New REIT regime?

The proposals by MAS on fee structures and exposure to development projects could boost returns. Which REITs should investors watch?

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If the new rules for real estate investment trusts proposed by the Monetary Authority of Singapore (MAS) on Oct 9 are implemented by 2016, investors could see higher returns, analysts say. On the other hand, the impact of the new rules on REIT managers is likely to be mixed.

The MAS proposals that could have the biggest impact on REIT investors and managers are those that relate to fee structures. Specifically, it has proposed that performance fees should be linked to net asset value (NAV) or distribution per unit (DPU).

At the moment, there is a wide variety of performance fee structures, including some that are based on the market capitalisation of REITs. MAS has also proposed that REIT managers no longer charge acquisition and divestment fees, but only seek to recover costs when they buy or sell assets for the REIT.

Standard Chartered Bank Research estimates that these proposals, had they been applied in 2013, would have lowered the total performance fees paid by Singapore-listed REITs by up to 60%. That, in turn, would have lowered total management fees by 21%, and lifted earnings of the REITs by 3%.

Ironically, it is the REITs with the most unfavourable fee structures for investors that could now draw the most interest from the market. According to Standard Chartered, **Lippo Malls Indonesian Retail Trust**, **Cambridge Industrial Trust** and **CDL Hospitality Trusts** would have the largest declines in total management fees if the performance fee proposals from MAS are implemented. LMIR Trust would see earnings per unit improve by 10%; **Suntec REIT** would see an accretion of 5.8%; and CDL Hospitality Trusts, 5%.

What does this mean for the REIT managers? On the face of it, they have done well versus REIT investors in recent years, and could now find themselves having to settle for less. According to Standard Chartered, Singapore-listed REITs saw their NAV per unit grow an average of 4% a year from 2011 to 2013, but the fees they paid to their managers grew by 12% a year during the same period.

"Cumulatively, management fees grew 37% during this period, compared with the 7% to 11% growth in total market cap, total distributions and weighted-average NAV/unit," Standard Chartered said in a report dated Oct 10.

Many REIT managers contacted by *The Edge Singapore* would only say that they were still studying the proposals from MAS. One exception was Wilson Ang, CEO of **Viva Industrial Trust**'s manager, who says the proposals are a step in the right direction.

"Changing [the] performance fee structure to align the interests of the REIT manager and unitholders is positive. The existing performance fee structure for a number of REIT managers is based on a fixed percentage of net income, and not according to the REIT's performance," he says. VIT's performance fee is linked to DPU growth.

Ang adds, however, that managers of smaller REITs are likely to be adversely affected if they are no longer allowed to charge acquisition and divestment fees.

"It would be good if MAS could fine-tune it such that the acquisition fee is payable only upon acquisition of [an] asset from a non-related party, or if the acquisition is accretive based on [a] certain debt/equity funding structure. This will provide sufficient incentive for the REIT managers to grow the portfolio [in a way] that adds value, and align the interest with the unitholders," Ang says.

The MAS proposal to limit acquisition and divestment fees for cost-recovery purposes are in line with global trends in property funds management (or LPs), where these fees are either scrapped or reduced drastically.

New debt ceiling

Besides mandating standards for fee structures, the MAS proposals also call for a new ceiling on leverage. At the moment, REITs have to maintain a debt-to-equity ratio of less than 60% if they have a debt rating, and 35% if they do not. MAS has proposed that the two-tier limit be scrapped, and that REITs simply maintain a debt-to-equity ratio of less than 45%, whether or not they have a rating.

Debt rating agency Fitch says allowing unrated REITs to raise their gearing raises their risk profiles. However, as it stands, most REITs do not allow their gearing to rise much beyond 40%, as anything higher than that makes investors nervous.

"The proposal by MAS to adopt a single-tier leverage limit of 45% shouldn't have much impact, as most of the REITs have already adopted a disciplined and prudent approach to capital management," Ang says.

But he adds that he will look to ensuring VIT has some headroom under the new ceiling. "We are already adopting a long-term gearing ratio of 40% and will bring it down to 35% to provide some safety margin if new policies are being implemented by MAS," he says.

Indeed, CIMB reckons that REITs with gearing levels close to this new ceiling of 45% might feel the need to cut their leverage to maintain the confidence of the market. "We believe REIT managers will lean towards keeping their leverage low to: create a buffer for investor confidence, maintain further growth potential, and reduce the potential risks of breaching bank covenants," CIMB said in a report dated Oct 15.

CIMB suggests that **Keppel REIT**, **Mapletree Commercial Trust**, **Ascott Residence Trust**, **Frasers Commercial Trust** and **OUE Commercial REIT** "may suffer more". Recently listed **Frasers Hospitality Trust** also has a gearing ratio of above 40%. On the other hand, REITs such as **Frasers Centrepoint Trust**, **CapitaCommercial Trust** (CCT) and CDL-Hospitality Trusts may be less affected, as they have lower leverage ratios and may be able to tap their sponsors for development projects, CIMB says.

Operational flexibility

One proposal from MAS that analysts find intriguing is that REITs be allowed to undertake more development and redevelopment projects. Currently, development projects are capped at 10% of their deposited property. Under the proposal from MAS, REITs would be allowed to raise this to 25%. However, exposure to greenfield projects would be capped at 10% of deposited property. The additional 15% exposure can involve only the redevelopment of properties that the REIT has owned for at least three years, and which it intends to hold for a further three years after redevelopment.

Analysts say the proposals, if implemented, would provide REITs with more operational flexibility. Notably, they would benefit REITs with ageing properties, and incentivise them to carry out redevelopment works of their own, without assistance from their sponsors, according to OSK-DMG. "These REITs can then reap the full benefits of the 'at-cost' development works, and not have to pay a higher market price to acquire the remaining stake of the 'redeveloped property' from their sponsors eventually," OSK-DMG says in a report.

Patrick Lecomte, an academic at Essec Business School, says allowing the REITs more room to redevelop and improve their properties may also help dispel their negative public image. "The enhanced operational flexibility might help assuage the claim that REITs depend too much on ever-higher rents to deliver sustainable income to their unitholders," Lecomte says.

Positive investor response

While many REIT managers are unwilling to comment on the proposals by MAS, some institutional investors are making positive noises. "By discouraging REIT managers from pursuing asset growth at the expense of excessive gearing risks or dilutive equity raising, the proposed new fee structure should align better with the incentives of REIT managers and unitholders," notes Jolene Seetoh, director of Asia Equities at UOB Asset Management. "The MAS proposal to refine the regulatory framework for REITs would help to improve valuations in the long term."

So, which REITs stand to benefit from the proposals? Apart from the ones that may soon be forced to improve their fee structures, some of the larger REITs could have more options to enhance their assets and deliver higher DPU, analysts say.

Among them is CCT. Its gearing ratio of 28.8% provides it with a debt headroom of $1.3 billion. It also has the potential to redevelop Golden Shoe Car Park. In 2011, CCT undertook to redevelop Market Street Car Park with its parent **CapitaLand**, because it did not have sufficient development allowance under the current regulations. Thus, it holds only a 40% stake in the soon-to-be-completed CapitaGreen. CapitaLand holds 50%, and Mitsubishi Estate Asia holds the remaining 10%. CCT has a call option to acquire the 60% it does not own. OSK-DMG has a "buy" rating on CCT, with a price target of $1.83. Its forecast yield is 5.5%.

Another beneficiary of the raised development limit could be **CapitaMall Trust**, according to OSK-DMG. Among its assets that could be enhanced is Funan Digitalife Mall, where it has utilised only 3.861 of the allowable plot ratio of 7.0. That means it could add as much as 385,000 sq ft of gross floor area to the property. OSK-DMG also points out that CMT's Plaza Singapura is more than 30 years old. It has a "buy" recommendation for CMT, with a price target of $2.30. CMT currently offers a forward yield of 5.58%.

Meanwhile, some of the industrial REITs have old industrial buildings with unused plot ratios too. **AIMS AMP Capital Industrial REIT** has 12 properties out of a portfolio of 20 with unused plot ratio. A handful of these 12 have redevelopment potential. OSK-DMG points out that **Ascendas REIT**, **Mapletree Industrial Trust** and **Mapletree Logistic Trust** have outdated business parks and industrial properties that could also be redeveloped.

REIT managers and sponsors have until Nov 10 to provide their feedback on the consultation paper from MAS. ◘

New rules, new potential

	PRICE AS AT OCT 21 ($)	YEAR-TO-DATE PERFORMANCE (%)	MARKET CAP ($ MIL)	ANNUALISED DPU FY2014/15 (CENTS)	YIELD (%)	GEARING (%)	BASE AND PERFORMANCE FEES AS*	
							% OF REVENUE	% OF ASSETS
Ascott Residence Trust	1.210	0.40	1,852.3	8.760	7.24	36.4	4.65	0.41
AIMS AMP Capital Industrial REIT	1.430	3.52	891.0	10.20	7.13	32.0	5.36	0.46
Ascendas REIT	2.250	2.27	5,409.4	14.560	6.47	31.6	5.80	0.48
Cambridge Industrial REIT	0.710	2.90	896.6	5.018	7.07	32.0	21.06	1.61
CapitaCommercial Trust	1.600	10.30	4,701.9	8.720	5.45	28.8	5.55	0.31
CapitaMall Trust	1.950	2.36	6,749.8	10.880	5.58	34.1	6.12	0.47
CDL Hospitality Trusts	1.660	1.22	1,624.7	10.500	6.33	29.5	8.34	0.55
Frasers Centrepoint Trust	1.910	8.56	1,748.4	12.090	6.33	30.2	7.29	0.54
Frasers Commercial Trust	1.380	8.66	933.2	8.510	6.17	37.1	10.00	0.63
Keppel REIT	1.1850	Unchanged	3,557.3	7.400	6.24	42.1	15.13	0.63
Lippo Malls Indonesia Retail Trust	0.380	-8.43	935.8	2.720	7.16	28.3	6.78	0.73
Mapletree Commercial Trust	1.420	19.33	2,979.5	7.800	5.49	38.3	6.59	0.43
Mapletree Industrial Trust	1.415	5.99	2,428.2	10.400	7.35	33.6	7.76	0.71
Mapletree Logistics Trust	1.190	12.80	2,930.2	7.520	6.32	33.3	9.90	0.70
OUE Commercial REIT	0.790	Unchanged	686.2	5.720	7.24	39.5	NA	NA
Suntec REIT	1.800	16.88	4,495.9	9.312	5.17	34.1	16.90	0.48
Viva Industrial Trust	0.805	3.87	481.9	6.748	8.38	38.5	7.10	0.09

*Based on last financial year

BLOOMBERG, COMPANY REPORTS

MAS proposals for REITs positive, says Essec's Lecomte

Patrick Lecomte, an academic at Essec Business School, has long extolled the virtues of real estate investment trusts as efficient managers of commercial property, even as their tenants have chafed at high rents. Now, he is strongly supportive of the new rules for REITs proposed by the Monetary Authority of Singapore (MAS) in a recent consultation paper, even as managers of the REITs worry about possibly lower fees and tougher corporate governance standards.

The way Lecomte sees it, MAS is going for an "all-out" approach to lift corporate governance standards for REITs, emphasising that the interests of managers and investors should be aligned and that no manager should be allowed to develop an entrenched position. Notably, MAS has proposed that REIT managers be required to submit themselves to reappointment at least every five years. At present, investors can, theoretically, boot out their REIT manager whenever they want, but they are unlikely to act unless something actually goes badly wrong. Regular reappointment might be effective in keeping the managers on their toes.

BRYAN FAY/THE EDGE SINGAPORE

Lecomte: MAS is going for an 'all-out' approach to lift corporate governance standards for REITS

Some industry players fear the rule might result in short-term thinking among investors and, consequently, the managers of the REITs. Others say managers of smaller REITs that are not backed by major property development groups could be more at risk from the potential wrath of investors during downcycles.

Lecomte is not persuaded by these arguments though. "I believe savvy investors know that, by nature, [the] REIT business is medium-to long-term. I believe smaller REITs have the same incentive as larger ones to implement good business practices [that] generate value for their unitholders. It is common sense to believe unitholders will reappoint a good manager who has delivered for them." At any rate, five years between reappointments is hardly short term, he adds.

MAS is also proposing that REITs be allowed to take on development projects equivalent to 25% of their deposited property value, versus 10% currently, Lecomte points out. "In my opinion, this might shorten REITs' business cycle and justify the need for unitholders to be in position to regularly assess their level of satisfaction with appointed REIT managers, like in any other companies."

Lecomte concedes, however, that REIT managers do face more risks now. That, in turn, could have unintended consequences for investors, as well as the whole industry. "I am concerned that the statutory duty imposed on REIT managers might [cause a] backlash and open the door to all kinds of legal issues affecting REITs' ability to run their business," he says.

According to him, there are a myriad of questions that need to be addressed to head off this risk. "Will there be an internal committee made up of fully independent experts in charge of ensuring that unitholders are never negatively impacted by any decisions taken by the REIT manager? How do you define conflict of interest practically? What would be the scope, metrics and time horizon selected to assert that the REIT manager has been harming unitholders?"

Lecomte also raises the question of what would happen to a REIT in the event that its manager breached its statutory duty and faced criminal or civil liability, as mentioned in the MAS consultation paper. "In particular, what would the impact be on REITs as going concerns, in case of disagreements between unitholders and the REIT manager [that are] liable to criminal and civil actions? Would there be a temporary manager chosen by the regulators?"

Still, taking a firm line on corporate governance standards for the REIT sector could be important in securing Singapore's future as a listing hub for these instruments. Singapore's first REIT — CapitaMall Trust — was listed in 2002. Since then, at least 32 other REITs have hit the market. A further six business trusts holding property assets have also listed. As the numbers swell, the risk of a "rotten apple" spoiling the whole barrel will certainly arise. So, the imposition of tough standards by MAS could be just what the REIT sector needs at this point.