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VALUE INVESTING IN REITs

A Most Reliable Form
of Passive Income

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that, this is not across the board, notably in Hong Kong, where there are no special tax incentives for REITs. However Hong Kong does have a relatively benign tax regime regime, making it unnecessary for favourable tax treatment.

In Singapore, a favourable tax treatment for REITs was not automatically introduced with the REIT legislation. Singapore's first REIT, CapitaMall Trust, had to negotiate a tax ruling with the Monetary Authority of Singapore in 2002 to obtain tax advantages for REITs⁵. You might ask, why would the Singapore government to promote REITs by giving various tax concessions? Well, for several reasons. From the point of view of the economy, the advent of REITs creates the professional manager who can manage efficiently and in a cost-effective manner properties in land scarce Singapore. This then sets a high standard for the management of properties in Singapore. The manager will often undertake refurbishment and renovations to enhance the appeal or efficiency of the buildings under its charge in order to extract more yield from them. This allows for a rejuvenation of properties in Singapore and the maximisation of a property's potential.

The REIT allows property owners to liquidate their property positions and generate cash for use in their business.

Admittedly, even without REITs, some of such works have been carried out in the past. The REIT managers however tend to intensify such efforts as their sole focus is to maximise yield for unitholders. Also importantly, REITs allow property owners to liquidate their property positions and generate cash

for use in their business. Previously, developers of property or banks or insurance companies all owned buildings and property, and ended up committing large sums of capital in property although that was not the focus of their business. By selling the properties into a REIT, they freed their capital for use in their core business while allowing professional managers to better manage these properties. From the unitholders' point of view, REITs provide another avenue for investment which straddles halfway between a bond and a stock. More of this will be explained later in the advantages of the REIT. For now, I would simply add that REITs allow unitholders to enjoy the benefits of the economies of scale and cost effectiveness that the REIT can garner from managing a large number of properties.

For all the above reasons and more, the government is happy to provide preferential tax treatment to REITs, notably the tax free "flow through" treatment of income.

EQUITY REITS

Equity REITs are the most common form of REITs. All the REITs to-date in Singapore are Equity REITs. Equity REITs invest in and own physical properties of various types such as residential, retail, office, hotel, industrial and healthcare properties. Most of them are specialised and they own specific building types. Their incomes are primarily derived from collected rents from properties in their portfolios, as well as any capital gains in the sale of such properties that have appreciated in value. Equity REITs are generally less speculative than Mortgage REITs as the REITs own the real estate directly.

MORTGAGE REITS

Mortgage REITs invest in mortgages on real estate properties. They loan money for mortgages to owners of real estate, as well as purchase existing mortgages or mortgage-backed securities (MBS). As they do not own or manage any property, most of the incomes are generated by the interest earned on the mortgage loans. Mortgage REITs are more volatile than Equity REITs as they are exposed to greater and direct interest rate risks, mortgage servicing schedules and redemptions as well as the risk of defaulting by the borrowers. One advantage of Mortgage REITs is that they tend to perform better during times of low interest rate.

HYBRID REITS

Hybrid REITs combine the characteristics of Mortgage and Equity REITs together. They own and manage both physical real estate properties as well as real estate loans. Most typical Hybrid REITs focus more on either equity or debt and there are very few equally balanced Hybrid REITs in the market.

As Singapore has presently only Equity REITs, the brief introduction above to the various other types of REITs should be sufficient for our purposes.

and CapitaMall Trust 2 year retail bonds was offered at fixed rate of 2% per annum in February 2011.

Figure 5-1 is a chart showing the respective interest rates paid by the various instruments as at March 2011. You will note the average REIT yield as represented by the FTSE ST REIT index is the highest and the only instrument exceeding the present inflation rate.

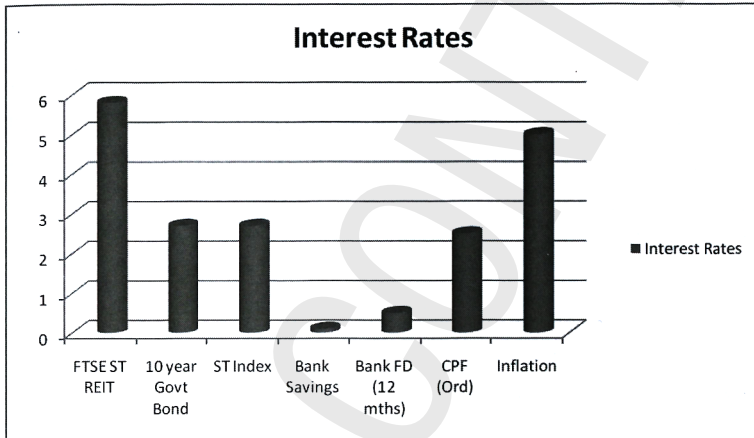


Figure 5-1: Interest rates paid by various instruments as at March 2011

LIQUID ASSET

One major advantage which REITs investment has over traditional private real estate ownership is its liquidity. For REITs which are listed on the stock exchange market, they have a pool of buyers and sellers prepared to transact at listed prices and this allows investors to easily convert their REIT investments into cash. By contrast, securing a buyer of the private property market is often a lengthy process involving often painful negotiation and numerous appointments. By investing in a liquid asset, an investor with a shorter time horizon can move into the investment securely, knowing that if that investor requires the cash to meet certain exigencies, he can easily liquidate his holdings without fuss.

In approaching an investment in REITs, one has to first examine his principal objective and motivation in such an investment. Much of this book is about the advantages and disadvantages of investing in REITs which will assist the investor in formulating his strategy in REIT investment. If the objective is about deriving a consistent and high distribution from the investment, the investor needs to be true to his strategy. He should not exit his investment the moment the share price of the REIT falls, if the REIT continues to pay a consistent and high distribution. Similarly he should not exit the acquired REIT at the first sign of capital gains arising when the REIT price rises as long as the REIT continues to pay a consistent and high distribution. It all depends on his original purpose in acquiring the REIT. Of course, the objective could be a mix of capital appreciation and yield, with a heavier weightage being placed on capital appreciation. In such an instance the investor might select the class of REIT which is more prone to give higher capital appreciation in exchange for a lower yield.

After identifying the primary purpose for the investment, the next step for the investor is to select the class of REIT that best meets this purpose. The 23 REITs¹⁷ in Singapore present an array of asset classes which may be generally classified under “Mall/Retail”, “Offices/Commercial”, “Hospitality”, “Industrial” and “Health Care”. Each class has its own characteristics which has been described earlier.

Within each class of REITs, there are several REITs to select. In this book, I have applied the most basic and fundamental analysis methodology to assist in this selection process. I am (conveniently) not a believer in the efficient market hypothesis and the accompanying capital asset pricing model¹⁸. As such, I have not applied betas and alphas in my analysis.

I have also not used the discounted cash flow method as the discount rates are difficult, if not impossible, to estimate for most real estate investments¹⁹. Moreover, the proof of the pudding is in the eating. What I mean is that since REITs pay out 90% of all their taxable profits, there is no need to try to extrapolate the cash flow to be received in the future and then discount it back to the present. If we can really say how much cash flow the REIT will receive in the future, we are already fortune tellers and have no need to estimate the impossible discount rate to be applied. Furthermore, as REITs grow by new acquisitions and often by rights issues and placement of units, the future cash flow per unit is just a shot in the dark.