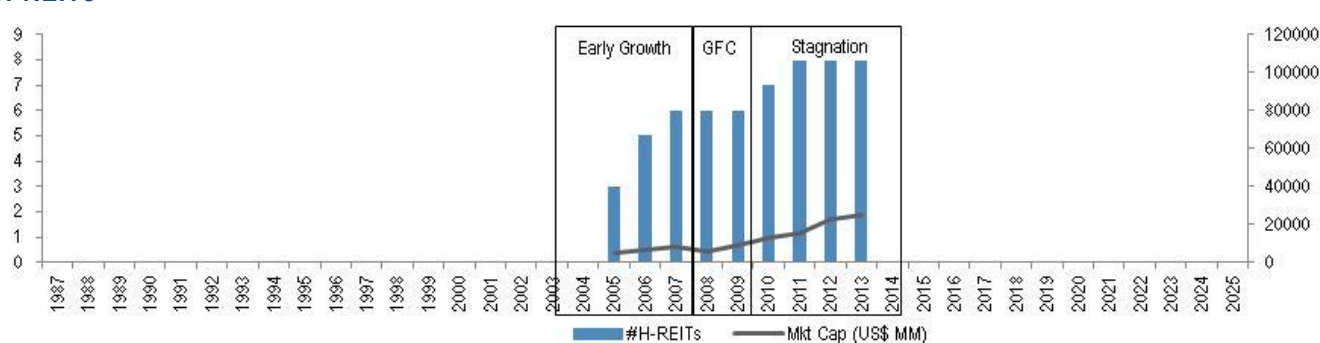
A-REITs



S-REITs



H-REITs



Source: J.P. Morgan

1.3 DEVELOPMENT AND CHARACTERISTICS OF THE H-REIT MARKET

The first portfolio of Hong Kong assets to be spun off and listed as a REIT was Fortune REIT, which was listed on the Singapore Exchange in 2003. It was not until 2005, with the listing of The Link REIT, that Hong Kong market had its first REIT listing. Within two months after the successful launch of The Link REIT, two more H-REITs were listed.

The revision of the Hong Kong REIT Code in 2005 lifted the geographic limitation of assets held in H-REITs. This change helped to bring cross-border deals into H-REITs. Two H-REITs with Chinese assets were launched in 2005 and 2007 respectively and were well-received by investors. The listing of Huixian REIT in 2011 also marked a significant step as it remains the only RMB-denominated REIT listed in Hong Kong. These H-REITs were means to gain direct exposure to rental growth in China through the listed securities market.

However, the H-REIT market has not been overly active, as only nine REITs in total remain listed. H-REITs are also not active in expansion, with only a handful of H-REITs having acquired selected assets from their sponsors. Apart from local Hong Kong and China assets, the Hong Kong market failed to attract any listings of overseas assets as H-REITs. The market suffered a severe blow when even local sponsors started pursuing alternative listing options to securitise their assets, such as listings in overseas exchanges or as a business trust, so to avoid becoming a listed H-REIT. These incidents highlighted the unpopularity of the H-REIT as a capital raising product for sponsors and the failure of H-REIT as a platform to build up Hong Kong's capital market.

1.4 CONCLUSION: REIT MARKETS EVOLVE WITH REGULATORY CHANGES

Throughout REIT's history, regulatory changes and tax incentives have been the most significant forces in boosting market evolutions. They deepened the markets for real estate securitisation and boosted market liquidity. The development of regional REITs depends on the creativity and discipline of the industry to add value for customers and investors. A good regulatory framework provides a suitable platform for continuous expansion.

SECTION 2 MARKET COMPARISON

2.1 REIT REGULATORY REGIMES

Most REITs function as non-taxable conduits. Consequently, each REIT system largely depends on the tax system of the country it operates in. REIT systems can be largely categorised into two major forms. The U.S. system has REITs structured around the country's tax system and are usually, though not always, internally managed. The Australian system has REITs that are established through an investment trust law and act as collective investment schemes with external asset managers (but many A-REITs are internally managed in the form of stapled securities).

Some jurisdictions, including Hong Kong, have adopted the Australian system using closed-end funds. However, many countries also adopt the U.S. system which allows investment in real estate development by REITs in addition to the more common "passive" activities of asset management and portfolio enhancement. In either system, the non-taxable conduit nature of REITs is largely achieved through a pay through structure with each country establishing different requirements to attain such status, usually involving minimum dividend levels, asset and income amounts, as well as minimum number of stockholders and additional requirements for public offerings and listings on exchanges.

In recent years, REIT systems favor a corporation-type model that can conduct mergers and acquisitions, reorganisation and purchase of treasury stocks, conduct active operations (such as development), and invest in overseas properties, among other things.

U.S. REIT SYSTEM

U.S. REIT system is directly based on U.S. tax law established with the revisions to the federal tax code in 1960. Requirements for conduit status include the distribution of at least 90% of its taxable income to investors, a minimum of 100 interest holders and a minimum of 75% income generated from assets related to real estate. U.S. REITs may be corporations, trusts or associations, but are not permitted to be financial institutions or insurance companies.

U.S. REITs can be either internally or externally managed and are also categorised according to investment type: equity REITs that invest directly in real estate assets and mortgage REITs which invest in housing loans and other real estate financing. Equity REITs are either specialised or diversified in their investment property types, with specialised REITs occupying the great majority, investing in office, industrial, retail, residential, hotels, self-storage and healthcare.

AUSTRALIAN REIT SYSTEM

A-REITs are closed-end funds, either listed or unlisted, under a trust vehicle. There are two management approaches: the external management-type trust model and internal management-type stapled securities model. In the trust model, the manager manages the assets owned by the A-REIT and earns a management fee as consideration. This structure was the basis for H-REITs and many other Asian REITs. The stapled securities model is a unique structure where the units of the trust are listed together with the manager's shares as an integrated unit.

Australian tax law limits trusts which function as non-taxable conduits to passive real estate activities such as leasing. The stapled securities model enables the group as a whole to manage and develop real estate, as it divides the group into a corporation that conducts non-passive tasks such as property development and a trust that passively owns real estate. In this way, the passive income of the trust can be paid to investors as dividend is untaxed.

A-REITs are required to invest in real estate that generates real estate income but no specific requirements are stipulated for the ratio of real estate owned to the overall portfolio. Additionally, no requirements are placed on the A-REIT regarding dividend amounts, although all profits are generally distributed as any income retained may be subject to taxation.

A-REITs have increasingly invested in overseas real estate as no limitation is placed on such investment and most investment-grade real estate in Australia have already been incorporated into the A-REIT market. They also increasingly adopt the stapled securities model in pursuit of higher profitability through real estate development.

REIT SYSTEMS IN ASIA

With the exception of the South Korean REIT system, most Asian REITs follow Australia's model and use closed-end structures with external asset managers. The Singaporean REIT system is considered the most established in Asia, with S-REITs proactively investing throughout the region, spurring further investor interests in the market. Most S-REITs are specialized in terms of investment property sectors, but in aggregate, S-REITs offer the widest range of asset types in Asia, ranging from the more "traditional" commercial properties such as retail, office and hospitality to office parks and healthcare facilities.

S-REITs are closed-end funds that utilize collective investment schemes and are externally managed. Conduit status is only granted to listed trusts under the tax law and consequently all current S-REITs are trusts. Other requirements for conduit status of S-REITs include a minimum of 75% of total assets invested in rental real estate and a minimum of 90% of taxable income distributed to investors. S-REITs are not permitted to actively engage in real estate development activities but may invest in development projects up to a certain degree.

The Hong Kong REIT system consists of H-REITs that are listed as closed-end funds employing a trust structure. But compared with other developed REIT markets in the region and around the world, Hong Kong has the most restrictive REIT regime in that H-REITs are completely prohibited from participation in development. H-REITs also receive no preferential tax treatment, and the same stamp duty is levied on property transactions similar to any property investors. In addition, there is no mechanism to enable a complete takeover and privatisation of an H-REIT, thereby creating hurdles and regulatory uncertainty for mergers and consolidation of the market.

FIGURE 5: REGULATION COMPARISON

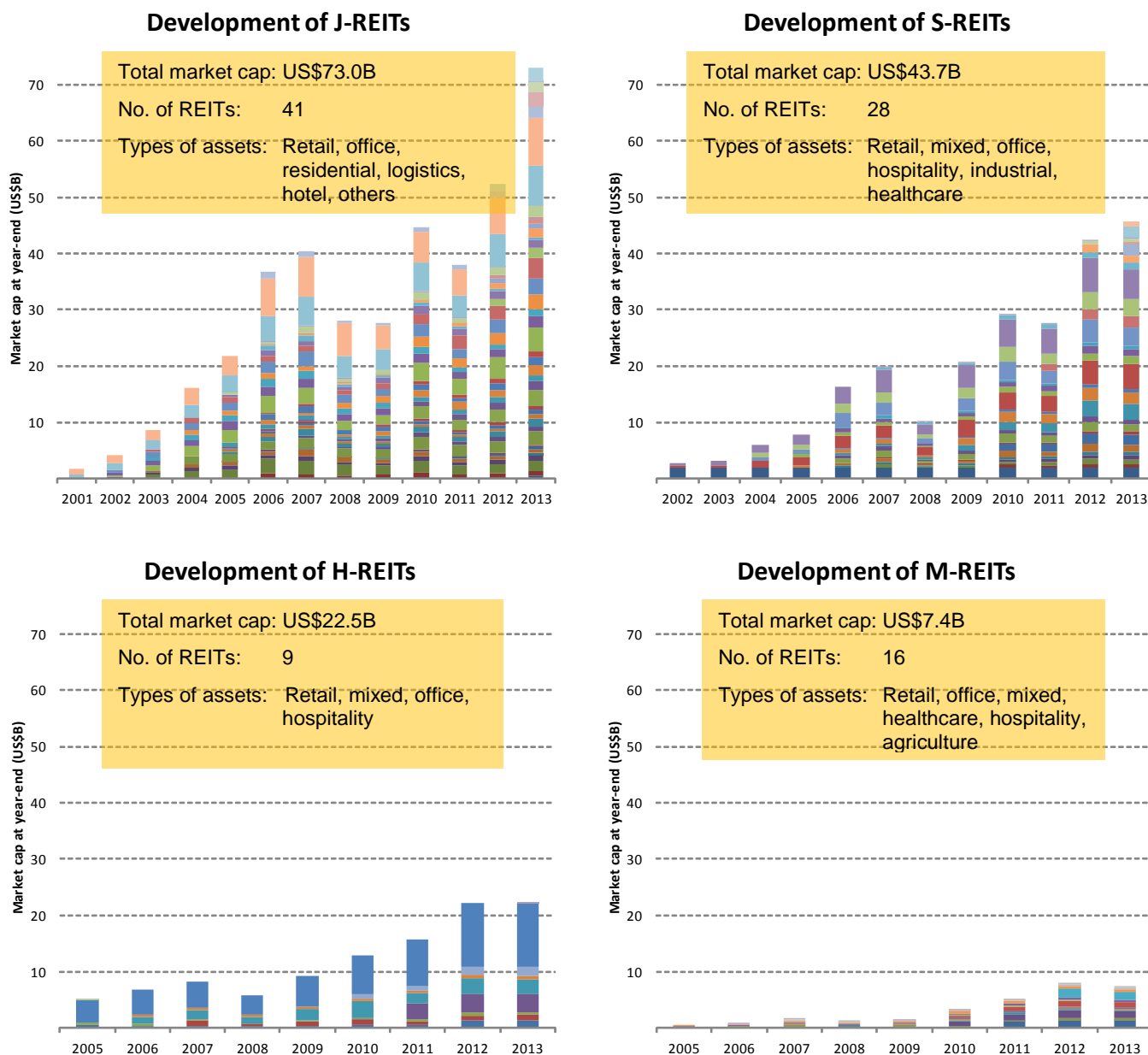
	Hong Kong	Singapore	Australia	Japan	United States	United Kingdom
Legal structure	Trust	Trust or Corporation	Trust	Trust or Corporation	Corporation	Close-ended company
Mandatory listing	Yes	No	No	No	No	Yes
Dividend policy	At least 90% net income after tax	At least 90% of taxable earnings	100% of taxable earnings	At least 90% of taxable earnings, capital gain is part of the distributable income.	At least 90% of taxable earnings	At least 90% of income from the property rental business
Overseas investments allowed?	Yes	Yes	Yes	Yes (amended Feb 08)	Yes	Yes
Real estate investments	100%	75%+ of income must be from rental or other specified sources.		70%+ of assets	95%+ of earnings and 75%+ of investments must be real estate	75%+ of both earnings and market value. Must hold at least 3 separate assets, no one exceed 40% of total assets
Development	Not allowed	10% of total assets. Development for sale not allowed	OK	No	OK	OK for the proposed of renting out
Tax treatment <i>At REIT level</i>						
Profit tax	1) HK REIT is not tax transparent and has to pay local income tax, no special tax treatment for REITs in HK	1) Tax exemption on eligible rental income upon 90% income distribution	1) Tax pass through for property trusts - Not taxed at Trust level provided unit holders are entitled to the Trust's income; Stapled trusts pay tax on active income	1) Japanese withholding tax can be credited.		1) Income from a property rental business is exempt from corporation tax. Residual business income is taxable at the highest rate of corporation tax (currently 26%)
Tax on capital gain and dividends	2) No tax on capital gains or dividends	2) No tax on capital gains	2) No capital gains tax provided unit holders are entitled to the Trusts' income	2) Dividends are deductible from taxable income.	2) Dividends are deductible from taxable income. No refund of foreign withholding tax	2) Distributions out of the property rental business profits are generally subject to 20% withholding tax; no withholding tax levied on distributions that are made out of the residual business income
Transaction tax	3) Stamp duty of up to 8.5% on transfer of real estate into a REIT	3) 2-3% stamp duty on purchase of real estate assets by REITs, remissioned; Transfer of properties not subject to GST	3) No stamp duty for listed Trusts, but duty of up to 6.75% on transfer of property/units in unlisted property trusts.	3) Reduced real property acquisition tax and registration, license tax on real estate purchase	3) Real property acquisition tax and registration tax apply	3) Stamp Duty of between 1% -4% for commercial property and 5% for residential property
<i>At investor level</i>						
Tax on distribution to domestic investors	1) No further tax to pay after corporate tax	1) Current income distribution taxed at corporate tax rate (17%); No tax on distribution to domestic investors	1) Franked dividend - No withholding tax; All other trust income - dependent on the taxable income of the individual and could be between 29% - 47% . Corporate unit holders pay at corporate tax rate (30%).	1) Dividends paid to corporations are subject to 15% withholding tax. Dividend income is aggregated with other income and taxed at corporate tax rate. Dividends paid to qualified pension funds are not subject to tax. Dividends paid to individual investors holdings less than 5% of total units are subject to withholding tax of 10% which can be credited against their own income tax liability.	1) Dividends paid to domestic corporations/individuals are subject to 35% tax	1) No further tax to pay after corporate tax; for individuals however, higher rate tax payers pay additional tax (the amount of which depends on their personal tax position)
Tax on distribution to foreign investors	2) No withholding tax for international institutional investors	2) Tax on distributions made to a foreign non-individual investor is 10% till 2015; tax treaty not applicable	2) Rules are different for 'managed investment trusts'. Non-final flat 30% tax on distributions to non-residents unit holders.	2) For foreign shareholder, withholding tax is final; can claim benefits from tax treaties.	2) For foreign shareholder, withholding tax is 30%	2) 20% withholding tax for international investors; can claim benefits from tax treaties.
Tax on capital gain		3) Capital gains are generally tax exempt	3) Taxable capital gains eligible for a 50% discount.		3) Shareholders are taxed on capital gain distributions from assets the REIT held for at least one year at a 15%	
Corporate tax rate	16.5%	17%	30%	38%	40%	24%

Source: J.P. Morgan, UBS Research, EPRA

2.2 KEY ASIAN REIT MARKETS

Traditionally, listed real estate exposure for investors in Asia was limited to listed property companies. This has changed significantly with the introduction of REITs to Asian markets since 2000. The REIT product has resulted in a major transformation of the listed real estate space in Asia by providing a stronger focus on quality real estate investment portfolios delivering attractive yields to investors.

FIGURE 6: COMPARISON OF KEY ASIAN MARKETS



Market cap at year-end except for 2013 data until 28 October 2013

Source: Bloomberg (as at 28 October 2013), ARES, NAREIT

Among the developed Asian REIT markets, Hong Kong is lagging behind Singapore, Japan and Malaysia in terms of the number of listings and diversity of asset types and geography. Although Hong Kong market size is bigger than that of Malaysia, Hong Kong market is dominated by one large player, The Link REIT, which constitutes approximately 50% of the market. The Malaysian market is relatively more diverse and evenly spread among the 16 issuers, while Hong Kong has only nine listed H-REITs.

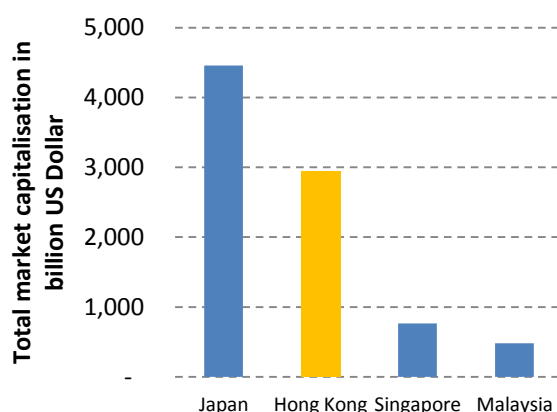
Other Asian markets have also been catching up on REIT activities. Singapore has been diversifying its REIT offerings and boosting governance standards. It has established the world's largest Shariah-complaint REIT. Malaysia allows M-REITs to conduct forward purchases, exempts M-REITs from income tax and waives stamp duty for asset acquisition by M-REITs.

2.3 OVERALL CAPITAL MARKET STRENGTH

HONG KONG IS THE LEADING CAPITAL MARKET IN ASIA

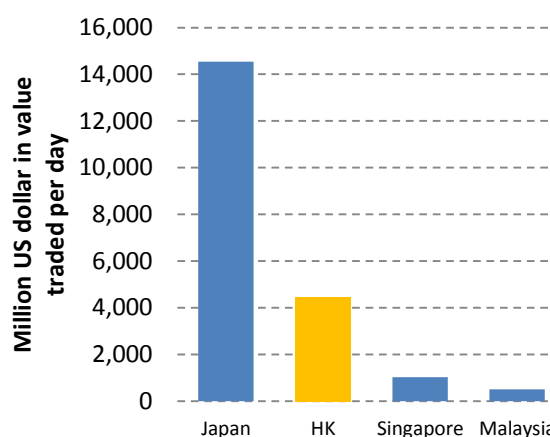
Hong Kong has been the regional and international financial hub. The success of Hong Kong's capital markets is demonstrated through the depth of funds traded in the market and the breadth of issuers attracted to the market. Among the key stock exchanges in Asia, Hong Kong comes second in terms of market capitalisation and trading activity (see Figures 7 and 8). It is also by far the largest in the amount of IPO proceeds raised over the last five years (see Figure 9). More importantly, Hong Kong has attracted issuers from across the globe, from high-end luxury brands in Italy (Prada) and world-renowned luggage manufacturer in the U.S. (Samsonite), to countless companies from across sectors and industries in Hong Kong and China. Hong Kong is widely considered by the global investment community as one of the most established and efficient capital markets in the world.

FIGURE 7: MARKET CAPITALISATION (SEP 2013)



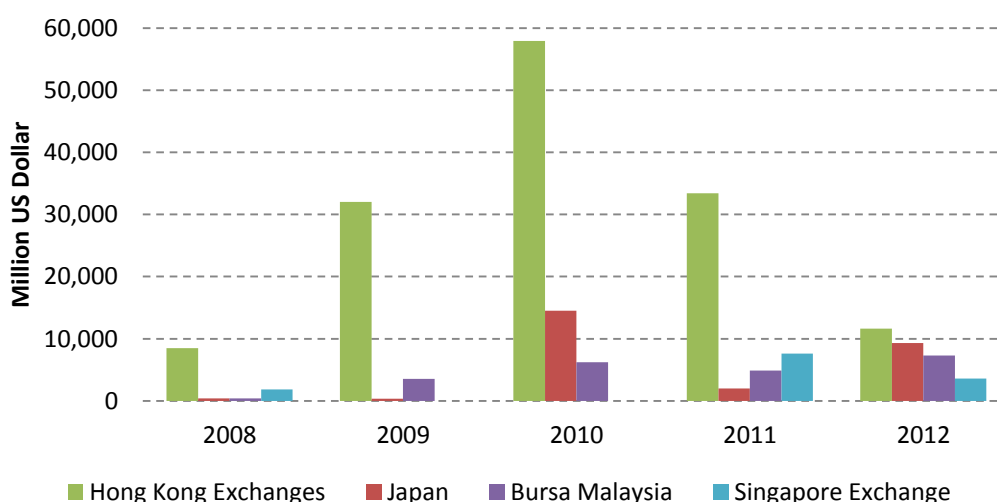
Source: World Federation of Exchanges

FIGURE 8: TRADING VALUE (CY2012)



Source: World Federation of Exchanges

FIGURE 9: COMPARISON OF IPO PROCEEDS IN SELECTED ASIAN MARKETS



Source: World Federation of Exchanges

Further evidence of the strength of Hong Kong's capital market can be demonstrated by comparing the trading behavior of securities listed in Hong Kong versus overseas markets. Perhaps the best example to illustrate is Fortune REIT, which is one of the few securities with a dual primary listing status in both Singaporean and Hong Kong stock exchanges and is subject to the regulatory regimes in both jurisdictions. Despite being listed first in Singapore since 2003 and subsequently becoming listed in Hong Kong in April 2010 via introduction with no new equity raised, the trading of Fortune REIT units has decidedly shifted from Singapore to Hong Kong. After only one year of attaining dual listing status, the average daily trading volume in 2012 was 2.74 million units in Hong Kong, over 2.4 times that of Singapore. Such phenomenon is a clear sign that Hong Kong is still the preferred market of choice by investors, and more importantly, Hong Kong's potential to develop into a global capital formation centre for REITs.

2.4 CONCLUSION: DE-REGULATION HELPED REITs GROW

Comparing the regulatory regimes between Hong Kong and other REIT markets internationally and within the region, Hong Kong is much more restrictive and lacking in incentives. The result of this comparative disadvantage is manifested through the H-REIT market development so far, which shows Hong Kong lagging substantially behind Japan, Singapore and even Malaysia. With Hong Kong's reputation and track record as one of the most vibrant equity markets in the world in terms of fund raising and liquidity, Hong Kong should position itself better to gain leadership as a capital formation platform in the regional REIT market.

SECTION 3 BENEFITS OF A THRIVING REIT MARKET

As Asia's financial hub, Hong Kong has all the criteria to grow a thriving REIT market and bring many benefits such as:

1. Fortifying Hong Kong as the region's centre for financial and capital markets;
2. Strengthening Hong Kong as a global capital formation centre by becoming the listing venue of choice for PRC and other overseas issuers and attracting international institutional investors to our platform;
3. Clustering effect to attract REIT analysts and global property specialists to Hong Kong, enhancing the width and depth of analyst coverage on REITs, industry practitioners' standards, and corporate governance; and
4. Further enhancing Hong Kong's capital markets as REITs are frequent capital market users, thus market participants will introduce more innovative fund raisings by REITs and more REIT-based structured products to Hong Kong.

3.1 FORTIFY HONG KONG'S MARKET POSITION

REITs were first created with the objective of enabling smaller investors to invest in large-scale, income-generating real estate in a cost effective manner, with a relatively transparent and well-defined investment strategy. Due to the listing status, relative liquidity, high pay-out ratio and "flow through" tax status, REITs are often considered an attractive income-generating investment and a possible alternative to physical real estate and bonds. REITs attract investments from both retail and institutional investors, especially those with a view to diversify their investment portfolios with smaller investment amounts.

One of the potentially biggest sources of funds investing into REITs is pension funds. With Asia accounting for 60% of the world's population, the growth of pension funds in Asia over the coming decades will be phenomenal. Asian pension funds are estimated to double their assets over 2006-2015 to US\$2.4 trillion, and further increasing to US\$4.3 trillion by 2030. The most significant growth in market share will be in China, South Korea and India.

FIGURE 10: EXPECTED GROWTH IN ASIAN PENSION FUND ASSETS 2006-2015

Country	Assets		Percentage of Asian assets	
	2006	2015	2006	2015
China	\$89B	\$581B	8%	25%
Hong Kong	\$60B	\$142B	5%	6%
India	\$57B	\$227B	5%	10%
Japan	\$789B	\$862B	69%	36%
Singapore	\$92B	\$155B	8%	7%
South Korea	\$45B	\$286B	4%	12%
Taiwan	\$6B	\$52B	1%	2%
Thailand	\$13B	\$66B	1%	3%
Total	\$1,151B	\$2,371B	100%	100%

Source: Allianz (2008)

In addition to the growth of pension funds in Asia, the industry is also undergoing fundamental shift in its investment strategy. Traditionally, pension funds in Asia focus their asset allocation on domestic fixed income assets. But these funds are gradually embracing real estate as an asset class as it offers alternative investment characteristics which match the long term liabilities of pension funds.

In a survey of major pension funds in Asia conducted by the Asia Pacific Real Estate Association (APREA), domestic REITs and international REITs are among the top three types of real estate investments considered suitable for pension funds. Given the significant levels of assets under management and estimated growth trajectory, Asian pension funds increasing their real estate allocations will be a significant stimulus for the REIT market in Asia. Thus, continuous development of the H-REIT market will ensure Hong Kong maintains its market position as a leading financial centre with sufficient breadth of investment products available to Asian pension funds.

3.2 STRENGTHEN HONG KONG AS A GLOBAL CAPITAL FORMATION CENTRE

With only nine H-REITs currently listed in Hong Kong and the relative inactivity of the H-REIT market, Hong Kong is frequently being overlooked as a potential listing venue for sponsors planning to list their REITs. However, statistics indicate that the potential market for REIT listings is significant.

FIGURE 11: SIZE OF ASIA-PACIFIC REAL ESTATE MARKETS IN 2011, 2012 AND 2031

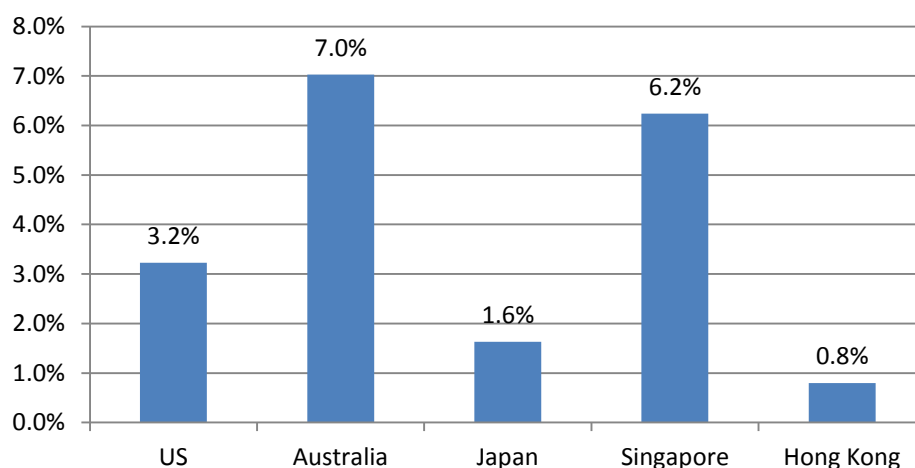
Country	2011		2021		2031	
	US\$B	% of Global	US\$B	% of Global	US\$B	% of Global
Japan	\$2,678	10.1%	\$3,073	6.3%	\$4,037	4.4%
China	\$1,864	7.0%	\$9,741	20.0%	\$26,395	28.7%
Hong Kong	\$211	0.8%	\$353	0.7%	\$623	0.7%
Singapore	\$241	0.9%	\$546	1.1%	\$1,128	1.2%
Malaysia	\$84	0.3%	\$246	0.5%	\$465	0.5%
Other Asia	\$2,091	7.9%	\$5,126	10.5%	\$12,289	13.3%
Asia subtotal	\$7,169	27.0%	\$19,085	39.2%	\$44,937	48.8%
Global total	\$26,559	100.0%	\$48,723	100.0%	\$92,065	100.0%

Source: "The Significance of The Asia-Pacific Real Estate Markets" by APREA

Given the explosive growth of the Asia-Pacific real estate market, particularly in China which will overtake the U.S. as the largest market in the world by 2031, demand for real estate securitisation will increase drastically. REITs offer property companies an important channel to monetise otherwise illiquid real estate assets. Companies are attracted by the opportunity to optimize into a more "asset light" business models, unlock value of their real estate portfolios, receive recurring fee based income (if they retain ownership of the REIT managers), thereby enhance capital productivity and diversify sources of capital. Many Asian property developers have already adopted the strategy to securitise their assets as listed REITs and build a sponsor platform to manage multiple REITs.

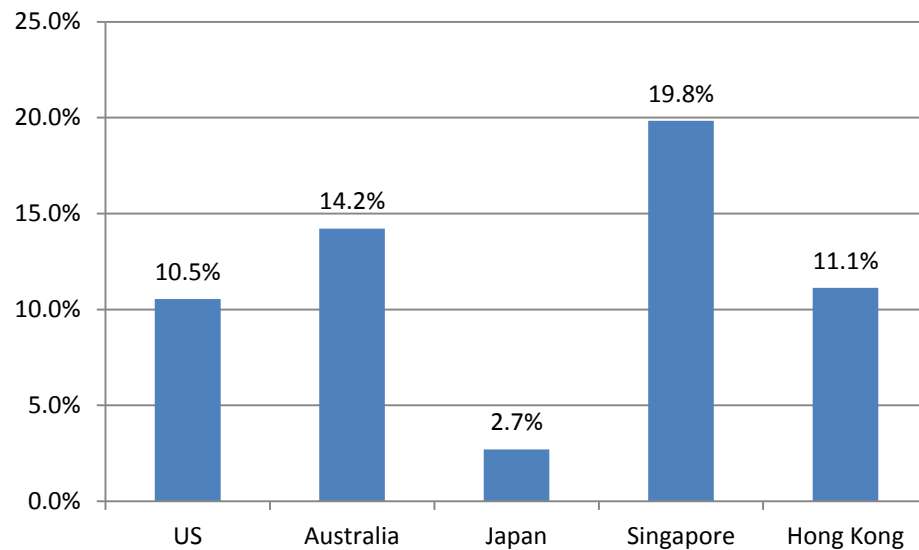
For the developed REIT markets in Singapore, U.S. and Australia, listed REITs currently constitute approximately 19.8%, 10.5% and 14.2% of their real estate markets, respectively. Applying the same ratio to the Hong Kong and China markets in aggregate by 2031, listed REITs may amount to US\$2,837 – 5,350 billion in size.

FIGURE 12: REIT MARKET CAPITALISATION AS % OF TOTAL MARKET CAPITALISATION



Source: Bloomberg, World Federation of Exchanges retrieved in October 2013

FIGURE 13: REIT MARKET CAPITALISATION AS % OF TOTAL INVESTABLE REAL ESTATE



Source: Bloomberg, "The Significance of The Asia-Pacific Real Estate Markets" by APREA

Over the past two decades, Hong Kong has acted as China's window for major capital market fund raisings and the listing venue of choice for major Chinese companies. Currently, the REIT market in China is still yet to be developed. Chinese authorities have not indicated any timetable for the finalisation of China's REIT regulations. Hong Kong stands as the market best positioned to tap into this substantial potential of REIT listings for Chinese assets. Hong Kong must seize this opportunity and gain back the prominence as the preferred listing venue for sponsors, from Chinese or other overseas markets, which are planning to list their REITs.

3.3 CLUSTER EFFECT

As more REITs become listed in Hong Kong, more investment analysts and global property specialists will be needed to cover the stocks. Brokerage services will also benefit from the increase in trading volume of the stock market.

Asset management market will also develop and grow to cope with the growing investment need. Such growth will enhance the skills and sophistication of fund managers in managing alternative investment products, broadening the range of investment products they can offer to the public. In addition to buy-side demand, H-REITs may lead to more real estate fund managers and professionals in Hong Kong, as some of these H-REITs take the form of externally-managed entities.

Actively managed REITs—through regular mergers, acquisitions and divestment activities—will impact on both the demand and liquidity of the property market.

REITs are potentially significant clients, especially for those REIT markets which are actively growing. With frequent acquisitions and regularly financing activities, REITs give rise to a lot of advisory work for a wide range of experts. Survey, legal, accounting, tax advisory professions will benefit from increasing demand of their services. As these professionals investigate into H-REITs' investment strategies, operations, income potential, payout ratios and valuation, they will also create higher transparency in the property market.

3.4 ENHANCE FINANCIAL AND CAPITAL MARKET

Traditionally, banks in Hong Kong have been important providers of capital to the property market. H-REITs provide additional demand of banking and financing products (such as bonds, equities, convertible securities and other financial advisory) as H-REIT managers seek more innovative means to improve liquidity, re-deploy capital and strengthen capital management capability. This demand will give rise to more REIT-based structured products in Hong Kong and further boost the capital market industry.

SECTION 4 REVITALIZE REIT MARKET IN HONG KONG THROUGH REGULATORY CHANGES

History shows that REIT regimes in various jurisdictions (such as the U.S., Australia and Japan) have gone through rounds of transformation. Their evolution not only addressed the needs of their markets and investors, they also became catalysts for continuous growth, both in terms of market value and number of REIT participants.

For Hong Kong to enjoy the benefits of a thriving H-REIT market, it will have to improve its competitiveness against other markets in the region. The improvements need to enhance both organic and inorganic sources of growth:

- **Inorganic growth** due to increasing numbers of REIT participants, which requires more issuer-friendly environment, broader investor base, and incentives to entice potential REIT issuers to come to Hong Kong to list their REITs; and
- **Organic growth** coming from the continuous expansion of incumbent H-REIT players, necessitating a market infrastructure more conducive to development, merger and acquisition activities.

4.1 INITIATIVES TO ENCOURAGE GROWTH: FACILITATE INVESTMENTS IN H-REITS

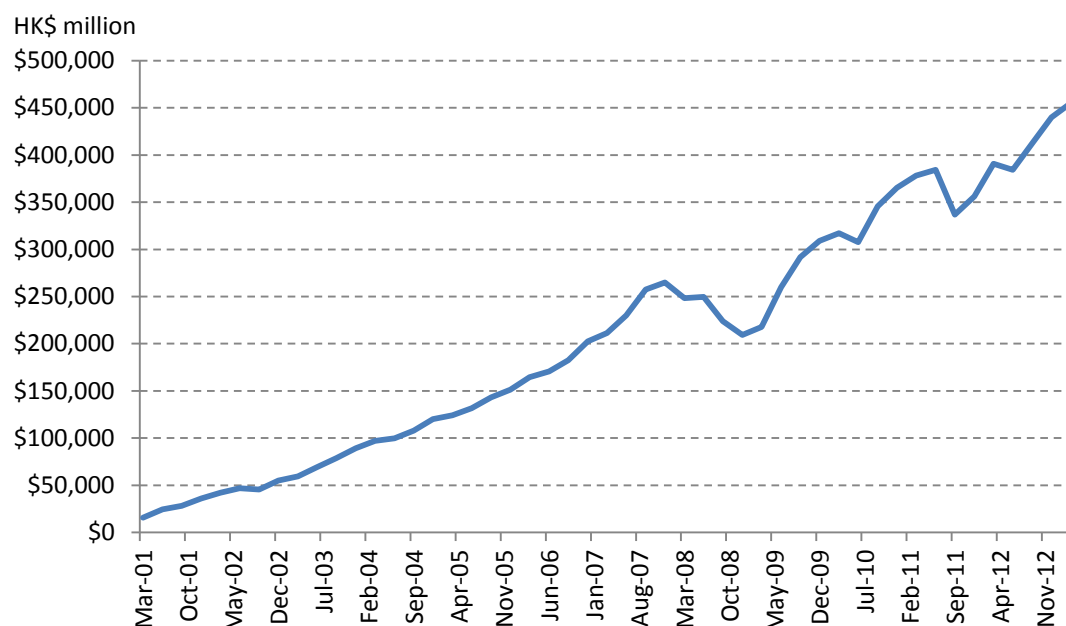
BACKGROUND

Superannuation funds regulated under the Mandatory Provident Fund Schemes Ordinance (MPF Schemes) are a significant potential investor base for H-REITs. However, MPF Schemes are currently subject to a limit of 10% of total scheme funds on their investments in H-REITs. This restriction is due to the categorisation of H-REITs as a type of permissible investment under section 8(2)(c) of Schedule 1 to the Mandatory Provident Fund Schemes (General) Regulation (MPFS Regulation). For permissible investments under section 8(2)(c) of Schedule 1 to the MPFS Regulation, constituent funds are restricted to invest a maximum of 10% of its total funds in such permissible investments. This limitation appears to be targeted at unlisted funds authorised by the SFC.

IMPACT ON H-REIT MARKET

According to statistics from the MPF Schemes Authority, approximately 70% of Hong Kong's employed population is currently covered under MPF Schemes. As at 30 June 2013, the aggregate net asset values of all MPF Schemes amounted to HK\$452.1 billion.

FIGURE 14: NAV OF APPROVED CONSTITUENT FUNDS OF MPF SCHEMES



Source: Mandatory Provident Fund Schemes Authority

Although there is no detail as to how much of the MPF Schemes are currently allocated to H-REIT investments, H-REITs are well-suited to the investment appetite of MPF Schemes due to their nature as an equity-bond hybrid product and their lower investment risk relative to ordinary listed equities. Similar to REITs, index-tracking collective investment schemes also appeal to MPF Schemes' investment appetite, but index trackers are not subject to any investment restrictions as they are exempted under Section 8(1) of the Schedule to the MPFS Regulation. It would be in the interest of MPF Scheme members to remove the restriction on their investment exposure to H-REITs as well.

COMPARISON WITH SHARES OF LISTED PROPERTY COMPANIES

Section 8(1) of the Schedule to the MPFS Regulation allows a constituent fund to invest in fully-paid up "shares" listed on approved stock exchanges. Thus, listed property companies are currently permissible investments under the MPFS Regulations and constituent funds are not restricted as to the amount of their portfolio which can be invested in listed property companies. Since this provision only applies to "shares", it does not permit investment in other listed securities with the same or similar characteristics (such as units in H-REITs) solely because technically they are not "shares".

The current provision is unduly restrictive in scope and has resulted in inconsistent treatment between H-REITs and listed property companies. H-REITs combine the features of an investment fund with that of listed property companies. In addition to

the similar nature and investment merits, H-REITs are subject to a corporate governance and disclosure regime that is on par with, or even superior to, one that governs listed companies, with additional requirements such as licensing of REIT manager, regulatory oversight by both the SFC and the Hong Kong Stock Exchange, and compliance with the REIT Code. To ensure parity of treatment with listed property companies, H-REITs should be re-categorised so that MPF Schemes are not limited in their exposure to H-REITs.

COMPARISON WITH OTHER REIT REGIMES

In Singapore, investors who are members of the Central Provident Fund (CPF) may use up to 35% of the investible savings in their CPF Ordinary Accounts to subscribe for units in S-REITs which has been approved for inclusion under the CPF Investment Scheme. In Australia, there is also no explicit investment restriction/limit imposed on a superannuation fund for its investment in A-REITs.

PROPOSAL FOR HONG KONG: AMEND MPFS REGULATION

The current categorisation of H-REITs under section 8(2)(c) of Schedule 1 to the MPFS Regulation should be amended. In order that the 10% investment limitation does not apply, it would be more appropriate for H-REITs to be categorised under a new section 6B and section 8(1)(c) of Schedule 1 to the MPFS Regulation.

SUGGESTED AMENDMENTS TO SCHEDULE 1 TO THE MPFS REGULATION

8. Permissible investments: equities and other securities

(1) The funds of a constituent fund may be invested in-

- a) fully-paid up shares listed on an approved stock exchange other than the shares of a company which is a collective investment scheme;
- b) an index-tracking collective investment scheme approved by the Authority for the purposes of section 6A of this Schedule; ~~or~~
- c) a real estate investment trust approved by the Authority for the purposes of section 6B of this Schedule; or
- d) securities listed on an approved stock exchange that are approved, or are of a kind approved, by the Authority.

6B. Permissible investments: real estate investment trust

The funds of a constituent fund may be invested in a real estate investment trust which is-

(a) either-

- i. authorised by the Securities and Futures Commission, within the meaning of the Securities and Futures Ordinance (Cap 571); or

- ii. listed on a stock exchange approved by the Authority for the purposes of this section; and

(b) approved by the Authority for the purposes of this section.

4.2 INITIATIVES TO ENCOURAGE GROWTH: TAX ADVANTAGES TO H-REITS

BACKGROUND

In major overseas REIT markets, REITs enjoy certain tax advantages when compared to property companies with a similar business nature. This tax advantage is a fundamental characteristic for REITs as an investment product and a key factor that contributes to REITs' popularity among investors. As long as a REIT satisfies the requirement to distribute most of its income to unitholders, it will not be subject to income tax at the trust level, though different jurisdictions will have different nuances to this rule (such as Singapore which restricts the tax benefit to only distribution to domestic investors).

In SFC's 2003 consultation, the regulator acknowledged that "investors in REITs can benefit by taking advantage of higher after-tax returns. This taxation benefit has been an important factor to the success of REITs in the U.S. and Australia."

IMPACT ON H-REIT MARKET

Hong Kong's REIT regulations do not accord H-REITs with any tax advantages. Currently, H-REITs have to pay 16.5% corporate tax on their profits, despite the REIT Code requirement to distribute no less than 90% of their after-tax income. Such tax levied on H-REITs severely reduces the distributable amount they can pay to their unitholders, thus putting H-REITs at a clear disadvantage against overseas peers which can offer a higher yielding investment to investors.

For H-REITs which are seeking to expand their portfolios through acquisitions, the absence of tax advantage also means that H-REITs are not in a position to price their offers competitively against other property investors. Given the existing investment restrictions for H-REITs which bar them from any development projects, they can only target mature, stable income-generating properties. With such limited investment opportunities for high-yielding assets and lack of any beneficial tax treatment, H-REITs have difficulty in growing their portfolios while offering an attractive investment proposition for their unitholders.

PROPOSAL FOR HONG KONG: H-REITS TO BE EXEMPT FROM INCOME TAX

To give H-REITs equivalent tax transparency as in other jurisdictions, the Inland Revenue Department should consider amending the Inland Revenue Ordinance to exempt profits tax for H-REITs on rental income. Such a change will provide clear incentives to the market – both potential sponsors of soon-to-list H-REITs as well as

existing listed H-REITs – to encourage more H-REIT listings and more properties to be acquired by H-REITs.

4.3 INITIATIVES TO ENCOURAGE GROWTH: DEVELOPMENT

BACKGROUND

H-REITs suffer from one of the most restrictive regulatory regimes in the world in terms of investment restrictions. H-REITs are currently barred from investing in vacant land and participation in any property development activities. The objective of such restrictions is to differentiate the investment scope, and thus the inherent risk profile, of H-REITs versus other listed property developers. However, the wording in Hong Kong's REIT Code is wide and unduly restrictive.

EXCERPTS OF THE CODE ON REAL ESTATE INVESTMENT TRUSTS ISSUED BY THE SECURITIES AND FUTURES COMMISSION (JUNE 2010)

Core Requirements

7.1 The scheme shall only invest in real estate.

7.2 The scheme is prohibited from investing in vacant land or engaging or participating in property development activities. For this purpose, property development activities do not include refurbishment, retrofitting and renovations."

Notes:

(1) The real estate shall generally be income-generating.

(2) The scheme may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, but the aggregate contract value of such real estate shall not exceed 10% of the total net asset value of the scheme at the time of acquisition.

IMPACT ON H-REIT MARKET

In competing with property developers who also hold investment properties for long-term investment, H-REITs are handicapped in that:

- **H-REITs cannot build their own assets.** H-REITs are stuck with the design and specifications of assets built by others. They have to incur additional costs if the need to modify any design or specifications arises after the purchase.
- **H-REITs can only acquire investment properties in the market.** There are few quality assets available for H-REITs to acquire in Hong Kong. Acquisition on an opportunistic basis makes it difficult for an H-REIT to formulate long term strategic growth plan.
- Note 2 to REIT Code 7.1 is not a solution because it only allows H-REITs to purchase uncompleted units in a building. Current Hong Kong and China land administrative regime invariably require that incomplete units can only

be sold after the property project has reached a certain stage of maturity and consent to sell is obtained from the relevant land authorities.

If H-REITs can invest early in the project cycle, they can take advantage of the lower purchase price closer to “at-cost” pricing, and not at “final product” pricing by the time the project reaches the post-sale consent period. More importantly, early investment into the project will allow H-REITs to have input and control over the final product it wishes to purchase. This early participation in a project will be ultimately beneficial to H-REIT investors due to lower costs and a more efficient acquisition.

H-REITs CANNOT EVEN RE-DEVELOP THEIR AGING PORTFOLIO

Because of the REIT Code 7.2 blanket prohibition on development activities, an H-REIT cannot re-build its existing assets even if they have fallen into dilapidation. Even with diligent property management and maintenance, many of today’s H-REIT assets will eventually need to be re-built due to aging, as normal repair and maintenance costs out-weigh the returns. This would imply that H-REITs are compelled to sell their aging assets. A disposal in such circumstances will not result in good pricing for the H-REITs as full potential of the asset under disposal is not reflected. Such under-pricing will not be in the best interests of H-REIT unitholders, not to mention the urban decay caused by aging structures.

COMPARISON WITH OTHER REIT REGIMES

Mature REIT markets – such as the US, UK, Australia or Japan – do not restrict REITs from undertaking real estate development activities. In certain jurisdictions such as Singapore, a REIT can undertake property development activities as long as such activities do not exceed a certain percentage of the value of the REIT and the REIT intends to hold the property as investment after completion of the development project.

EXCERPTS OF THE CODE ON COLLECTIVE INVESTMENT SCHEMES ISSUED BY THE MONETARY AUTHORITY OF SINGAPORE

7 Restrictions and Requirements on Investments and Activities

- 7.1 A property fund should comply with the following restrictions and requirements:*
- a. subject to paragraph 7.5, at least 75% of the property fund’s deposited property should be invested in income-producing real estate;*
 - b. a property fund should not undertake property development activities whether on its own, in a joint venture with others, or by investing in unlisted property development companies, unless the property fund intends to hold the developed property upon completion. For this purpose, property development activities do not include refurbishment, retrofitting and renovations.*
 - c. a property fund should not invest in vacant land and mortgages (except for mortgage-backed securities). This prohibition does not prevent a property*

fund from investing in real estate to be built on vacant land that has been approved for development or other uncompleted property developments.

- d. the total contract value of property development activities undertaken and investments in uncompleted property developments should not exceed 10% of the property fund's deposited property. For the purpose of this paragraph, the value of the investment refers to the contracted purchase price and not the value of progress payments made to date...*

Guidance

An uncompleted property is one that has not been granted a Temporary Occupation Permit or equivalent by the relevant authorities.

Malaysian regulations also have similar provisions to allow M-REITs to invest in property under construction.

EXCERPTS OF THE GUIDELINES ON REAL ESTATE INVESTMENT TRUSTS ISSUED BY SECURITIES COMMISSION MALAYSIA

8.14 For real estates under construction, a fund may enter into an arrangement or agreement at any stage during the construction phase to acquire the real estate, provided that the following criteria are met:

- a. Income from real estates within the fund's investment portfolio is sufficient to ensure that there is no substantial dilution to the fund's earnings per unit during the construction period;*
- b. The purchase agreement is made subject to the completion of the building with sufficient cover for construction risks;*
- c. The construction of the real estate must be carried out on terms which are the best available for the fund and at arm's length transaction between independent parties;*
- d. The prospects for the real estate to be acquired upon its completion is reasonably expected to be favourable, and*
- e. The total value of real estates under construction acquired by the fund does not exceed 10% of the fund's total asset value (after the acquisition).*

WILL DEVELOPMENT CHANGE H-REIT'S RISK PROFILE?

One of the key concerns regarding H-REITs' participation in development activities is the potential change to H-REITs' risk profile. REIT has long been recognized as a relatively safe investment product focusing on stable yield returns and low risks. As evidenced in overseas REIT markets' experience, allowing REITs to participate in development activities has not caused fundamental changes to the product's risk profile. Similarly, investors' perception of REITs' investment merits have not been affected, and investors' appetite for the product have not dampened. On the contrary, having a more diverse range of H-REITs with different focus and risk profiles may lower the risk of the sector as a whole.

Flexibility for individual REIT managers to decide on their investment strategy does not necessarily result in sweeping changes to every REIT's portfolio mix. For instance, H-REITs are subject to a gearing cap of 45%, but historically very few H-REITs would leverage up to such levels, and each REIT manager would exercise management discretion based on its specific borrowing needs and prevailing market

conditions. By expanding H-REITs' investments to include development activities, each REIT manager will have the liberty to choose whether to partake in project development according to its management expertise, risk appetite and growth strategy. Those who choose to do so will have their valuations adjusted by the market accordingly, as REIT investors will make their investment decisions taking into account the REIT's development risks and other merits, such as asset quality, management profile, growth potential, and capital structure.

Although development activities may pose certain risks, arguably such risks are not new to H-REITs:

- **Construction risks.** H-REITs frequently invest in asset enhancements. Such projects are also subject to construction risks such as project delays, cost overrun, legal and counter-party risks, some of which may be mitigated by insurance.
- **Financing risks.** H-REITs are currently subject to a gearing cap of 45%. Despite the addition of development activities, H-REIT will still be subject to such restriction. As to the lack of income during the development period, it is similar to asset enhancement projects which also suffer from lower to no rental revenues when the assets are under renovation. Restricting H-REITs' development activities to no more than 10% of total assets will ensure there will be sufficient incoming-producing assets to generate dividend payments to unitholders.
- **Market risks.** One might argue that development projects are more susceptible to market risks as the market conditions may change once a development project is completed, and the H-REIT may fail to lease up the project. But asset enhancement projects by H-REITs also encounter similar market risks, given many large-scale asset enhancements may take several years to complete, by which point market environment may have changed. In addition, acquisitions of development projects typically cost less relative to buying completed properties (after adding up land costs, development costs, financing costs plus developers' profits) and thus require smaller financial outlay and pose lower risks to the buyer. The risk is further mitigated as the projects will be developed and tailored to the design specifications of the H-REITs, which will hold the assets as long term investments and are subject to REIT Code's two-year minimum holding period. The market risk is lower for H-REITs which are developing to hold, as opposed to other developers which are developing to sell.

PROPOSAL FOR HONG KONG: ALLOW “DESIGN-AND-BUILD”

In light of the risk profile that investors expect of H-REITs, H-REITs should arguably be subject to certain restrictions in investing in vacant land, participation in land- hoarding and land speculation. However, Chapter 7 of the Hong Kong REIT Code should be relaxed and amended to accommodate a “design-and-build” scheme for H-REITs. Within acceptable limits of investors’ protection, H-REITs should be allowed to invest, with respect to a specified portion of their properties, projects which H-REITs will own and manage after completion. H-REITs will then be able to purchase an asset that is designed and built according to their specific needs. This scheme will benefit not only investors of H-REITs, but also the long term development of Hong Kong’s investment property market.

Investors are protected along the following principles:

- A “design-and-build” scheme allowing H-REITs to invest in a structure which holds development projects already approved or ear-marked for development;
- This type of development is limited by a cap – such as 10% of the H-REIT’s total assets; and
- There should be a minimum holding period – no less than 2 years (similar to the minimum holding period for other acquired assets) from completion of the development project.

We believe this update will achieve a balance between investor protection and flexibility in H-REIT operations to benefit the development of H-REIT market.

SUGGESTED AMENDMENTS TO HONG KONG REIT CODE 7.1

Chapter 7: Investment Limitations and Dividend Policy

Core Requirements

7.1 The scheme shall only invest in real estate.

Notes: (1) The real estate shall generally be income-generating.

(2) The scheme may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, ~~but the aggregate contract value of such real estate shall not exceed 10% of the total net asset value of the scheme at the time of acquisition.~~

(3) The offering document shall clearly disclose if the scheme intends to acquire further properties during the first 12 months from listing.

7.2 The scheme is prohibited from investing in vacant land. This prohibition does not prevent the scheme from investing in real estate to be built on vacant land that has

been approved for development or other uncompleted property developments which have not been granted an Occupation Permit or equivalent by the relevant authorities.

7.3 The scheme should not engage or participate in property development activities, unless the scheme intends to hold the developed property upon completion. For this purpose, property development activities do not include refurbishment, retrofitting and renovations.

7.4 The aggregate contract value of such real estate undertaken under 7.1 Note (2), 7.2 and 7.3 shall not exceed 10% of the total asset value of the scheme at the time of acquisition.

4.4 INITIATIVES TO ENCOURAGE GROWTH: TAKEOVER AND PRIVATISATION

BACKGROUND

Takeover and mergers are common ways for REITs to grow their businesses. From an investor's perspective, a REIT and a listed property company are in substance very similar to each other. Despite their different legal forms and structures, units in a REIT versus shares in a listed company are similar economically and in terms of the basic rights and interests attached thereto. Merger and acquisition activities of REITs and listed companies also present similar commercial features.

In 2010, the SFC extended the Codes on Takeovers and Mergers and Share Repurchases ("Takeovers Code") to H-REITs. However, as noted by the SFC in the Consultation Paper in January 2010, H-REIT regulations suffer two key deficiencies:

- Absence of "squeeze-out" provisions facilitating takeover of a REIT
- Non availability of "scheme of arrangement" in the privatisation of a REIT

NO "SQUEEZE-OUT" RIGHT

Despite the application of Takeovers Code for H-REITs, the failure of statutory compulsory acquisition following a general offer for H-REITs has rendered a complete takeover impossible. An offer with 100% acceptance by all unitholders is impossible to achieve, while an offer with less than 100% acceptance may result in the offeror being stuck with minority unitholders. Unlike listed companies, there is no mechanism in the Hong Kong REIT Code for the offeror to take out the recalcitrant minority unitholders, no matter how small they are.

In Australia, the compulsory acquisition provisions under the Corporations Act were expressly extended to listed managed investment schemes in March 2000.

Chapter 6A – Compulsory Acquisitions and Buy-outs
Section 660B

Chapter extends to listed managed investment schemes

- (1) *This Chapter extends to the acquisition of interests in a registered scheme that is also listed as if:*
- (a) the scheme were a company; and*
 - (b) interests in the scheme were shares in the company; and*
 - (c) voting interests in the scheme were voting shares in the company.*

Singapore also passed legislation to establish a statutory compulsory acquisition regime applicable to S-REITs in January 2009 (for details please see Appendix I.)

However, there is no equivalent statutory compulsory acquisition mechanism for H-REITs in Hong Kong. Privatisation by way of a general offer followed by a compulsory acquisition would not be applicable to H-REITs.

NO SCHEME OF ARRANGEMENT

Scheme of arrangement is another commonly method adopted by Hong Kong listed companies to carry out privatisations or other corporate restructurings. Once approved in meeting by shareholders and/or creditors (representing 75% present and voting in person or by proxy) and sanctioned by court, a scheme of arrangement is binding on all shareholders, including those who object to the scheme proposal. But similar to “squeeze out” provisions in the case of compulsory acquisitions, there is no equivalent for H-REITs to effect a scheme of arrangement similar to that under the Companies Ordinance for corporate entities.

In Australia, privatisation of A-REITs by way of a “scheme of arrangement” can be effect through the “trust schemes” via a contractual (as opposed to the statutory framework for companies) arrangement with unitholders.

In 2008, Singaporean authorities also made provisions for a similar “trust scheme”. This involves an amendment to the trust deed to include provisions that will allow a specific merger or privatisation to take place. Such trust schemes are subject to unitholder approval (majority in number representing three-fourths in value of unitholders or class of unitholders present and voting either in person or by proxy at a meeting convened to approve the trust scheme) and the trustee or trustee manager obtains Court approval for the trust scheme.

EXCERPT FROM SINGAPORE’S SECURITIES INDUSTRY COUNCIL PRACTICE STATEMENT ON TRUST SCHEMES IN RESPECT OF MERGERS AND PRIVATISATIONS

A merger or privatisation of a business trust or Real Estate Investment Trust may be effected via a trust scheme which involves an amendment to the trust deed to include provisions that will allow a specific merger or privatisation to take place. Such trust schemes are subject to unitholder approval. Given that dissenting

unitholders will lose their units compulsorily once the trust scheme is approved, Council is concerned that the trust scheme should be fair and reasonable....

Despite the Singaporean and Australian references, SFC stated in the January 2010 Consultation Paper that schemes of arrangement may not really be viable in the case of H-REITs.

EXCERPT FROM SFC'S CONSULTATION PAPER ON (1) THE PROPOSAL TO EXTEND THE APPLICATION OF THE CODES ON TAKEOVERS AND MERGERS AND SHARE REPURCHASES TO SFC-AUTHORISED REAL ESTATE INVESTMENT TRUSTS AND RELATED AMENDMENTS AND (2) THE PROPOSAL TO EXTEND PARTS XIII TO XV OF THE SECURITIES AND FUTURES ORDINANCE TO LISTED COLLECTIVE INVESTMENT SCHEMES

In the absence of any statutory framework or case law, it appears that there remains a high degree of uncertainty as to whether Hong Kong courts would give sanction to a scheme of arrangement concerning Hong Kong REITs without legislative requirements similar to those in section 166 of the Companies Ordinance. Without any statutory or other form of court sanction of the scheme approval process undertaken by a REIT, investors' interests may not be properly protected to the same extent as shareholders of a listed company that undertakes a scheme of arrangement under section 166 of the Companies Ordinance. As such, schemes of arrangement may not really be viable in the case of REITs.

PROPOSAL FOR HONG KONG: SFC TO ISSUE PRACTICE NOTE OR AMEND COMPANIES ORDINANCE

In the SFC's market consultation in 2010, these deficiencies in the privatisation of H-REITs were raised by numerous market participants. Regrettably, no solution has since been put forward. To facilitate a compulsory acquisition of and scheme of arrangement for an H-REIT, Sections 166 and 168 and Ninth Schedule of Companies Ordinance should be amended by inserting wordings to extend their application to listed collective investment schemes. The SFC should also issue a Practice Note on their application to ensure minority unitholders of H-REITs are accorded the same level of protection as shareholders in listed companies. In addition, H-REIT unitholders have an additional level of scrutiny from the trustee in any takeovers and privatizations, a protection which shareholders of normal listed companies do not enjoy.

It is imperative to close the gap left in the 2010 market consultation. The same takeover / privatization tools available to other Hong Kong listed companies should also be available to H-REITs as they represent the same economic features and substance. Otherwise, H-REITs will be handicapped if they want to grow inorganically.

4.5 OTHER INITIATIVES FOR CONSIDERATION

STAMP DUTY FOR SALE OR TRANSFER OF PROPERTY

One discrepancy between H-REIT market and other REIT markets is the exemption from payment of stamp duty for the sale or transfer of property. Under Hong Kong

laws, both the buyer and seller are jointly and severally liable to pay the stamp duty. Whether it is a sponsor identifying assets for injection into a soon-to-list H-REIT, or an incumbent listed H-REIT trying to expand its portfolio by acquiring new assets from third parties, H-REITs do not enjoy any stamp duty waiver or incentive.

However, in the case of H-REITs, the impact of stamp duty waiver is arguably not significant as the majority of Hong Kong's large-scale commercial property transactions are executed through the sale of property holding companies. Similarly, most acquisitions by H-REITs have taken the form of sale and transfer of shares in the property holding companies. To date, the majority of existing H-REITs' property holdings are held via such a company structure, which are registered in either Hong Kong or overseas jurisdictions such as the Cayman Islands or British Virgin Islands. H-REITs are required to pay stamp duty on transfer of Hong Kong stock, for which the Inland Revenue Department charges a flat rate of 0.1%.

Hong Kong property stamp duty is much higher as it has been used as a tool to curb property prices. Property stamp duty has been raised on several occasions. Most recently, on 22 February 2013, the ad valorem stamp duty rate on sale or transfer of immovable property in Hong Kong was adjusted to reach as high as 8.5%, doubling the previous rate.

On the issue of stamp duty for REITs, the closest reference for Hong Kong is Singapore. In 2005, the Inland Revenue Authority of Singapore permitted stamp duty remission for the sale of property or interest to an S-REIT, as long as the S-REIT is listed on the Singapore Exchange. This rule was later extended for property transactions up to 2015.

EXCERPT FROM STAMP DUTIES (REAL ESTATE INVESTMENT TRUSTS) (REMISSION) RULES 2010

Remission of duty

3. There shall be remitted all duty chargeable under the Act on any contract, agreement or instrument executed during the period from 18th February 2010 to 31st March 2015 (both dates inclusive) relating to any of the following:

(a) the conveyance, assignment or transfer on sale of any immovable property or any interest thereof from any person to a real estate investment trust that —

(i) is listed on the Singapore Exchange; or

(ii) is to be listed on the Singapore Exchange —

(A) within 6 months after the execution of such conveyance, assignment or transfer; or

(B) within such longer period, and on such terms and conditions, as the Minister or such other person as he may appoint may specify in any particular case;

(b) the conveyance, assignment or transfer on sale to a real estate investment trust that —

(i) is listed on the Singapore Exchange; or

(ii) is to be listed on the Singapore Exchange —

(A) within 6 months after the execution of such conveyance, assignment or transfer; or
(B) within such longer period, and on such terms and conditions, as the Minister or such other person as he may appoint may specify in any particular case,
of 100% of the issued share capital or of the interest therein of any company incorporated in Singapore —
(AA) that holds, directly or indirectly, immovable property situated outside Singapore; and
(BB) that was set up for the sole purpose of holding, directly or indirectly, such property.

The Hong Kong Inland Revenue Department may consider giving H-REITs a more level playing field with their Singaporean counterparts and amend the Stamp Duty Ordinance to eliminate the rates for non-residential property acquired by an H-REIT that is listed on the Hong Kong Stock Exchange.

SECTION 5 CONCLUSION

Evolutions of REITs in other jurisdictions have shown that regulatory reforms correlated to periods of expansion in REIT market's size, diversity and geographical coverage. However, Hong Kong has been lagging behind in REIT market development. Compared to the size and liquidity of its capital market, Hong Kong's REIT market has fewer listings, smaller REIT sizes and less diversity in asset type.

The proposed amendments to Inland Revenue Ordinance, REIT Code, MPFS Regulation and Companies Ordinance should boost REIT market development in Hong Kong. They will prepare Hong Kong to capture the impending growth in demand for asset securitisation products and the REIT market in general. A well-developed REIT market is beneficial to the long-term stability of banking system and property market, provide liquidity to property companies and the stock market, facilitate partnership between fund managers and property managers, and provide additional means for portfolio diversification. These benefits would no doubt enhance Hong Kong's competitiveness as a global capital formation centre and international financial centre.

APPENDIX I

Excerpts from Business Trusts Act (Chapter 31A) of Singapore

“Power to acquire units of unitholders dissenting from arrangement or contract approved by 90% majority

40A.—

(1) Where an arrangement or a contract involving the transfer of all of the units, or all of the units in any particular class, in a business trust (referred to in this section as the subject trust) to —

(a) the trustee of another trust (including the trustee-manager of another business trust and the trustee of a real estate investment trust); or

(b) a corporation,

referred to in this section as the transferee has, within 4 months after the making of the offer in that behalf by the transferee, been approved as to the units or as to each class of units whose transfer is involved by the holders of not less than 90% of the total number of those units or of the units of that class (other than units already held at the date of the offer by the transferee), the transferee may, at any time within 2 months after the offer has been so approved, give notice in the prescribed manner to any dissenting unitholder that it desires to acquire his units.

(2) When a notice referred to in subsection (1) is given, the transferee shall, unless on an application made by a dissenting unitholder within one month from the date on which the notice was given or within 14 days of a statement being supplied to a dissenting unitholder under subsection (3) (whichever is the later) a court thinks fit to order otherwise, be entitled and bound to acquire those units —

(a) on the terms which under the arrangement or contract the units of the approving unitholders are to be transferred to the transferee; or

(b) if the offer contained 2 or more alternative sets of terms, on the terms which were specified in the offer as being applicable to dissenting unitholders.

(3) Where a transferee has given notice to any dissenting unitholder of the subject trust that it desires to acquire his units, the dissenting unitholder shall be entitled to require the transferee by a demand in writing served on the transferee, within one month from the date on which the notice was given, to supply him with a statement in writing of the names and addresses of all other dissenting unitholders as shown in the register of unitholders of the subject trust; and the transferee shall not be entitled or bound to acquire the units of the dissenting unitholders until 14 days after the posting of the statement of such names and addresses to the dissenting unitholder.

(4) Where, in pursuance of any such arrangement or contract, units in the subject trust are transferred to a transferee or its nominee and those units together with any other units in the subject trust held by the transferee at the date of the transfer comprise or include 90% of the total number of the units in the subject trust or of any class of those units, then —

(a) the transferee shall within one month from the date of the transfer (unless on a previous transfer pursuant to the arrangement or contract it has already complied with this requirement) give notice of that fact in the prescribed manner to the holders of the remaining units in, or of the remaining units of that class of units in, the subject trust who have not assented to the arrangement or contract; and

- (b) any such holder may within 3 months from receiving the notice require the transferee to acquire his units.*
- (5) Where a unitholder has given notice under subsection (4)(b) with respect to any units, the transferee shall be entitled and bound to acquire those units —*
- (a) on the terms on which under the arrangement or contract the units of the approving unitholders were transferred to it; or*
 - (b) on such other terms as are agreed or as the court on the application of either the transferee or the unitholder thinks fit to order.*
- (6) Where a notice has been given by the transferee under subsection (1) and a court has not, on an application made by the dissenting unitholder, ordered to the contrary, the transferee shall —*
- (a) after the expiration of one month after the date on which the notice has been given;*
 - (b) after 14 days after a statement has been supplied to a dissenting unitholder under subsection (3); or*
 - (c) if an application to the court by the dissenting unitholder is then pending, after that application has been disposed of,*
- transmit a copy of the notice to the trustee of the subject trust together with an instrument of transfer executed on behalf of the unitholder by any person appointed by the transferee and on its own behalf by the transferee, and pay, allot or transfer to the trustee of the subject trust the amount or other consideration representing the price payable by the transferee for the units which by virtue of this section the transferee is entitled to acquire, and the trustee of the subject trust shall thereupon register the transferee as the holder of those units.*
- (7) Any sums received by the trustee of the subject trust under this section shall be paid into a separate bank account, and any such sums and any other consideration so received shall be held by that trustee in trust for the several persons who had held the units in respect of which they were respectively received.*
- (8) Where any consideration other than cash is held in trust by the trustee of the subject trust for any person under this section, the trustee may, after the expiration of 2 years from, and shall, before the expiration of 10 years from, the date on which such consideration was allotted or transferred to him, transfer such consideration to the Official Receiver.*
- (9) The Official Receiver shall sell or dispose of any consideration so received in such manner as he thinks fit and shall deal with the proceeds of such sale or disposal as if it were moneys paid to him pursuant to section 49.*
- (10) In determining the units in the subject trust already held by the transferee at the date of the offer under subsection (1) or the percentage of the total number of units in the subject trust or of any class of those units held by the transferee under subsection (4), units held or acquired —*
- (a) by a nominee on behalf of the transferee;*
 - (b) where the transferee is a corporation, by its related corporation or by a nominee of the related corporation;*
 - (c) where the transferee is the trustee-manager of a business trust or the trustee of a real estate investment trust —*
 - (i) by a person who controls more than 50% of the voting power in the business trust or real estate investment trust, or by a nominee of that person;*
 - (ii) by the trustee-manager of the business trust on its own account, or by the manager for the real estate investment trust, or by a nominee of the trustee-manager or manager; or*

(iii) by a related corporation of the trustee-manager for the business trust or the manager for the real estate investment trust or by a nominee of that related corporation; or

(d) where the transferee is the trustee of a trust that is not a business trust or a real estate investment trust, by a related corporation of the trustee (being a corporation) or by a nominee of that related corporation,

shall be treated as held or acquired by the transferee.

(11) For the avoidance of doubt, in this section —

(a) a reference to a transferee (being the trustee of a trust) holding, acquiring or contracting to acquire units in another trust is a reference to his doing any of these as trustee of the first-mentioned trust; and

(b) a reference to a transfer of units of a trust to a transferee (being the trustee of another trust) is a reference to such transfer of units to him as trustee of that other trust.

(12) The reference in subsection (1) to units already held by the transferee —

(a) includes a reference to units which the transferee has contracted to acquire; but

(b) excludes units which are the subject of a contract binding the holder thereof to accept the offer when it is made, being a contract entered into by the holder for no consideration and under seal or for no consideration other than a promise by the transferee to make the offer.

(13) Where, during the period within which an offer for the transfer of units to the transferee can be approved, the transferee acquires or contracts to acquire any of the units whose transfer is involved but otherwise than by virtue of the approval of the offer, then the transferee may be treated for the purposes of this section as having acquired or contracted to acquire those units by virtue of the approval of the offer if, and only if —

(a) the consideration for which the units are acquired or contracted to be acquired (referred to in this subsection as the acquisition consideration) does not at that time exceed the consideration specified in the terms of the offer; or

(b) those terms are subsequently revised so that when the revision is announced the acquisition consideration, at the time referred to in paragraph

(a), no longer exceeds the consideration specified in those terms.

(14) In this section —

“dissenting unitholder” includes a unitholder who has not assented to the arrangement or contract and any unitholder who has failed or refused to transfer his units to the transferee in accordance with the arrangement or contract;

“real estate investment trust” means a collective investment scheme that is —

(a) authorised under section 286 of the Securities and Futures Act (Cap. 289) or recognised under section 287 of that Act; and

(b) a trust that invests primarily in real estate and real estate-related assets specified by the Authority in the Code on Collective Investment Schemes and all or any of the units of which are listed for quotation on a securities exchange.”; and”

SOURCES

¹ Bank of America Merrill Lynch United States Equity Research. *"BofAML REIT Primer, 4th Ed. A Peek Into the Industry"* Bank of America Merrill Lynch Research. (May 6,2013)

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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