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International
Islamic
Financial
Market

 ISLAMIC FINANCIAL
MARKETS CONFERENCE
AND SPECIALIZED WORKSHOPS
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Potential and Prospects of Islamic Real Estate Investment Trusts


Arshad Zaman



Outline:

1. Global Survey
2. Conventional REITs
3. Islamic REITs (I-REITs)
4. Prospects for I-REITs
5. Conclusion

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1. Global Survey

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1.1 What is a REIT?

A REIT is a:

- Pooled-investment vehicle (partnership, trust, company, &c.) that invests in RE equity and/or mortgages, and meets
- Special *regulatory* and *operational* requirements, so as to obtain
- Special tax treatment (mainly: pass-through taxation)

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1.2 REITs have many names

- REIT (US, Hong Kong, Korea, Singapore)
- Listed Property Trust (LPT) (Australia)
- Japanese REIT (J-REIT)
- Real Estate Property Trust (REIT) (Malaysia)
- Property Unit Trust (PUT) (South Africa)
- Real Estate Investment Fund (REIF) (Italy, Spain)
- Real Estate Mutual Fund (REMF) (Greece)
- Mutual Fund Trusts (Canada)
- Proposed: UK-REIT, EU-REIT

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1.3 Key Countries & Regions

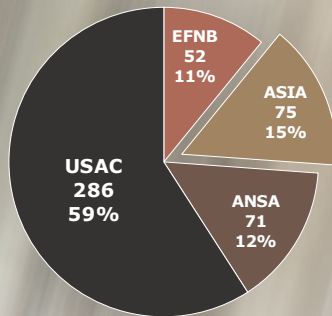
North America	USAC
■ USA, Canada	
Austral-Africa	ANSA
■ Australia, New Zealand, S. Africa	
Asia	ASIA
■ Japan, Hong Kong, Singapore, South Korea, Malaysia	
Europe	EFNB
■ France, Netherlands, Belgium	

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Re-classification of countries covered by Ernst & Young, *Global REIT Report 2006*, Oct 2006

1.4 Number by Regions

Number of REITs by Major Regions (30 Jun 2006)



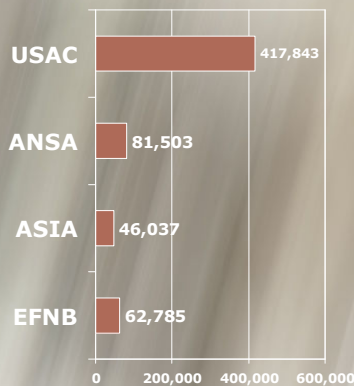
- USA (253)
Canada (33)
- Australia (58)
New Zealand (6)
South Africa (7)
- Japan (38)
Hong Kong (4)
Singapore (11)
South Korea (11)
Malaysia (11)
- France (30)
Netherlands (9)
Belgium (13)

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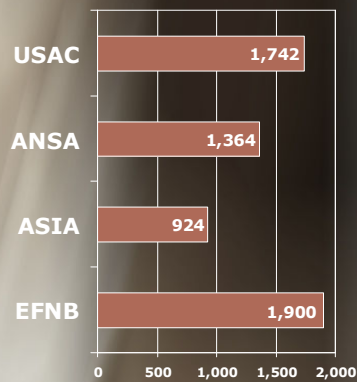
Source: Estimates based on Ernst & Young Data

1.5 Market Capitalization

Total Market Capitalization (US\$ million)



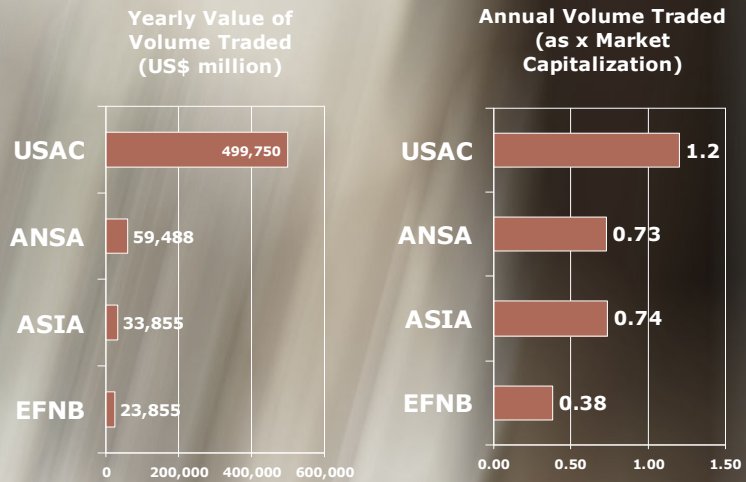
Average REIT Capitalization (US\$ million)



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Source: Estimates based on Ernst & Young Data

1.6 Market Depth & Turnover

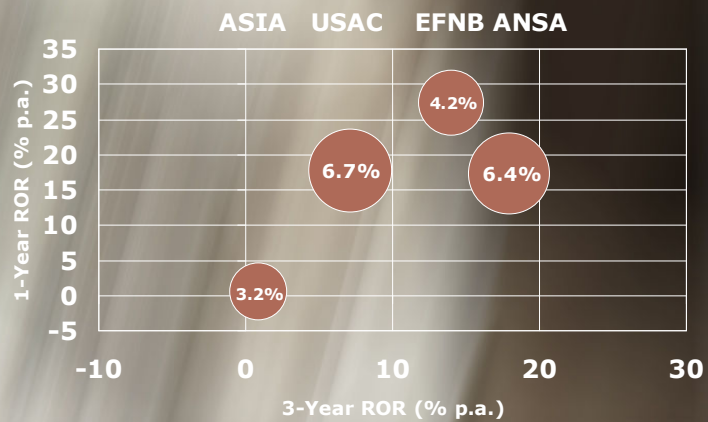


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Source: Estimates based on Ernst & Young Data

1.7 Returns & Yields

Total (Capital & Income) Rates of Return & Dividend Yield (to 30 Jun 2006)

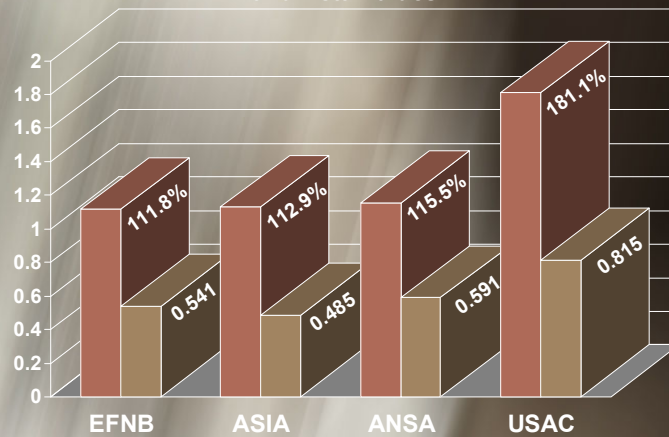


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Source: Estimates based on Ernst & Young Data

1.8 Price Premiums & Volatility

Premium of Market Price to Net Assets (%)
and Beta Values



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Source: Estimates based on Ernst & Young Data

2. Conventional REITs

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2.1 Short History: USA

- Early 1800s Real Estate Trusts (ownership)
- Real Estate Syndicates
- 1960 REITs introduced
- **1976 Tax Reform Act**
- 1981 Economic Recovery Tax Act
- **1986 Tax Reform Act**
- Early 1990s: RE market crash
- 1992 Umbrella Partnership REIT (UPREITs)
- 1992-98 US REITs surged from \$8.7b to \$105.2b (11% to 44% of global listed property market)
- On 30 Jun 2006: \$394.7b.

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2.2 Real Estate Syndicate

- Promoters select property
- Estimate “cash yield after tax”
- Syndicate manager acquires property on price and terms yielding target investor returns, making a 5-10% deposit
- Promoter organizes syndicate
- Markets participation shares & recoups most of cash invested

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2.3 Syndicate Forms

- Mostly LPs with sponsors as GPs
- But also: corporation, general partnership, tenants-in-common, & hybrid forms
- Taxed accordingly
- Regulated under 1933 Securities Act & “Blue Sky” Laws: (1) Anti-Fraud, (2) Security Registration, (3) Broker-Dealer Registration

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2.4 Syndicator's Profits

- Brokerage fee from seller
- Profit on transfer of property (or assignment of executory sales contract) to Syndicate
- Promotional underwriting discounts and commissions
- Legal fees, retainer (if attorney)
- Revenue share as operating tenant or holder of participating share
- Rights to (disproportionate) share of gains from re-sale or re-finance

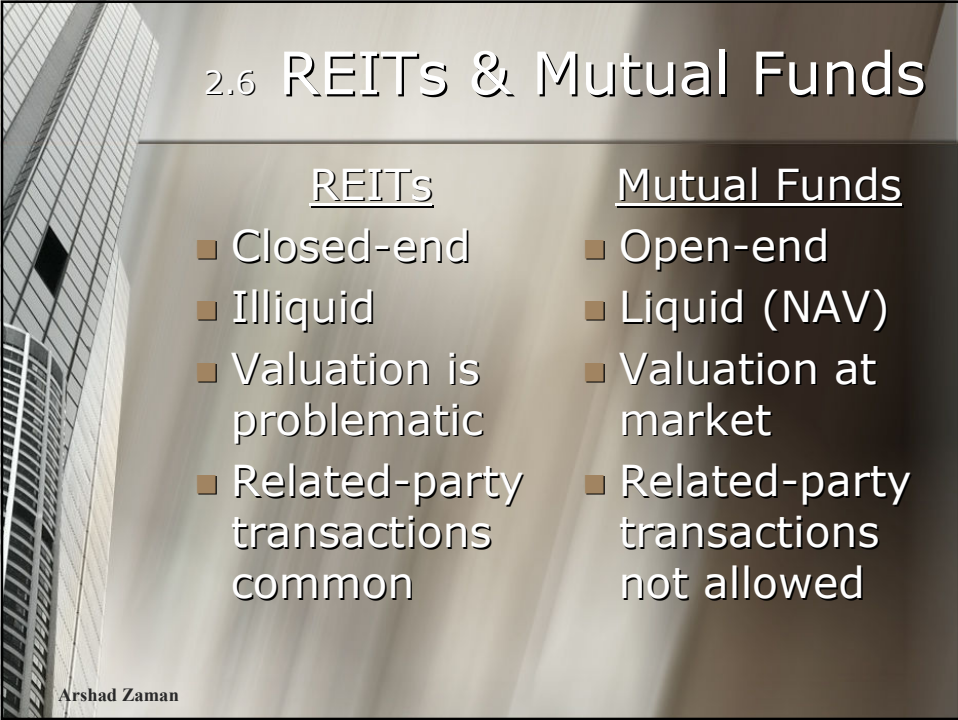
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2.5 Types of REITs

- Equity REITs
- Mortgage REITs
- Hybrid REITs

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2.6 REITs & Mutual Funds

- | <u>REITs</u> | <u>Mutual Funds</u> |
|-------------------------------------|--|
| ■ Closed-end | ■ Open-end |
| ■ Illiquid | ■ Liquid (NAV) |
| ■ Valuation is problematic | ■ Valuation at market |
| ■ Related-party transactions common | ■ Related-party transactions not allowed |

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2.7 Organizational Structure

Generally meet four tests:

1. Organization: widely-held trust
2. Assets:
 - a) Mainly in real estate,
 - b) Diversified portfolio of securities
3. Distribution: Conduit – “Pass through” at least **95%** to shareholders
4. (Gross) Income:
 1. Over **90%** from its **investments** (incl. RE)
 2. Over **75%** from **passive** RE investments
 3. Under **30%** from **short-term capital gains** on stock and securities, and real property held for less than 4 years

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2.8 Tax Treatment

- Trusts (Business Trusts) eligible for “conduit” tax treatment
- 1936 Extended to corporate mutual funds
- 1976 Extended to corporate-form REITs (like regulated investment companies)
- Must be “passive investment” (not “active business”)

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2.9 Valuation Issues

- EPS and P/E Ratios make little sense for REITs

	<u>2006</u>	<u>2005</u>	<u>%</u>
Net Income	540	430	2.2
Plus: Depreciation	440	420	
Gain on Property Sales	(300)	(100)	
Funds From Operations	680	750	- 9.3
Minus: Capital Expenditures	(180)	(150)	
Minus: Other Amortizations	<u>N/A</u>	<u>N/A</u>	
Adjusted FFO	500	600	-16.6

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2.10 Pitfalls of RE Investment

- Oversupply & Under-occupancy
- Obsolescence
- Undesirable location
- Management
- Financing
- Risks peculiar to Syndication:
 - Illiquidity of investment interests
 - Lack of investor control
 - Changing "tax shelter" rules

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3. Islamic REITs

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3.1 *Shari`ah* Requirements

Basic Requirements:

- Honesty and fair dealing
- Avoiding potential disputes
- **Strictly avoiding “prohibited gain” (*riba*)**
- Fulfilling higher goals (or “the spirit”) of the *shari`ah*

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3.2 *Riba* of Hadith

Gold for gold,
silver for silver,
wheat for wheat,
barley for barley,
dates for dates,
salt for salt, like for
like, equal for
equal, hand to
hand; but if the
kinds differ, trade
as you like, as long
as it is hand to
hand. [Muslim, et. al.]

الذهب بالذهب و
الفضه بالفضه و البر
بالبر و الشعير بالشعير
و التمر بالتمر و
الملح بالملح مثلا بمثل
سواء بسواء يدا بيد
فاذا اختلفت هذه
الاصناف فبيعوا كيف
شءتم اذا كان يدا بيد -
[رواه مسلم، و غيره]

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3.3 The Economic Context

- MONEY Bi-metallic commodity money, initially by weight (gold *dinar*, silver *dirham* – much later: copper or nickel *fulus*)
- TRANSACTIONS **Sale**, self-liquidating long distance trade, agriculture, livestock, food processing, and handicraft

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3.4 Dinars & Dirhams



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3.5 Loan versus Credit

- **CREDIT** Transfer of ownership and risk of loss of a property, against future obligation to return **money** counter-value
- **LOAN** Transfer of ownership and risk of loss of a property, against future obligation to return **similar** counter-value
- **RENTAL** Transfer of "use" of a property against claim to "rent"

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3.6 *Riba* 1

- In a loan: any excess on the original capital is *riba*
- In a sale on credit: any excess on the original price is *riba*
- In an exchange of any one “money” or “near-money” food staple with itself:
 - Any deferred transaction is *riba*
 - Any quality premium in spot transactions is *riba*

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3.7 *Riba* 2

- *Riba* is “prohibited gain” – All gain is prohibited, (mainly) if:
 - Received in pre-agreed exchange without a **tangible counter-value**; or when
 - Received in a transaction in which the **risk of loss** of the underlying asset is not borne by the recipient of the gain
[الخراج بالضمان؛ لا ربح ما لم يضمن]
- Sale of financial assets is prohibited.

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3.8 Islamic financial engineering

... in one easy lesson:

A market in **Financial** Assets (or Asset Backed Securities) is **not** permitted.

A market in **Tangible** Asset Backed Securities **is** permitted

- So *the solution* is: (i) to “staple” the claim to financial assets to a claim to an underlying tangible asset; and (ii) to ensure that *ownership* and *risk of loss* are kept together.

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3.9 Stapled securities

Yield returns (“gains”) that might not be classified as *riba* but as:

- Rents, where underlying assets can be construed as having been leased; or as
- Profits, where goods are bought and sold, directly or indirectly; or as
- Wages, where services are provided as part of the transaction

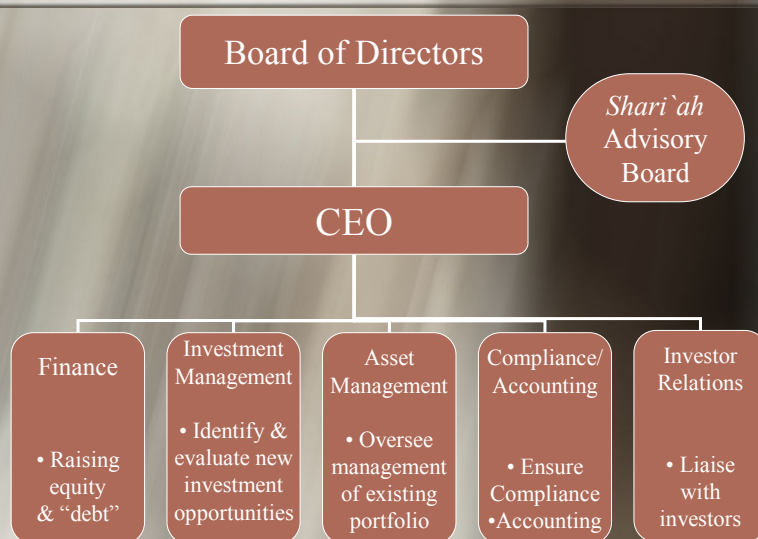
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3.10 Successful I-RE Models

- Lease, with buy-out agreement
- Joint purchase, lease, with buy-out agreement (“Declining balance partnership”)
- Securitization
- Cost-plus sale
- Contract to manufacture (by fixed date, against future payment)

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3.11 I-REIT Manager Setup



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3.12 REIT Manager Income

1. Recurring Management Fee
2. Performance-based Fee
3. Transaction Fees
 - Acquisition/Disposal Fee
 - If profit is forecast:
 - Expected incremental income
 - Expected incremental management & performance fee

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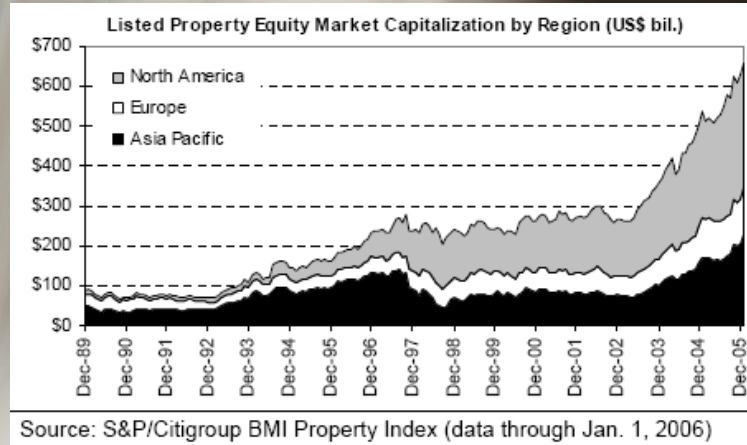
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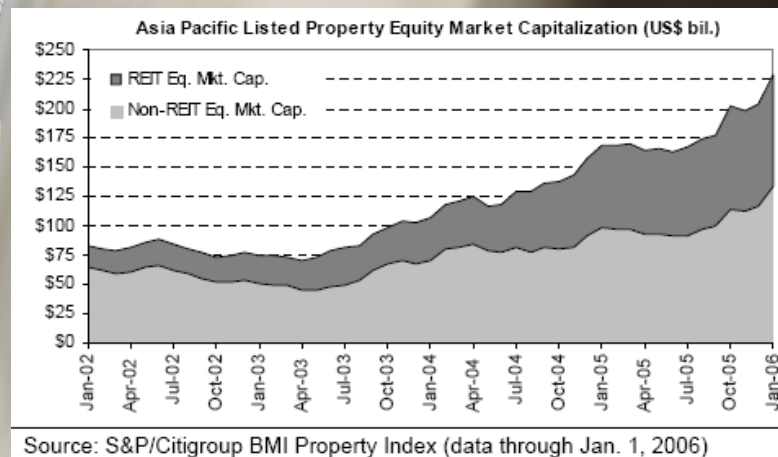
4.1 Asia has a big share

...in global listed property market



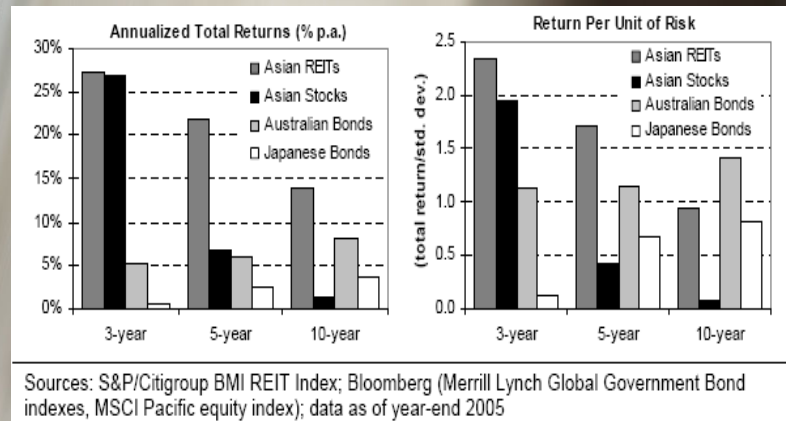
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4.2 REITs Market: Rapid Growth



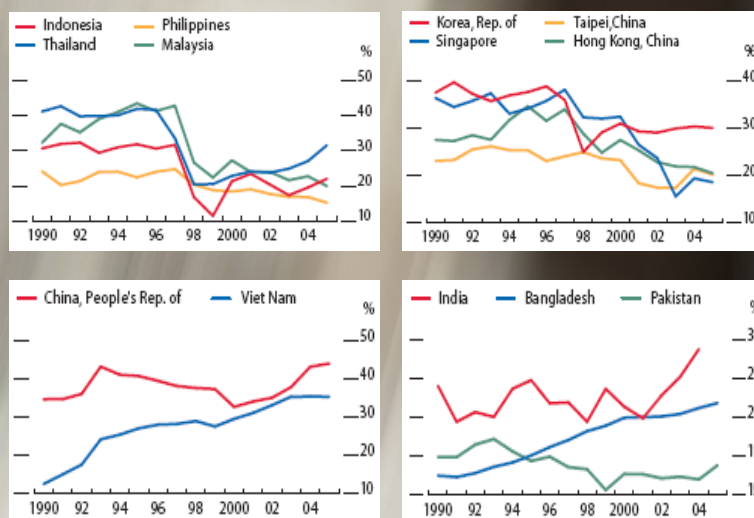
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4.3 Absolute & Risk Adjusted Returns



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4.4 Investment Rates



Source: ADB, Asian Development Outlook 2006 Update

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4.5 World Economy Prospects

Indicators	2006	2007	2008-2011
Growth: Industrial Countries	3.1	2.7	2.7
Rest of the World	7.3	7.2	6.7
Prices: Manufactures	2.2	2.3	1.2
Oil	29.7	9.1	-2.1
Non-Fuel Primary Com.	22.1	- 4.8	- 6.1
Inflation: Industrial Countries	2.6	2.3	2.2
Rest of the World	5.2	5.0	4.2
Int. Rates (%): Real 6m LIBOR	2.4	3.5	3.5
World Real LT-IR	1.8	2.7	3.1

Source: IMF, *World Economic Outlook*, Sep 2006

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4.6 Regional Growth Prospects

Real Economic Growth	2006	2007	2008-2011
"Rest of the World"	7.3	7.2	6.7
Africa	5.4	5.9	5.1
Central & Eastern Europe	5.3	5.0	4.7
Central Asia (CIS)	6.8	6.5	5.7
Developing Asia	8.7	8.6	8.0
Middle East	5.8	5.4	5.4
Western Hemisphere	4.8	4.2	3.7

Source: IMF, *World Economic Outlook*, Sep 2006

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4.7 Investment Prospects

Investment/GDP Ratios	2006	2007	2008-2011
"Rest of the World"	27.3	28.2	29.8
Africa	21.8	22.1	22.9
Central & Eastern Europe	24.9	25.6	26.6
Central Asia (CIS)	20.5	20.8	22.5
Developing Asia	36.3	37.9	39.5
Middle East	23.1	23.6	25.6
Western Hemisphere	20.7	21.1	21.3

Source: IMF, *World Economic Outlook*, Sep 2006

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5. Conclusion

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5.1 Success Drivers in Malaysia

- Liberal *Shari`ah* Permissibility
- Pro-active government support
- Relatively developed legal framework
- Relatively developed capital markets
- Healthy construction sector
- Sizeable private investor base

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5.2 I-REITs Strategy

- Need for demand-, rather than supply-induced, innovation
- Tapping “contractual savings” (insurance and pension funds)
- Islamicity premium needs to be reduced
- Fiduciary responsibilities of and standards for Shariah Boards

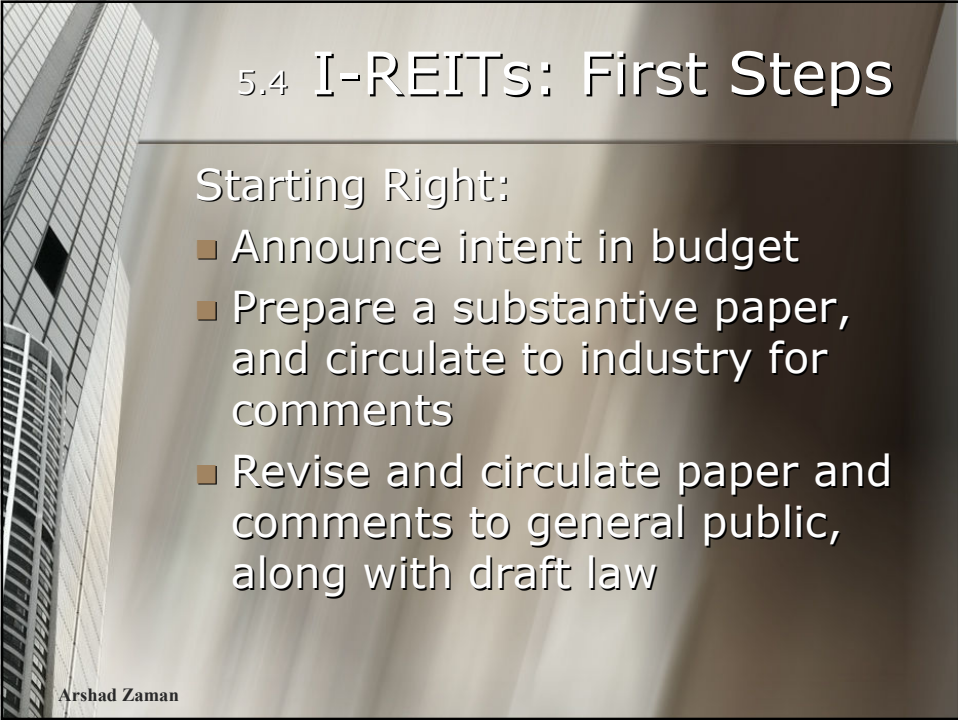
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5.3 Standards Needed

- Licensing REITs Managers (like CFAs for securities)
- Licensing certified appraisers
- Defining “interested parties” (sponsor, manager, adviser, director, major unit-holder)
- Disclosure requirements
- Trustee role (due diligence, custody, clear title, reporting)

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5.4 I-REITs: First Steps

Starting Right:

- Announce intent in budget
- Prepare a substantive paper, and circulate to industry for comments
- Revise and circulate paper and comments to general public, along with draft law

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5.5 Opportunities: Pre-Identification

Country-specific review of:

- Structure and growth of construction sector investment
- Foreign investment (in and out)
- Investor sentiment
- Regulatory regime
- Business organization law
- Property transactions, rent control laws (statute and case law)
- Judicial process (institutions of dispute resolution)

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5.6 Opportunities: Conventional

Identify scope for secure, better-than-benchmark returns in specific sectors:

- Commercial property
- Plantations, residential, Hospitals, logistics, Warehouses, etc

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5.7 Opportunities: Innovative

Explore scope in specific unconventional sectors:

- Agriculture (like plantations in Malaysia)
- Factories, warehouses, etc.
- Residential co-operatives and condominiums
- Pension funds

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Thank You