THESIS REPORT

REIT & ITS IMPLEMENTATION IN PAKISTAN

Submitted To
Dr. Salim Batla

Submitted By
Nadia Akbar Malik
MBA 2K4
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NADIA AKBAR MALIK
MBA 2K4.

Table of Contents

List of Tables

List of Figures

EXECUTIVE SUMMARY

A Real Estate Investment Trust (REIT) is a real estate company that offers common shares to the public. In this way, a REIT stock is similar to any other stocks that represents ownership in an operating business and are tradable on stock exchange. REIT uses investors' money to purchase and operate income properties, so its major function is managing groups of income-producing properties and it must distribute almost 90% of its profits as dividend in order to keep its status as an REIT. By doing this, REITs avoid paying corporate income tax, A regular corporation makes a profit and pays taxes on the entire profits, and then decides how to allocate its after-tax profits between dividends and reinvestment; but a REIT simply distributes all or almost all of its profits and gets to skip the taxation. The major advantage of REIT implementation is that it allows the small investors to invest in real estate. So real beneficiary of this scheme would be small investors and general public.

The REITs are divided into three major categories and that are of Equity REITs, Mortgage REIT and the Hybrid REIT. This Hybrid REIT is the combination of both equity and mortgage REITs. Fewer than 10% of REITs fall into Mortgage REIT class, as they generate their revenues in the form of Interest that they earn on mortgage loans and secured by real estate. Equity REITs tend to specialize in owning certain building types such as apartments, regional malls, and office buildings. Some are diversified and some are specialized Most of investors are interested in owing them because they've shown that they have the potential to deliver competitive long-term returns andtheir revenue is in the form of Rents.

Real Estate Investment Trusts (REITs) entered the financial markets as closed-end publicly-traded stock companies based in 1960 within specific structural and dispositional requirements. The REIT corporation allows the investors to hold portfolios of highly illiquid real estate assets while simultaneously enjoying traditional stock market liquidity and marketability advantages. After converting to REIT, the corporation will become free of future Capital Gains Tax (CGT) and corporation tax provided that it distributes the majority of its rental income and a proportion of future Capital Gain on property assets to its shareholders. Shareholders will therefore benefit from increased dividend payouts.

The risks for the investor will be the same as with any collective investment, including mismanagement and high charges. REITs have a low correlation to other equities. Historically REITs have exhibited low volatility, which makes them a wonderful investment opportunity for low risk profile investors such as Pension funds, Pensioners.

As added inducement for institutional investors, the regulatory structure of REITs was designed to maximize distribution by mandating high dividend payments, and facilitate pure play strategies by limiting REIT investment choices to real estate assets.These factors, in conjunction with the liquidity of REITs over real property has proven to be the primary attraction for including them in portfolios, and have led to the large investor following and tremendous growth of this market sector over the last ten years. Over the period 1990 to 2005, the number of traded equity REITs has increased from **58 to 152,** with the total equity market capitalization of REITs increasing from **$7.6 billion to $312 billion**.

REITs major ivestors would include the small investors who otherwise could not afford to buy land at such high prices. Apart from these small investors, REIT would attract other instituinal investors like financial institutions, pension and provident funds and others. The major advantage of investment of institutional investers in REIT would be their better understanding and judgement in valuing REITs as compared to individuals. These investors can monitor the REIT management decisions. History indicates that REITs with more institutional investors perform better as these institutions brings more financial analyst which helps to increase the flow of information.

There are very attractive opportunities lies in Pakistan for REIT's implementation. As Pakistan is experiencing housing shortfall, prices of real estate has gone up significantly in last few years, there are no attractive housing financing schemes, inflation has grown up. All these factors make it very difficult for an individual to buy the property. However there are certain bottlenecks too that can hinder its implementation in Pakistan and these issues are high rate of transfer fees, registration and transaction cost, undocumented market, inadequate land records and tenancy laws. All these problems are very significant in the development of REIT in Pakistan.

For successful implementation of REITs significant changes would be required in NBFC rules regarding investment restriction and leverage. Sector exposure and limit needs to be redefined and land record system should be computerized to facilitate the transaction. These are the some suggestions that would help the REIT market to operate in Pakistan.

CHAPTER # 1: INTRODUCTION

1.1 Research Topic

REIT & Its Implementation in Pakistan

REIT

REIT is the abbreviation of **REAL ESTATE INVESTMENT TRUST**. For the purposes of this study I will follow the GOP's own concept of REIT defined under two new clauses of section 2 and according to clause 2 (47A) REIT is defined as:

> ***REIT as a scheme that consists of a closed-end collective investment scheme. Such a closed end collective investment is constituted as a unit trust fund and managed by a REIT management company. The purpose of REIT is to investment in real estate. However, it must be approved and authorized by the Security and Exchange Commission of Pakistan under the Real Estate Investment Trust Rules, 2006[1]***

And under section 2(47B) defines it as:

> ***Real Estate Investment Trust Management Company" means a company licensed by the Security and Exchange Commission of Pakistan under the Real Estate Investment Trust Rules, 2006.[2]***

Worldwide it is defined as a company, usually traded publicly, that buys, develops, sells and manages a portfolio of real estate to earn profits for shareholders. REIT has been applied in many countries world wide with the same concept of investment. It works under the same principal of Mutual Funds. As the investment in real estate is highly illiquid but the

[1] Accountancy ArticleA Critical Appraisal of Finance Bill, 2006.htm

investment through REITs provides High Liquidity to its investors. REIT receives special tax considerations and typically offers its investors high yields and high returns.

The report shows the detailed analysis of important characteristics of REIT that shows how the REIT is better than the other modes of investment. Generally REIT has been qualified as pass-through entity or companies who are able to distribute the majority of income cash flows to investors without taxation at the corporate level (providing that certain conditions are met). As pass-through entities, whose main function is to pass profits on to investors, REIT business activities are generally restricted to generation of property rental income. Another major advantage of REIT investment is its liquidity.

To qualify as a REIT, a real estate company must agree to pay out in dividends at least 90% of its taxable profit (and fulfill additional but less important requirements). By having REIT status, a company avoids corporate income tax. A regular corporation makes a profit and pays taxes on the entire profits, and then decides how to allocate its after-tax profits between dividends and reinvestment; but a REIT simply distributes all. Including REITs in investment program helps to build a diversified portfolio. REITs are bought and sold on the major exchanges just like any other stock

After successful implementation in U.S, Canada and Australia, this concept is rapidly coming in many Asian countries like Singapore, Hong Kong and planning to start in China, India, Pakistan and may other countries. There are many major issues, which acts as restriction in real estate can affect its implementation. So each country needs either to remove these restrictions or to give little ease to its investors and encourage them to invest in real estate sector. Pakistan too is imposing several restrictions stated in NBFC Rules 2003 related to investment. So for successful implementation of REIT the government of Pakistan along with the SECP has passed modifications in the investment regulation.

This study is aimed to measure the impact of REIT implementation in Pakistan and to the prove that REIT is much better method of investment in Real Estate with the minimum risk, high yield and better returns. The study will prove the fact that investment in REIT is much better than other investment vehicle.

As in Pakistan the prices of real estate has grown too fact in the last few years and under such conditions the general public could not afford to buy land at such high prices. In such circumstances the REIT would help to improve the situation by giving the chance to general public to invest in real estate through this investment vehicle.

Further this study elaborates that there are certain serious issues that could hinder REIT's implementation in Pakistan. The streamline of this study shows that government of Pakistan needs to address several issues and find the appropriate solution for successful implementation of REIT.

1.2 Significance of the Study

There is an increasing reliance on REIT as the instrument of investment in real estate all over the world. Now the Government of Pakistan emphasizes the provision of REIT as a key aspect of its investment strategy in real estate and has passed several regulations for its implementation in Pakistan. Its major aim is to give the chance to small investors to earn high returns. REIT has been an important aspect of real estate investment since 1960's implemented for the first time in U.S. After U.S and Australia several other countries started the investment in real estate under the same concept.

In order to cater this global concept and to make significant competitive position in Pakistan, REIT rules are promulgated by Pakistan and are incorporated in finance bill, 2006 by recognizing such entities as tax transparent and pass through entities with the 90% distribution criteria to investors.

Government of Pakistan is taking serious interest in its implementation and considered it as a beautiful concept that should go beyond mere creating of organized land mafia for construction to productive horizon. They consider it as an opportunity that needs to be coupled with a vision of creating employment and fostering as regional hub. REITs ad its implementation in Pakistan is considered as an emerging issue that has drawn the attention of the speculative investors.

1.3 Scope of the Study

The paper attempts to assess impact of REIT and its implementation in Pakistan through the evidence that has been collected in this respect. The report also scans the status of REIT in international market. It shows how other countries especially Asian countries are trying to implement it according to their own rules and limitation, and how much are they successful in it. The report also highlights most important fundamentals of REIT and the comparison of the REIT with other real estate investment vehicles.

My major concern of this study is REIT implementation in Pakistan. I highlighted the facts and factors that can become the bottleneck and could make hindrance in its implementation. This study also shows the typical REIT operating structure around the world and the one that is most optimal for Pakistan.

1.4 Research Methodology

The objectives of the study determined the choice of methodology and that is a qualitative, exploratory approach that aimed at obtaining a deep insight into the research areas outlined above. I have collected primary information through a series of focus group discussions using participatory rapid appraisal tools and a number of in-depth interviews. Information about real estate stocks and mutual funds abounds on the Internet

Other than these focus group interviews, the methods that would be used for research are:

- Internet Research
- Consultation of books
- Newspaper research

Most of analysis is done through Internet by browsing the Web, using search-engine sites, visiting company / product site, looking research papers, visiting reference sites, reading news publications, and viewing stock quotes.

1.5 literature Review

As part of the several initiatives taken by the Securities and Exchange Commission of Pakistan (SECP) to promote and consolidate the Financial Sector, the SECP has notified draft of the Real Estate Investment Trust Rules, 2005 (the REIT Rules). The objective is to make real estate accessible as an investment avenue to the average household investor. REIT's are envisaged to be close-end trusts with tax treatment similar to that of a mutual fund in Pakistan in terms of tax exemption.[3]

Modern Portfolio Theory has demonstrated the ***Importance Of Diversification*** in selecting an optimal portfolio. . Since these securities do not move in synchronization with equities, brokers stress the diversification appeal of REITs. The low historical correlation between real estate assets and the broader market indices makes them desirable in any portfolio. In order to afford a broad spectrum of investors the opportunity to own commercial real estate, the United States Congress created Real Estate Investment Trusts (REITs) in 1960 as an investment vehicle.

As added inducement for institutional investors, the regulatory structure of REITs was designed to maximize distribution by mandating high dividend payments, and facilitate pure play strategies by limiting REIT investment choices to real estate assets. These factors, in conjunction with the liquidity of REITs over real property has proven to be the primary attraction for including them in portfolios, and have led to the large investor following and tremendous growth of this market sector over the last ten years.

Over the period 1990 to 2005, the number of traded equity REITs has increased from **58 to 152**, with the total equity market capitalization of REITs increasing from **$7.6 billion to $312 billion**.

[3] www.businessrecorder.com

Before investing in REITs, investors need to check the prospectus or annual report for REITs with established track records. Although there are quality managers who have been in business less than a decade, ***Michael Evans, national director of E&Y Kenneth Leventhal Group*****,** real estate consultants in San Francisco in the article ***" The Right Way To Invest In REIT"***, suggests targeting those that have weathered several real estate cycles. Then, check the annual report to determine the amount and type--variable and fixed rate--of debt that the REIT has on its balance sheets. Institutional investors suggest debt levels no higher than **35%** of total capitalization. And further the study emphasizes that REITs with lots of variable-rate debt will be hurt if rates keep rising. Another tip was discussed in the article that doesn't be lured by high yields alone. Too often, REITs with the heftiest dividends are also the ones that carry the most risk. For example, the average factory-outlet REIT pays a generous 8% dividend. But because regional markets can only support a limited number of outlets, future earnings growth may be modest. Conversely, many low-yielding REITs shouldn't be overlooked. Office REITs, with modest yields of around 5.5% on average, now are the most expensive sector of the market. Lastly, another point that was emphasized for investors was the need to get a sense of whether the REIT is reasonably priced. They should ask broker about adjusted funds from operations, which is how analysts measure cash flow. Buying wisely in this market requires extensive analysis. So if broker cannot explain these basic fundamentals, investor shouldn't be buying at all.

Another study by ***Andrew Davis, Portfolio Manager of Davis Real Estate Fund***, in Santa Fe, N.M, focuses on high levels of institutional and insider ownership. If management is selling, why should investor be buying? The study shows that proxy will tell investors how much of the common stock is owned by REIT insiders. A minimum of 10% of outstanding shares is recommended. Inside ownership averages 18% for the REITs tracked by New York-based Cohen & Steers Capital Management.

It's also important to make sure that the individual REITs are diversified by wide range in property type and geographic location. ***Robert H. Steers of Cohen & Steers*** study shows that investor can own the best-managed REIT available, but if it is a property type or region that isn't doing well, investor won't make money. Robert H. Steers of Cohen & Steers, REITs typically own more than 30 properties ranging from shopping malls to office buildings.

The growing popularity of and market interest in REITs has been recognized by Standard and Poor's (S&P). In 1997, S&P created an exclusive REIT index called the S&P REIT Composite Index. The REIT Index consists of 100 REITs and covers over 89% of the securitized U.S. real estate market. Further confirmation of the significance of the size and nature of the REIT industry came within years of the creation of the REIT Index, when on October 9, 2001, S&P announced that six REIT stocks were to be added to the general S&P 400, 500 and 600 indices for the first time. Coincidentally, during the same period of time, the academic research of REITs gained momentum. Fruitful results and useful insights are discovered in the areas such as corporate governance, capital structure, dividend policy and more.

REIT implementation needs government's strong favor and also needs many amendments in the existing rules and regulations. ***Ros Rowe, Tax Partner At Pricewaterhousecoopers***, says: "REITs have been widely welcomed within the property sector but some proposed rules in the consultative document are far from ideal. I encourage the government to consider amending those rules to ensure there is the healthy take-up that all sides want." Most investors are concerned with tax transparency. As an investor in a real estate company effectively pays double taxation - firstly on rental income and capital appreciation of the underlying assets and, secondly, the company is taxed at the corporate level. A REIT will be taxed only on underlying assets, which effectively means that the income an investor receives through a dividend will not have been taxed at the corporate level accounting for the higher income yield

Pakistan is tapping the REIT market five years after Asian pioneer Japan, which was followed by South Korea, Singapore and Hong Kong. The government wants to take advantage of rising property values in the $118 billion economy, give developers an opportunity to free up cash and more choice for investors.

Salman Ali Shaikh, commissioner at the Securities & Exchange Commission will regulate the REITs. He highlighted the significance of REITs in his an interview by expressing that just three million Pakistanis own land out of a population of 160 million, and now "REITs will mean that those who don't have access to land will have access to land upsides." The Securities & Exchange Commission, which has patterned the regulatory structure for REITs on Singapore and Hong Kong, expects that about six REITs will be licensed within the first year. Land will be forfeited to the government if it is not developed within four years of purchase, which would curb speculation.

Salman Ali Shaikh further discussed the structure of REIT in Pakistan. According to him a REIT management company will need a minimum equity of 50 million rupees and will have to distribute 90 percent of its net annual income like mutual funds, according to a copy of the draft rules. Each fund by a REIT manager will need a minimum size of 250 million rupees.

CHAPTER # 2: REITS & ITS WORKING

2.1 REITs Introduction

A Real Estate Investment Trust (REIT) is a real estate company offering common shares to the public, which is usually tradable publicly on the stock exchange. Moreover it manages a portfolio of real estate to earn profits for shareholders. In this way, a REIT stock is similar to any other stock that represents ownership in an operating business.

A REIT can buys, develops, manages and sells real estate assets. REITs allow participants to invest in a professionally managed portfolio of real estate properties. REITs qualify as pass-through entity, which are able to distribute the majority of income cash flows to investors without taxation at the corporate level (providing that certain conditions are met).

Individuals can invest in REITs either by purchasing their shares directly on an open exchange or by investing in a mutual fund that specializes in public real estate. An additional benefit to investing in REITs is the fact that many are accompanied by dividend reinvestment plans (DRIPs). Some REITs invest specifically in one area of real estate - shopping malls, for example - or in one specific region, state or country. Among other things, REITs invest in office buildings, apartments, warehouses and hotels. Investing in REITs is a liquid investment, giving dividends to participants in the real estate market. REITs are a liquid asset and liquid asset or investment is one that has a generally accepted value and a market where it can be sold easily and quickly at little or no discount to that value. Direct investment in real estate is not liquid. The right buyer must be found, and even then, the value is not clearly established. Most publicly traded stocks are liquid. REITS are real estate related investments that enjoy the benefits of common stock liquidity.

Real Estate Investment Trusts (REITs) offer small investors the chance to participate in a broad range of real estate opportunities across most major property sectors and geographic locations.

2.2 History of REIT's

The origins of the real estate investment trust, or REIT (pronounced "reet") date back to the 1880s. At that time, investors could avoid double taxation because trusts were not taxed at the corporate level if income was distributed to beneficiaries. This tax advantage, however, was reversed in the 1930s, and all passive investments were taxed first at the corporate level and later taxed as a part of individual incomes. Unlike stock and bond investment companies, REITs were unable to secure legislation to overturn the 1930 decision until 30 years later. The U.S. Congress created REITs in 1960 to give anyone and everyone the ability to invest in large-scale commercial properties. The REIT industry has grown dramatically in size and importance since then, and during the last decade in particular.

REIT investment increased throughout the 1980s with the elimination of certain real estate tax shelters. Investments in real estate provided investors with income and appreciation. The **Tax Reform Act of 1986** allowed REITs to manage their properties directly, and in 1993 REIT investment barriers to pension funds were eliminated. This trend of reforms continued to increase the interest in and value of REIT investment.

In 2001, **Standard & Poor's** recognized the evolution and growth of the REIT industry as a mainstream investment by adding REITs to its major indexes. Today, there are more than **193** publicly traded REIT's operating in the United States their assets total over **$500 billion.** Approximately two-thirds of these trade on the National Stock Exchanges.[4]

Today, real estate securities (approximately 300 companies globally) represent only a small percentage of the total value of global real estate assets. The investable universe has a listed capitalization of about **$700bn**. But this represents only 10% of the estimated $7 trillion of institutional direct property investment assets and a minute proportion of the$15 trillion global real estate market. Most investors are, therefore, under-represented.

[4] http://www.nareit.com

REITs were first introduced in the US in 1960 and were later followed in the Netherlands, Belgium, France, Japan, Singapore and Australia. It is estimated that the market could grow from its current $700 billion to over $1 trillion by 2010 due to strong growth of Asian REITs and developments in the UK and Germany.

2.2.1 Changing Attitude Towards REITS

For many years, REITs were regarded as somehow different from traditional investments. Standard & Poor's still not admit even the largest REIT into the S&P 500 Index. One of the main reasons that REITs were suspect for so long is that many people who traditionally invested in real estate didn't really understand the stock market, where as those who invested in stocks were not comfortable with real estates. REITs just didn't fit into either category and therefore fell between them.

But all this is changing now very rapidly. There is still a tremendous amount of real estate in private hands that will eventually come into the public market through REITs.

2.3 Benefits of REITs

Now no one can negate the importance of REITs as it is providing lots of benefits discussed as follows:

- REIT allows indirect investment in real estate for small investors who otherwise could not had this opportunity before. It allows accessible indirect investment in real estate. Participants can invest in a professionally managed portfolio of real estate that is held in tax transparent structures.

- Historically wherever it has been Implemented provides a positive return track record over the long-term.

- It enables participants to broaden their investment portfolio and diversify risk.

- It offers the potential for capital appreciation.

- In general, REITs and their performance have some common characteristics with small-cap stocks and bond-like investments. However, REITs have advantages over stocks and bonds in terms of dividends.

- As pass-through entity, whose main function is to pass profits on to investors, a REIT's business activities are generally restricted to generation of property rental income.

- Another major advantage of REIT investment is its high liquidity (ease of liquidation of assets into cash), as compared to traditional private real estate ownership, which is not very easy to liquidate. One reason for the liquid nature of REIT investments is that its shares are primarily traded on major exchanges, making it easier to buy and sell REIT assets/shares than to buy and sell properties in private markets. Every investor apart from profitable returns always concerns about the liquidity, as the liquidity gives the sense of safety. By being listed, REITs would answer investors' liquidity requirements. With this arrangement investor not only would be enable to sell its stock at any time through stock exchange but also he or she would be able to trade at a fair market price.

- REITs receive special tax considerations and typically offer investors high yields. REIT is one of the investment vehicles that have single taxation. It is typically tax transparent. There is only one level of taxation. The REIT does not pay tax on its profits thereby maximizing dividends to shareholders who then pay their tax on their dividends and on profits made when they sell their shares. Typically a US REIT will pay back at least 90 per cent of its profits to its shareholders and in many cases even more than that, with some REITs distributing all their profits to their shareholders.

- A REIT aims to promote transparency. The combination of fiscal transparency, cleaning of all latent taxation, and commitment to distribute dividends is expected to bring companies' performances closer to its underlying assets. In addition, the REITs commitment to dividend distribution helps markets towards better pricing and clearly acts as a support to the stock prices themselves.

- The market will constantly keep track of valuations, and market authorities will require companies to disclose regular in-depth information to investors.

- The long-term performance of an individual REIT is determined by the value of its real estate assets at any given time. One of the primary incentives for REIT investment is the low correlation of its value to that of other financial assets. Because of this, REITs possess low relative historical volatility and provide some degree of inflation protection.

- REITs offer investors current income that is usually stable and often provides an attractive return. It exposes the investors to lower risk and provide higher stability - relative to many stocks.

- Another factor attractive to the investor is that a REIT's performance is monitored on a regular basis by independent directors of the REIT, analysts, auditors, and the business and financial media.

2.4 Factors Affecting REIT Performance

Certain things are true for all commercial properties i.e. their value and profitability depends on location, maintenance, and tenancy and on other such macro factors of the economy like Interest rates and Inflation. Before selecting a REIT its necessary to understand the specific investment characteristics that set each kind of property apart. Both foreign and domestic sources provide investment in the REIT market. Currently REITs are owned by thousands of individuals, as well as large ***institutional investors including pension funds, endowment funds, insurance companies, bank trust departments and mutual funds*** all around the world. Investment goals for REIT share ownership are much the same as investment in other stocks and that is ***Current Income Distributions*** and ***Long-Term Appreciation*** potential.

The majority of REIT shares can be purchased on the major stock exchanges, and orders can be placed through stockbrokers. Financial planners and investment advisors can help to match an investor's objectives with individual REIT investment.
REITs also provide an annual report, prospectus and other financial information directly to an investor. Recently, mutual funds have emerged specializing in REIT investment and diversification.

Some of the key elements in evaluating a REIT include:

2.4.1 Management

As with any business, a key to successful performance lies with the expertise of management. However, a couple of indicators used to assess a REITs value and that are its management's amount of experience as well as the length of time the management team has worked together. If a REIT has recently booked a new source of funds, it can be inferred that the institution providing the capital feels comfortable with the strengths and strategies of the REIT's management.

2.4.2 Capital Sources

Because REITs are, by definition, obligated to distribute 90% of their taxable income to investors, they must rely upon external funding as their key source of capital. Investors must consider REITs potential for future success, assessing whether individual REITs have the access to debt or equity capital sufficient to fund their future growth plans. REITs that have the ability to properly leverage themselves usually deliver superior returns.

2.4.3 Earnings:

Net income under Generally Accepted Accounting Principals assumes that the value of assets diminishes predictably over time. However, real estate values tend to rise and fall with current market conditions. ***Funds From Operations (FFO)*** were adopted to address the problems with valuation and performance by excluding historical depreciation costs from the net income figure. [5]

FFO has become the industry wide performance standard for REIT operating performance, but other factors should be considered when evaluating a REIT's overall performance. For instance, if a REIT has a portfolio, which includes older properties, its higher capital expenditure needs make its FFO value misleading to investors. Many professional REIT investors calculate cash flow after capital items (known as Cash Available for Distribution or CAD) as another measure of a REIT's performance. In addition, investors must also be familiar with the REIT dividend payout ratio as a measure of sustainability of dividends.

2.5 Essential Determinants of Real Estate Risks

The three essential determinants of real estate risk which are leverage, diversification and quality of management which are described as follows:

2.5.1 Leverage

Leverage in real estate is no more different than the leverage in any other investment. The more of it investor use, the greater is the investor potential to gain or loss. Any asset

[5] http://www.reitnet.com

obtained at high margin, whether an office building, a blue-chip stock, or even a T-note, will involve substantial risk. Although real estate investments have often been highly leveraged, it's the high leverage rather than the real estate that is at great risk.

2.5.2 Diversification

The same rule is applies to REITs as applies to other mode of investment. Like other investment, in REITs the diversification lowers the risk.

2.5.3 Management Quality

Real estate like other types of investment cannot be bought and neglected. It requires active, capable management. REIT investment would be less risky if it is managed by professional, active and capable personals.

2.6 General Nature of Real Estate

Real estate prices and profits move in cycles, usually predictable in type but not always in length and severity. If the investor is long-term conservative REIT investor, then they should buy and hold their REITs even as their properties move through their inevitable ups and downs. Nevertheless, they understand and are aware of those cycles since they can dramatically affect a REIT's funds from operations (FFO) and dividend growth. If the investor considers themselves as the short-term market timers, then they will plan their REIT investment either in accordance with general real estate cycle or with the cycle of an individual property sector.

The ***Phases Of The Real Estate*** cycle are depression, recovery, boom and over building and then downturn.[6]

2.6.1 Phase 1: Depression

Depression is the phase in which vacancies are high, rents are low and real estate prices are down. Many properties, particularly the highly leveraged ones, are being repossessed or are

[6] Investing In REITs:(Ralph L. Block, April 2002)

in foreclosure. There is virtually no new construction. The properties are selling at prices well below replacement cost.

2.6.2 Phase 2: The Gradual Recovery

The gradual recovery is the phase in which occupancy rates rise, rents stabilizes and gradually increases and property prices stabilize. There is still little or no new building but prices are firming up or rising slightly.

2.6.3 Phase 3: The Boom

After a while, most vacant spaces have been absorbed, allowing property owners to boost rents rapidly. With high occupancy and rising rents, landlords are getting excellent returns. Property prices are rising to the point that new construction makes sense again. Investors and lenders feel that they must join the party and must provide all the financing.

2.6.4 Phase 4: Over building & Downturn

After property prices have been rising rapidly, overbuilding frequently follows. Vacancy rates rises and rents soften. Eventually there is an economic recession. As the return on real estate investment declines, so real estate prices come down. Eventually this downturn phase may turn to depression phase, depending on the severity of the overbuilding or economic recession. After this cycle completes and begins new. Real estate is tied up closely to not only to national economy but also to the local economy.

2.7 Types of REITs

There are three basic categories of REITs

- Equity REITs
- Mortgage REITs
- Hybrid REITs

2.7.1 Equity REITs

An equity REIT is a publicly traded company that, as its principal business, buy, manages, renovates, maintains, and occasionally sells real properties. It also acquires properties and frequently develops new properties when economies are favorable. It is tax advantaged in that it is not taxed on the corporate level, and, by law, must pay out at least 95 percent of its income as dividends to its investors.

For an individual investor, equity REITs are less vulnerable to changes in interest rates and have historically provided better total returns, more stable market price performance, lower risks, and greater liquidity. In addition to that, equity REITs allow the investor to diversify not only in the type of property he or she invests in, but also in the geographic location of the property.

Equity REITS invest in and own properties. Their revenues come principally from their ***Properties' Rents.*** Equity REITs increasingly have become primarily real estate operating companies that engage in a wide range of real estate activities, including leasing, development of real property and tenant services.

2.7.2 Mortgage REITs

A mortgage REIT is a REIT that makes and holds loans and other obligations that are secured by real estate collateral. Mortgage REITs deal in investment and ownership of property mortgages. These REITs loan money for mortgages to owners of real estate, or invest in (purchase) existing mortgages or mortgage backed securities. Their revenues are generated primarily by the ***Interest*** that they earn on the mortgage loans. Today's mortgage REITs generally extends mortgage credit only on existing properties. Many modern mortgage REITs also manage their interest rate risk using securitized mortgage investments and dynamic hedging techniques.

2.7.3 Hybrid REITs:

Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages. As the name suggests, a hybrid REIT both owns properties and makes loans to real estate owners and operators.

REITs invest in a variety of property types: shopping centers, apartments, warehouses, office buildings, hotels, and others. Most REITs specialize in one property type only, such as shopping malls, self-storage facilities or factory outlet stores. Health care REITs specialize in health care facilities, including acute care, rehabilitation and psychiatric hospitals, medical office buildings, nursing homes and assisted living centers. Some REITs invest throughout the country or in certain other countries. Others specialize in one region only, or even a single metropolitan area.

All these types of REITs uses net income as defined under Generally Accepted Accounting Principles (GAAP) as the primary operating performance measure for real estate companies. They also uses Funds From Operations (FFO) as a supplemental measure of a REIT's operating performance which is defined as net income (computed in accordance with GAAP) excluding gains or losses from sales of most property and depreciation of real estate.

2.8 REITs Limitations

Although we have analyzed all the benefits of REIT, but still it has some limitations that are as follows:

- Difficult to influence management.
- Increased specialization of REITs reduces diversification.
- Difficulties in valuing REIT assets and share prices.
- Frequent dilution - little retained earnings, so they must grow by new offerings of shares.
- Slow capital growth, also due to high dividend payout ratios.

CHAPTER # 3: REITS CHARACTERISTICS AND COMPARISON

3.1 General Investment Characteristics

Following are the important general characteristics of REIT:

3.1.1 Low Betas

A stock beta is simply an evaluation of its volatility and return relative to an index of the stock, such as the S&P 500. With the base being 1, a stock with a beta greater than 1 is more volatile than the index. Modern Portfolio Theory (MPT) equates "risk" in a stock with its tendency to rise or fall more than a broad stock market index. The theory is that higher risk stocks provide investor with higher returns in order to compensate them for extra risk. Usually the REITs stock has ***Low Beta*** as compared to broad market, when broad market index is rising sharply, REITs relatively low beta will act as a drag on their performance relative to broad stock market indices. Conversely on bear market, low beta stocks such as REITs should provide ***Stability*** to cushion the drop in the value of a fully diversified portfolio. So we can say that REITs offer diversification to investor's portfolio because they don't necessarily move in correlation with the rest of the market.

3.1.2 Low Volatility

Stocks volatility refers to the extent to which its price tends to bounce around from day to day or even hour to hour. REITs high current yields acts as a shock absorber against daily market fluctuations.

3.1.3 Low Risk

There is just no way to avoid risk completely. Simple preservation of capital carries its own risks i.e. inflation. Since inflation came along, there is no such thing as "no risk". Real estate ownership and management like any other business or commercial endeavor, is subject to all sort of risks. Mall REITs are subject to the changing taste and lifestyles of the consumers; Apartment REITs are subject to overbuilding and declining job growth in their properties geographical areas; and Health care REITs are subject to the politics of government cuts in health care reimbursement.

Yet, despite this, property owners are somewhat insulated from the failures of their tenants i.e. if they are diversified in sector and geographic location. Analysts who follow REITs are normally able to forecast quarterly results. This is because of the Stability and Predictability of REITs operating cash flows, rents, built-in increases and real estate operating costs. If investor is investing in the higher-quality REITs the long-term risks of REITs investment is far lower than that of most other common stocks.[7]

3.1.4 High Returns

There are certain distinct advantages to owing high-yield stocks such as REITs. One is that it is at the shareholders rather than the management 's discretion to decide what to do with ones portion of the company operating income. As REITs pay substantial dividends, investor can choose to plow the money back into the REITs, invest the funds somewhere else altogether.

Another advantage is based on balancing of the investor's portfolio. One of the first rules of investing is to be diversified. From an overall portfolio perspective, REITs can provide that diversification.

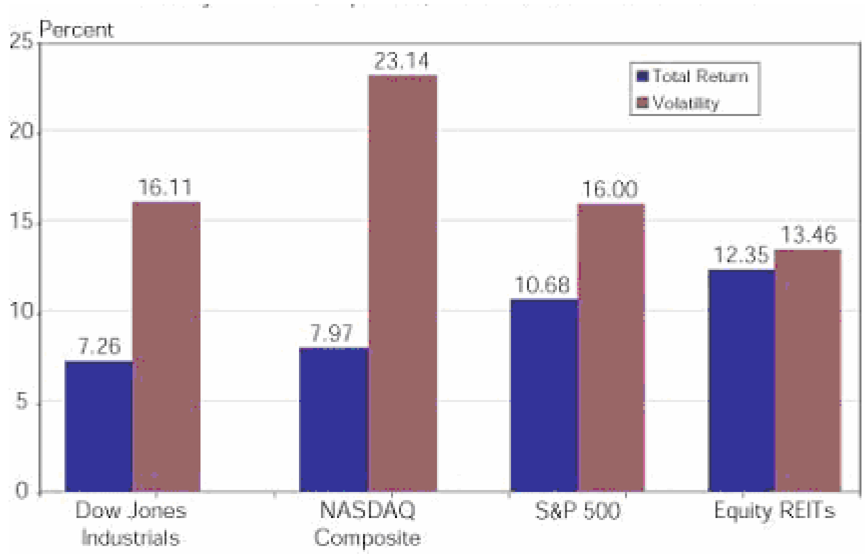
With investors receiving at least 95 percent of the taxable income (excluding capital gains), the REITs has very little retained capital with which to expand the business and, therefore, its future operating income. To the extent that stock price appreciation results from rapidly rising earnings, a REITs share price should normally raise at a slower pace than that of non-REITs stock. However, the REITs investor does not mind that; he or she expects to make up the difference through higher dividend payments, and thus maintains a high total return.

[7] Investing In REITs:(Ralph L. Block, April 2002)

Nevertheless, for the REITs, there are other alternatives by which it can propel growth. If management wants to expand, it can do so through additional stock or debt offering, through private equity placements, by exchanging new shares or partnership units for properties, or through loans from banks or insurance companies. When selecting the REITs for investment, it is strong ones that can attract additional capital and this provides the most growth potential.

Typically, investments behave in such a way that higher rates of return are achieved when the investor assumes greater risk. It's evident from the fact that, over a 31-year period, REIT stocks have generated higher returns than most leading U.S. benchmarks, while experiencing lower volatility as a measure of risk. The chart illustrates that for the three decades ending Dec. 31, 2002, Equity REITs generated a compound total return of 12.35 percent while assuming 13.46 percent risk. Over the same 31-year period, the S&P 500, Nasdaq Composite and Dow Jones Industrial Average generated lower compound annual total returns while demonstrating much greater volatility, and therefore, more risk.[8]

Figure 3.1: REIT & Other Investment Return



Note: Volatility is measured as the standard deviation of monthly returns.

[8] http://www.nareit.com

3.2 REITs Vs. Competitive Investments

Before deciding if REITs are the right investment for the investors, its important to measure their merits, point by point, against those of other investments. That comparison is only meaningful, however if the comparison is made with investments that are truly similar, or make the comparison with other investments in the relevant market.

REITs might be more accurately compared to securities investments with similar characteristics: utility stock, preferred stock, bonds, and convertibles. These are the investment of choice for those investors who normally invest in higher-yielding securities. So we ‘ll make the comparison to nonconvertible bonds and preferred stocks, and with convertibles and other real estate investments.

3.2.1 REITs vs. Bonds

Bonds generally provide higher yields than the best quality REITs, the investor gets only the interest coupon, but no growth potential in bonds. Bonds do offer something that REITs can not provide: and that is the repayment of principal at maturity so that, in absence of bankruptcy or other default, the investor will always get back his or her investment.

3.2.1.1 Return with Bonds

With bonds, what investor see is what he or she get: pure yield and very little else.
Lets assume that if a investor invest 10,000 in a bond that yields 7 percent a year and matures in ten years. At the end of en years, the investor will have his or her 10000 in cash, plus the cumulative amount of the interest he or she received during the ten-year period (10X700), or a total of 17,000, less taxes on the interest.[9]

10,000 Invested in Bonds:

(With 7 percent coupon and 10-year maturity)

10,000 (Value at maturity) +

[9] Investing In REITs: (Ralph L. Block, April 2002)

7,000(10 yrs x 700/yr. Interest) = 17,000

If however, the investor invests the same amount of money in REIT, the total return would probably calculate something like this:

10,000 Invested in REITs:

(With 6 percent Dividend over 10-year period)

16,895 (Value at maturity) +

7,908(10 yrs cumulative dividends) = 24,803

3.2.1.2 Assumptions

- The investor purchase 1000 shares of REIT trading at 10 per share, providing a 6 percent yield (or 0.60 per share).
- The REIT increases its "Funds from Operations" ("FFO" is essentially cash flow) by 6 percent annually and increases the dividend by 6 percent annually.
- Shares will raise proportionality with the increased FFO and dividend payments.

Ten years later, the REIT will be paying **1.01 in dividends**, and investor's total investment will be of worth **24,803** (7,908 in cumulative dividends received plus 16,895 in share value at that time). That's 24,803 from REIT, vs. only 17,000 from the ten-year bond, or a difference of 7,803. Taxes, of course, will have to be paid on both the bond interest and dividend payment on REIT.

Of course conventional wisdom says that REITs should provide a higher total return, because they are much riskier than bonds. However, that's not always true if investor look at the facts. Its true that, unlike bonds, REIT shares offer no specific maturity date, and there is no guarantee of the price investor 'll get when they sell them. However, with bonds investors get no inflation protection, and so they are at substantial risk of declining purchasing power.

In history it has been observed that REITs, unlike bonds, will appreciate in value as the value of their underlying real estate appreciates and the rents from their tenants increase over time.

Table 3.1: REIT vs. Bond Returns

Year	Price	Dividends
1	10.00	0.60
2	10.60	0.64
3	11.24	0.67
4	11.91	0.71
5	12.62	0.76
6	13.38	0.80
7	14.19	0.85
8	15.04	0.90
9	15.94	0.96
10	16.89	1.01
		7.91
X 1,000 shares	16,894.79	7908.48
TOTAL INVESTMENT		24,803.27

In fact the risks are stacked against the bond investor, since, if inflation rises, so generally will interest rates, which reduces the market value of the bond while its being held and results in an actual loss of capital if the bond is sold prior to maturity. On the other hand, if inflation slows, resulting in lower interest rates, many bonds are "called" before their maturity dates, depriving the investor of what, with hindsight, was a very attractive yield and forcing him or her to find some other investment vehicle, one that will pay a much lower rate of interest.

Treasury bonds are not callable prior to their maturity and entail no repayment risk, but their yields are lower than those of corporate bonds and also fluctuate with interest rates.

3.2.2 REITs vs. Preferred Stocks

Unlike bonds, preferred stocks do not represent the promise of the issuer to repay a specific amount at a specific date in the future, and in the legal pecking order their claims against the corporation are below those of every other creditor. Unless the terms of the preferred stock provide for the right of the holder to demand redemption, preferred shares enjoy the worst of all possible worlds: neither do they have fixed maturity date, nor are their holders considered creditors. They do, however, provide relatively high yields in market. The problem here is as with bonds, what the investor see is what he or she can get: pure yield and very little else.

REITs are not as interest rate sensitive as the bonds and preferred stocks. While the high dividends are enticing, preferred stock, unlike REITs and common stocks, offer little in the way of price appreciation potential or hedge against inflation. Their prices, like bonds, are very interest rate sensitive.

3.2.3 REITs vs. Convertibles

When we compare REITs to convertible bonds and convertible preferred stocks, we finally come to an investment that does, in fact, provide direct competition for REITs. These securities offer yields comparable to REITs and appreciation potential-if the common stock into which the convertible bonds or preferred stocks may be converted rises substantially. In case of convertible bonds, there is the security of a fixed maturity date in case the underlying common stock fails to appreciate in value. Convertibles can be a relatively attractive investment concept.

The problem with good convertibles is that most companies don’t issue them. The yield-hungry investor just has to keep an eye out for these hybrids and from time to time, there is a small window of opportunity to purchase them. Then if the underlying common stock appears to be a good investment, the convertible may be a good investment.

3.3 REITs vs. Other Real Estate Investments

As an asset class, real estate can be a very good investment. A well-suited, well-maintained investment property may grow in value over the years, and its rent may grow with it. While buildings may depreciate over time and neighborhood change, only a finite amount of land exists upon which an apartments, store, or building can be built. If the investor owns such a facility in the right area, it can be, if not a gold mine, a cash cow whose value is likely to increase over the years. New competitive buildings will not be built unless rents are high enough to justify the development cost. Then these higher rental rates on the new buildings might well establish a new prevailing level of market rents that enable the owners, even of older buildings, to increase rents.

However, contrary to popular wisdom, there is no necessary correlation between inflation and the value of real estate. REITs ownership addresses all the problems raised by every other real estate investment vehicle: and i.e. diversification, liquidity, management, and in most cases, conflicts of interest between management and investor.

Accepting that commercial property is generally a good long-term investment and accepting the view that REITs are the best way to invest in commercial property. Since it behaves differently from all the other assets like bonds, cash or possibly gold. It adds another dimension and therefore helps to diversify the investor's holdings. There are numbers of ways, however, in which the investor can choose to hold real estate.

3.3.1 Private Ownership

Private ownership means that the investors are in the real estate business. Sometimes it becomes difficult to manage property or to have it as a full time career. Sometimes it becomes cumbersome job to judge when is a good time to buy, sell or hold the property. There are some circumstances when buying real estate at cheap prices, then selling it, is more profitable than holding and managing it, depending on the market climate. For most individual investors, having a real estate professional make this decision is far wiser than being in real estate directly. Effective and efficient property management is also crucial; the importance of competent, experienced management cannot be overstated, and individuals often lack the resources to accomplish this.

Private ownership may sometimes offer higher profits than investing in a REIT, but probably the investor don't have the time or experience o be in real estate business. Although it is sometimes more profitable not to have to share returns with anyone else, it is also clearly riskier. The investment value of real estate is quite often determined by the local economy; at any given time, apartment buildings may be doing well. Most individuals simply do not have the financial resources to buy enough properties to be safely diversified, either by property type or by geography.

Then there is a problem of liquidity: selling a single piece of real property may be very difficult and costly. Furthermore, it may not happen when the investor want it to, although selling may be the investor only way to cash out.

Finally, even the investors are willing to accept all the inconveniences and disadvantages of inexperience, risk, and ill-liquidity, there would be more chances of break-in or stuck up. If investor utilizes an outside management company, the investor's profits will be substantially reduced.

3.3.2 C-Corporation

As we know that REIT is the most tax-efficient way for individuals to own real estate in public form, since the REITs pay no tax on its net income if the REITs distribute at least 95 percent of that income to its shareholders in the form of dividends. However there is another publicly traded security that can own real estate and it is C-Corporation. Since C-corporation is not required to distribute any income to shareholders, it may thus have more capital available for growth and expansion. Here its not compulsory to distribute its income as dividend, its on the discretion of the shareholders. This is also the liquid investment as the shareholders can easily sell the stock on stock exchanges to get the value of their share.

For the shareholders, however, this is not necessarily an advantage, depending on his or her investment goals. The dividend yields of C-Corporation are puny compared to REIT yields, and most investors who choose to own real estate prefer high dividends. The bottom line is that aggressive real estate investors who are more interested in capital appreciation than income should go for C-Corporation that own and manage real estate.

3.3.3 Corporate Property Bonds

Here the real estate company issues the debt in the form of the bond. Like other bonds, corporate property bonds have the fixed payout ratio, that shows like other bonds its returns would be in form of interest and that would be paid after the fixed interval of time. Here the investment is made according to the choice of board of directors.

Like other bonds, these property bonds are ill-liquid, as they can not be tradable on the stock exchange to liquidate it. Because of this it has high concentration risk.

3.4 Conclusion

From the above comparison, it's clear that REITs are more effective and efficient vehicle for investment in real estate. REITs are sort of a hybrid between bonds and stocks. As a general rule, they have a higher risk than bonds, but lower risk than stocks. On the basis of these characteristics, the industry the debating whether the REIT securities are the equities or the real estate but the fact is that over the short term they behave more like equities and over the period of long term they behave more like real estates and are driven by real estate fundamentals. Investors should therefore look at REITs as a very efficient and very liquid way of building a real estate position, which is very attractive long-term investment.

Table 3.2 REIT vs. Other Modes of RE Investment

Comparison to other Modes of Real Estate Investment

Table 1: Characteristics of Various Investments in Real Estate

	REITS	Direct Property Ownership	Real Estate Company Equity	Corporate Property Bonds
Type of Investment	Units in a listed trust/share of corporation owning real estate properties	Investment in physical real estate	Shares of a listed company owning real estate and other businesses	Debt issued by the underlying real estate company
Payout	Majority of taxable income paid to unit holders	Majority of income paid to owner	Discretionary dividends to shareholders	Fixed payout
Investment Strategy	Focused Activity	Focused Activity	Investment choices determined by the company board	Investment choices determined by the company
Liquidity	Liquid investment	Illiquid investment	Liquid investment	Low liquidity Investment
Diversity	Diversified portfolio	Concentration risk	Diversified portfolio	Concentration risk
Risk	Perceived low risk	Perceived high risk	Perceived high risk	Perceived low risk
Gearing	Gearing is limited by regulations	High gearing between 70% to 80%	Moderate gearing level between 60% to 70%	Moderate gearing level

CHAPTER # 4: REITS IN PAKISTAN

Real estate investment Trust is the liquid investment vehicle, which provides an exposure to real estate income either through investment in owing properties or through investment in mortgage loans. REIT has become popular as an investment vehicle that provides single taxation at personal/corporate level.

4.1 Dynamics of Current Real Estate Market in Pakistan

Pakistan is a predominantly agricultural economy, but the agricultural revenue base system is more than two hundred years old. This conventional system is not fulfilling the changing demands of time and new local governance system of Devolution properly.

The REIT proposition is very attractive in the case of Pakistan. As Pakistan is experiencing housing shortfall due to last year earth quick, and government of Pakistan is needing massive construction for developing new cities like Gawader e.t.c., Therefore REIT will find it easier to have a ready market for such products as it has a scope in developing, managing, building and maintaining the properties.

Real estate is the most profitable sector of the country. As their returns are safer than the stock market, so investors feel more confident for investing in real estates. In Pakistan, currently there is a monopoly of few wealthy individuals who have large amount of the capital available at hand, dominating the real estate market. The prices of real estate have gone up significantly in the last few years, which make it very difficult for individuals or small investors to buy the property at such higher rates. Pakistan's real estate sector needs stability in term of prices, and this could become possible by implementing the REITs which would help in stabilizing the prices and improving the price discovery process.

In Pakistan very complex and elaborate system of land record management is implemented that was basically founded by Sher Shah Suri(1472-1545 AD) and followed by various

Mughals and British powers. At present all over Pakistan **Board of Revenue** (BOR) is responsible to maintain land records and in the field a junior officer called "Patwari / Tape-Dar" is the sole custodian of data. Although the system of local governance has changed for the better management, but the mechanism of land records handling and revenue assessment remains same as followed since Mughal era.[10]

The most significant asset among all the other assets owned by the people in both urban and rural context in Pakistan is the Land. The information system related to this asset is predominately paper based in the form of filing system started from British Colonial system.

In Pakistan, there is no proper land record maintaining system, showing the ownership of the investors. Some times there occur instances of multiple ownership of the same property. There is no proper record of sale and purchase of residential, commercial and industrial plots previously showing the unprotected interest of investors. Land records are maintained by district administration for deciding ownership and boundaries of land or property. The process of defining and determining land in favor of an owner is called registry of land. Municipal Corporation also uses the ownership information for tax collection. All land disputes come under the charge of Tahsildar, Naib Tahsildar, and Patwari. These officials assist Collector in resolving land disputes. Land records are usually maintained on paper due to which administration faces the problems in retrieving the data when needed, and it took too much time for updating any record. In such circumstances there is the serious problem of its preservation and storage.

It is strongly needed that Government of Pakistan should take step in implementing management information system regarding real estate problems. In such circumstances computerization of land record is very essential. As history shows, government of Pakistan embarked number of initiatives to introduce computerization in official businesses. The most significant example of such initiative is of establishment of National Database Registration Authority (NADRA). NADRA used ICT based solutions to gather the demographic data and had completed the job successfully.

[10] Computerization Of Land Records In Pakistan; Muhammed Usman Qazi; April 2006

The transaction cost, which normally includes registration fee and mutation charges, is very high in Pakistan and that is approximately 6-7%. In addition to these charges, various authorities also charge the transfer fee separately. However, when we make its regional comparison it is evident that it's higher approximately by 3-4%.

Real estate sector is highly unorganized and unstructured. In such turbulent environment there is no corporate player for managing, developing or maintaining the real estate. Only few private players are there who are developing the houses, malls, and apartments like Behria Town comes under the same category. No multinational companies or any corporate player is there.

Historically the rules and regulations in case of tenancy laws have shown a tilt towards the tenant as compared to the owners. In that scenario the owner was not safe and there had been the instances of the court cases pending up to 20 years.

By considering all these issues the donor agencies primarily World Bank found it useful to reduce the formal and informal transaction making the land assets more efficiently integrated into the market and number of previous attempts had been made since 1980's to computerize the land records. The manually recorded data was entered into the computers in close collaboration with the "Patwaris" and they were trained in operating the system as an integral part of project design. After data input and validation, the provincial Government through legislation granted legal status to the ***"fards"*** produced by the system and then abolished the practice of issuance o manual ***"fards" in*** the plot area. But all these practices were not sufficient and successful because of number of technological and other political reasons.

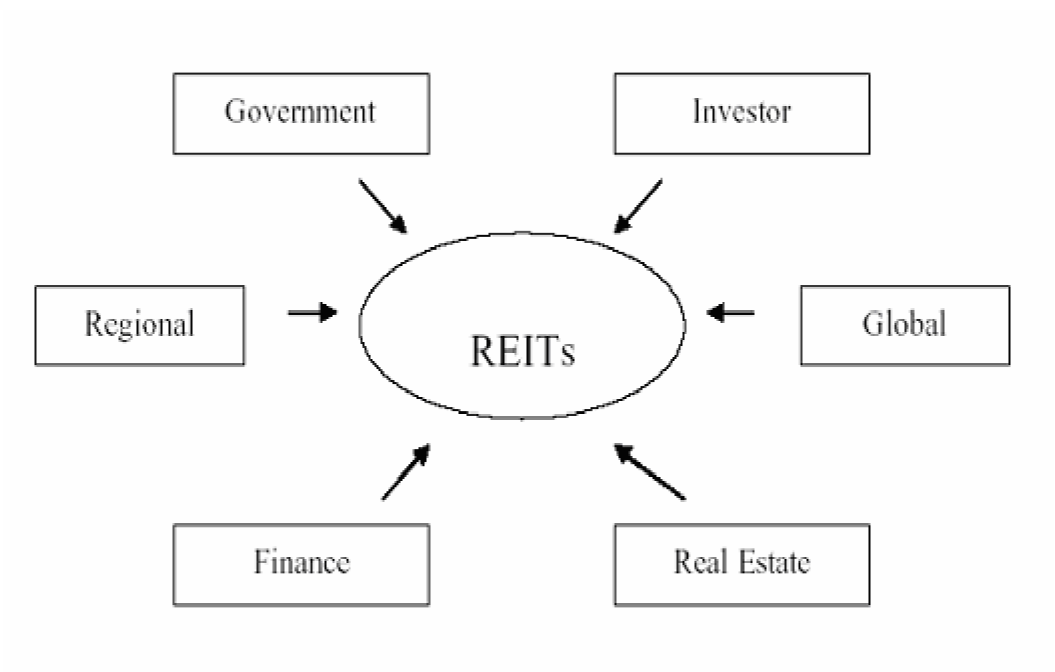
In short we can conclude this by stating that there are some flaws and shortcomings in existing system like all transaction related data is unsafe and stored in dilapidated conditions, Maps do not follow cartographic rules, Manually generated records have poor accuracy, Approximate Measurements, Conventional mapping and survey is slow and time consuming, Records again need to be updated at the completion of survey, System is complex and Data is Widely Distributed.

Presently there is an enormous opportunity to overcome such weaknesses as lot of real estate related mega projects are in governments pipeline. Now there is the need to maintain proper record of sale and purchase of real estate so as to protect interests of investors.

4.2 Major Aspects Affecting REIT

Many factors may influence the success and efficiency of the proposed REIT markets in Pakistan. Based on the current situation of Asian REITs, and by combining the experiences of mature REIT markets of US, Australia Singapore and Hong Kong, we construct six major aspects, which could affect the implementation of REITs in Pakistan. These factors are shown in the following figure:

Figure 4.1 Major Aspects Impacting The Developing REITs



4.2.1 Government

Government from legislative aspect has always acted a crucial role in creating and developing a REIT market all over the world. As the REIT is at early stage of implementation, it is absolutely necessary to have strong legislative framework that allows and supports the development of REITs. This includes favourable regulations with fewer restrictions on real estate investment, taxation and gearing. Specific designed incentives such as exemption from property related taxes and fees would also help the growth of this industry.

Otherwise, legislative restrictions will limit and obstruct the development of REIT. It can be easily evidenced from the evolution of REITs in US and Australia, and the short history of Asian REIT market as well.

4.2.2 Investor

The demand of REITs is generated from investor's interest in this sector. Whether the investor is the individual or institution, it's the risk and return profile that matters like a key issue while choosing investment instrument. A huge trend in current investors is looking for safe investments based on the facts of high savings rate and the investments free of extreme speculation. The high distributions, stable capitalization growth while low risk characteristics provided by REITs just match the common investor's appetite.

4.2.3 Finance

As an investment instrument related to specific asset of real estate, REITs provides real estate (property) market with great financing opportunities, while supplying the capital (stock) market with a less-correlated asset class to diversify the portfolio in their investment. As REITs are listed and traded on stock market, therefore, financial environment affect the performance of the REIT markets directly.

4.2.4 Real estate

Most value of a REIT was on the value of underlying asset (real estate). As REITs are obligated to focus on real estate asset and its rental as major income resource, the change of real estate market will fundamentally affect and vary the value of the REIT.

4.2.5 Global

As this analysis concentrates on the REITs market in Pakistan, external factors from global aspect come from matured REIT market in US and Australia. So some negative factors like immature local market system and potentially over-speculation in real estate normally becomes the weakness and threats for the market.

4.3 Real Estate Opportunities in Pakistan

By analyzing the dynamics of the real estate market in Pakistan we can better identify the areas that shows the constructive signs for REITs implementation. There is a significant scope for REIT industry to grow successfully as there are good opportunities available in Pakistan. The real estate market shows the following trends:

1. The housing situation in Pakistan has continuously deteriorated over past many years due to ineffective policies of previous governments, which resulted in a huge housing backlog of around 6 million housing units in the country, or even more due to destruction of houses in earth quick. On an annual basis, the construction industry needs to produce 570,000 housing units against the actual supply of 300,000 units, which already is resulting in an annual shortfall of 270,000 units, and with time this backlog is increasing.

2. The prices of real estate have increased significantly during the last few years because of high demand of property, as in Pakistani culture the individuals try to build their houses in earlier part of their life cycle. So high demand resulted in higher ratio of urban property prices as compared to purchasing power of individuals. But land suitable for housing is becoming scarce particularly in and around urban centers. There is non-availability of affordable land specially for low income groups

3. Population growth also boosts the demand for apartments and Pakistan is one of the thickly populated countries whose population is increasing day by day. So in such

economy, growth in employment, capital investment and household spending increase the demand for new office buildings, apartments, industrial facilities and retail stores.

4. The rental yield in Pakistan lies in the range of 3.5% to 5.0%, which is amongst the lowest in the World. This is a result of the prevailing joint family system, which results in lower number of first house buyers per annum and large (6.6x) number of dwellers per house. So development REITs can work here better.

5. In Pakistan the government has approved another mega project of free port in Gawadar. The prospects for lucrative business and profitable investment in real estate and construction sector have brightened since the official move to encourage setting up of hotels, motels, playgrounds, boating clubs, theme parks, marino and other recreation projects. The port city will be connected to the whole of country through land, sea and air links. Gwadar port is the focus of speculative trade in real estate as brokers are engaged in sale and purchase of property that does not exist but which is being planned for the future. Investors are being lured into buying industrial and residential plots in various schemes in and around Gwadar and also along the Mekran coastal highway on payment under different packages. So it's cleared that either the local people would be primary beneficiary of the mega port project or the wealthy individuals who can buy the property at higher rates.

6. In Pakistan, historically the investors either invest in real estate through bilateral transaction or through investments in schemes launched by various developers. Both of these methods have their own shortcomings as in Bilateral Transaction large amount of capital is required which can be only available with the wealthy individuals. Whereas investment is developer's scheme is significantly less regulated sector. Hence in both cases the participation of general public is on lower side resulting in instable real estate market in Pakistan.

In Pakistan due to inflationary trends in the economy, the cost of building material have sky rocketed and there is storage of affordable housing finance. The multiplicity of these housing related issues in the country is mainly generated by population explosion. So in such conditions the REIT could be a successful option to improve all these conditions.

4.4 REIT Management Company

Real Estate Investment Trust ("REIT") in its working replicates the working of a closed-end fund. The concept of REIT can be used both for real estate development as well as real estate management projects. For Pakistan the government has appreciated the concept and also set the guidelines for the investors who are interested in its implementation. The important guidelines issued by SECP are as follows:

- The application to set-up a REIT management company will be put forward to **SECP** (Securities and Exchange Commission of Pakistan);
- The promoters of the REIT Management Company shall not dispose of their shares for a minimum period of three years and will hold at least 20% of the issued capital of the REIT Management Company;
- During the validity of this permission, the promoters of the REIT management company shall get the REIT management company incorporated as a **Public Limited Company** under the Ordinance;
- Upon public listing, REIT Management Company will make an application to SECP for grant of **License** for establishing a REIT Scheme and carrying on the business of providing REIT management services;
- REIT Management Company will have on its board of directors at all times at least one person with senior management level experience of at least five years in the Financial Sector and employ at least two persons in senior management positions each of whom will have at least 5 years' experience in Managing Collective Investment Schemes;
- REIT Management Company should be assigned a **Credit Rating** which shall not be lower than a minimum investment grade, and such credit rating shall be updated at least once every financial year;

- Investments out of REIT Funds shall only be made in assets in Pakistan with 80% of the funds invested in real estate and 20% in financial assets;
- Not less than 90% of the annual audited accounting income arising out of a scheme shall be distributed to unit holders as Dividend;
- Any real estate acquired shall be held for a period of at least two years;
- The units of the REIT Fund shall be held by 100 or more persons for all years of operations and not more than 50% of the units may be held by five or fewer persons;
- The investment policy of REIT scheme should state allocations amongst
    (1) Yielding assets,
    (2) Real estate to be acquired, held and resold; and
    (3) Real estate to be acquired, developed and resold;
- The investment policy of REIT scheme should also specify whether the REIT Scheme is to exist for a definite or indefinite period;
- The REIT funds shall not invest in more than five real estate projects;
- The REIT management company shall be entitled to pay annually a remuneration not exceeding 3% of the average net asset value over the preceding year.

CHAPTER # 5: INTERNATIONAL REIT MARKET

REIT has been introduced in many major countries worldwide for many years and wherever they implemented, they have generally proved of value.

5.1 Successful Foreign Experience

REITs have been used around the world for many years. They have been established in the US for first time 40 years back. With the successful feedback, they gained the popularity and implemented in many Australian and Asian countries (like Japan, Hong-Kong, Singapore, Thailand, and very recently China) and many European countries (France 1960s to 1990s and again from 2003, Netherlands, Italy, Finland and very recently started in UK).

Successful outcome of REIT from the above mentioned countries encouraged the other countries for making the move in the same direction. Now amongst other countries Germany, Spain, Pakistan and India are at the very early stages of planning for implementing the REIT

Globally, REIT implementation ended up positively, both in terms of stock performances and its consequences on the property industry. It has also provided strong support to the savings industry, which is probably the main cause of their further extension. Different countries have different REIT structure regarding shareholding pattern, authorized level of gearing and components of the business portfolio etc. However there exist some commonalities, which may help to explain their success:

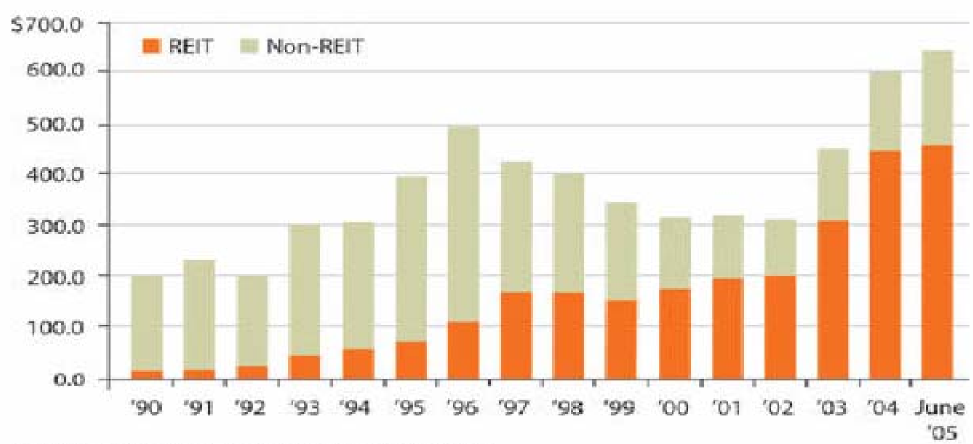
- The countries have active stock markets with a strong track record and they have domestic as well as international skilled investors with appropriate knowledge.

- Each of these countries has a significant property market, amounting to approximately half of their GDP, which offers a great opportunity to those skilled investors to make broad investment in this sector.

- The most successful REIT like the oldest ones (US & Netherlands), were introduced in countries which have a pension fund system providing a regular flow of new money into the property sector.

Globally Real Estate Investment Trusts (REITs) increasingly gained the popularity as a **Public Property Investment Market**. Nowadays, nearly 75% of all listed real estates are in the form of REITs as demonstrated in the figure.

Figure 5.1: REIT & Non-REIT Comparison



Source: UBS, Thomson Financial Datastream

According to the statistics, nearly all of the recent growth in the global securitization of real estate assets has been through REIT structures.

Generally wherever the REITs operate, three key elements that are of essential importance in the structure of REITs are considered and they are:

1.) Underlying assets and most of the income of REITs are closely restricted to real estate, plus a limited portfolio of securities.

2.) REITs' units are tradable on stock market like normal share, and are exempted from taxation at corporate level enjoying the benefits of tax transparency.
3.) The compulsory distribution of most of earnings to its investors.

With exception of the above three essential elements, which are fundamental to the definition of all REITs, there are some other limitations on REIT structure, financing, operation issues. These restrictive issues aimed to reduce unfair competition with other taxable entities. Normally these issues varied in response to the different region/market and the changing business environment.

The two most matured REIT markets in the world are: REITs in US and LPTs in Australia, which adopted this concept and debuted their REITs in 1960 and 1971, respectively. Since then, REIT family underwent significant evolution over the past four decades. With their success and impressive growth in recent 10 years, REIT markets have grown bigger and matured.

From the following Figure 2 & Figure 3, it shows that up to the end of 2005, US REITs accounted for over US$301 billion in total market capitalization, which dramatically increased over 7 times in the past ten years. During the past three decades (since 1972), it outperformed on major shares indices like Dow Jones Industrial, NASDAQ Composite, and S&P 500 with significantly less volatility. [**The Development Of REITS In Asia; School of Construction, Property and Planning University of Western Sydney**]

Figure 5.2 Evolution of US REIT Market Capitalization

Source: Author's compilation based on NAREIT data

Table 5.1 U.S REIT Performance (June 2004)

	1 Yr	3 Yrs	5 Yrs	10 Yrs	15 Yrs
REITs	27.0%	15.4%	14.5%	12.1%	11.6%
SHARE	19.1%	-0.7%	-2.2%	11.9%	11.3%
PROPERTY	10.8%	8.0%	9.4%	10.4%	6.8%

Source: NAREIT

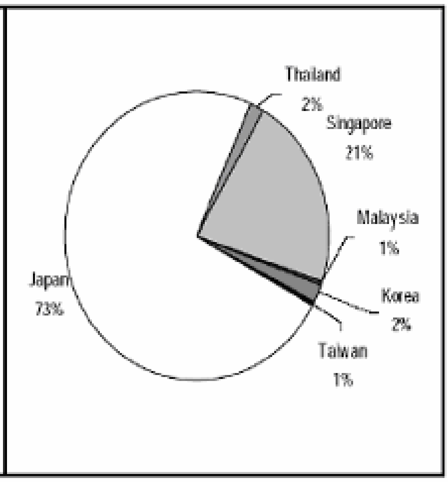
Further it shows that REITs outperformed direct property and shares in terms of absolute return in all mediums to long term (3-year, 5-year, 10-year and 15-year terms), and also outperformed direct property for the 1-Year period.

5.2 Asian REITs Development:

In Asia the first REIT was developed in Japan in 2001. Because of its advantages the rapid development of REIT market has been compelling. Figure presents the last years composition of Asian REIT market with Japan being the one with highest percentage of total market capitalization of 73%, following by Singapore of having 21% total capitalization. Following the US and Australian trend, Asian REIT markets are developing rapidly, and the future of Asian REITs looks extremely bright.

Table 5.2 Current Composition of Asian REIT (Oct 2005)

Regimes	No. of REITs	Market Cap. US$bn	% of Total Cap.
Japan	23	22.1	73%
Singapore	7	6.5	21%
Korea	7	0.6	2%
Malaysia	4	0.2	1%
Thailand	8	0.5	2%
Taiwan	1	0.2	1%
Total:	*50*	*30.1*	*100%*



Source: Bloomberg, Credit Suisse First Boston

Overall, Asian REITs are experiencing fast growth in the initial stage. As each country has a different set of real estate market conditions, economic environment and variety of tax, accounting and government regulatory policies relating to real estate investment, the success of REITs in Asian would depend on how Asian REIT market evolves with the changing internal and external economic environment. Therefore, timely research on these changing factors is an important task for REIT industrial participants.

Based on the current situation of Asian REITs, we are going to examine the characteristics of REITs currently successfully operating in Australia, Hong Kong and Singapore so that we can conclude easily how the other Asian countries can avail this opportunity by combining the experiences of these mature REIT markets.

As far as these countries are concerned the legal form of REIT should be of Trust or corporation. There is no minimum capital requirement for REIT in these countries. There is no restriction in listing requirement in these countries except in Singapore the REITs must have at least 500 shareholders. In these countries the REIT is required to deploy or invest its funds in real estate to derive its profitable returns with the option to avail the leverage facility, which shouldn't exceed 35% of total asset value in Hong Kong and Singapore.

REITs in these countries are working under the same principle of distributing its majority of its income to its shareholders either annually or semi annually.

	Australia	Hong Kong	Singapore
Legal Form	Resident/non-resident (public) unit trust. No minimum capital requirements exist;	Unit Trust domiciled in Hong Kong, no minimum capital requirements;	Trust or Corporation;
Listing Requirements	No restrictions;	No restrictions;	At least 500 shareholders;
Investments/Activities	Investment in land for deriving rent. Public Unit Trusts that carry on trading business, are not accorded 'flow through' treatment;	Investment in Hong Kong real estate only; Assets should be income generating; REIT required to hold the property for at least two years;	At least 70% of the funds should be invested in real estate and real estate related assets;
Leverage	Unlimited, subject to thin capitalization rules;	Aggregate borrowing shall not at any time exceed 35% of the total gross asset value;	Total borrowings should not exceed 35% of deposited property;
Profit Distribution Obligations • Operating Income • Capital Gains on disposed investments • Timing	• Distribution of 100% of trust's income; • Distribution of 100% of realized capital gains; • distribution must occur annually;	• Distribution of 90% of audited annual net income; • 90% of audited annual net income after tax (the trustee may determine if any of the amount of the gain may form part of net income); • Annual distributions;	• Distribution of 90% of taxable income; • No requirement; • Semi-annually (in practice)
Tax Treatment • Income • Capital Gain • Withholding	• Not taxable, provided unit holders are entitled to trust's income; • Tax treatment is similar to that of ordinary income. 50% CGT discount may be available; • Dividend and interest paid to non-resident unit holders is subject to withholding tax as dividends and interests;	• REIT is subjected to property tax for property held directly, dividend income from SPVs is tax exempt from profits tax; • No capital gain tax; • None;	• Not taxable at trustee level to the extent of taxable income distributed; • No capital gains tax; • 70% on distributions to non-qualifying unit holders, e.g. non-resident corporate unit holders;
Conversion to REIT Status	N/A;	There is no specific transition regulation in Hong Kong governing the transformation of a corporation to a REIT;	No special tax rules for transition of property from a normally taxable entity to an SREIT. The transferor is subject to normal tax treatment on gains realized;

Table 5.3 REITs Regulation & Structure in Australia, Hong Kong, Singapore

5.3 Attractiveness of REIT Development in Asian Countries

The main strengths of current developing Asian REITs are listed as follows:[11]

5.3.1 Strong Demand and Supply

As REITs provide high dividend, low volatility and diversification benefits in investment portfolio, investors demanding higher yield has been and remains the biggest demand driver. By comparing them with other investment vehicles like stocks that are too risky or bonds that have less attractive returns, REITs risk and return profile has been able to boost the demand amongst the investors.

Both institutional and individual investors in Asia warmly welcomed REITs with these characteristics. The institutional investors, such as pension funds and insurance companies put REITs into their investment portfolio. As the aging society approaching in Asian and other countries, the related growing pension liability is expected to add further demand to REITs in Asia. Ask. Sofar it's going fine.

The driving forces for REITs came mainly from the following three related groups: Financial Institutions, Real Estate Owners Or Developers, and some Government Departments who are the in charge of social real estate assets. Using REITs, these groups activate the capital, which was locked in these assets by transferring their ownership. Commercial banks in Asia, always keep the risks in the balance sheet for their real estate borrowers. Especially after Asian financial crisis in 1990's, many banks burdened with amount of non- performing loans, are longing for the route to exit the situation. REITs just satisfied this huge demand.

Many real estate companies in Asia act as major developers and part of property owners. On one hand, REITs provides alternative sources of funding for development business other than heavily depend on bank financing. On the other hand, divestment of these assets ownership to public makes the capital of the asset to be recycled or redeployed to other investment businesses.

[11] The Development Of REITS In Asia; School of Construction, Property and Planning University of Western Sydney

REITs also open a door for government to divest the social assets to public ownership. LINK REIT in Hong Kong is the new listed, biggest representative, which comprise of much of prior government assets. After transforming into REITs, these assets were owned publicly, managed by professional asset manager.

In other words, REITs paved a relative broad way to almost all major real estate participants to upgrade their financial situation, create financial support opportunity by transferring the ownership. And this function in practice has been accepted widely in Asian market, which is reflected by the current strong demand and supply situation.

5.3.2 Government Incentives

A government incentive to establish and promote REIT market is the most important factor, at least in the current infancy stage of Asian REIT. Government incentives to introduction of REITs largely rooted from their motivations, as in Korea and Taiwan government helped the financial institutions and other government asset management companies to divest non-core investment. In Hong Kong it divest the real estate as it focus more on development and it divest the government asset by transferring the ownership to public. In Singapore it changed the business strategy to grow fund management income and transferred the ownership to public via REITs. Singapore government, apparently, played an important role in forming and growing a successful environment for their local REIT market and respectively the response is very prompt.

More over, as Singapore and Hong Kong government are competing to be the hub role in regional REIT market, it is reasonable to believe that more government incentives on issues of Tax, Gearing, And Overseas Investment, will stimulate the growth of local REIT market and guide the across-boarder listing for undeveloped REIT market, e.g. China, India and Pakistan.

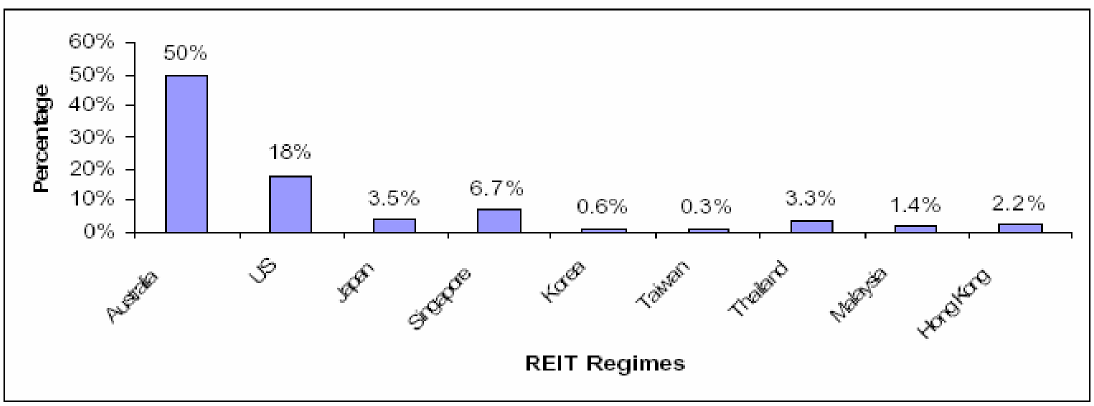
5.3.3 Exceptional Returns

Strong demand and supply boosted the Asian REIT market out performance. The returns generated by Asian REITs to date have been extraordinarily high and attractive. As per the established REIT track record in Japan and Singapore, Asian REITs have generated double-digit returns annually. Moreover, its low level of volatility means that the less risk profile can be more attractive than other equities in capital market.

5.3.4 Growth Prospects

The main attractive feature for Asian REITs is that the total capitalization of Asian REITs is still quite small, comparing to mature REIT market in US and Australia, the emerging Asian REITs market still has room for further growth.

Despite the fact the Asian REIT has grown rapidly in recent years, the ownership of investment grade properties by REITs in Asia is estimated to be quite small, compared to about 18% for US, 50% for Australia (Fullerton, 2005). The percentage of REITs among investment grade property by capitalization was depicted in the following diagram:



Source: Author's compilation based on information from Prudential Real Estate Investors, Henderson Global Investors, Bloomberg, and UBS research

Australia enjoys the highest percentage position in this diagram, which means half of investment grade property asset are securitised by REITs form, while most of Asian countries are fewer than 5%. As REITs generally focus on investment grade property, it indicates that much of quality property asset has not been involved into REITs structure in Asia.

Real estate assets held in private companies are typically less efficient in terms of management and taxes. As the property market continues to evolve, the trend will be the shifting of ownership from the private to the public sector, i.e. REITs. It is estimated that total market capitalization of listed real estate company in Asia is over US$230bn. As REITs were accepted by private company owner as a favorable vehicle to reach their strategy goal at corporation level

1. Unlocking real estate capital and turning into higher return opportunities.
2. Transfer the private ownership to public while adopt asset light strategy.
3. Creation of REIT funds management plat form ensures fee-based income.

The trend of transferring ownership via REITs form will open a greater space for Asian REIT to grow.

5.4 Conclusion

Since the first Asian REITs was floated in Japan, over the past 4 years, Asian REITs have achieved compelling market capitalization. Some other Asian governments are considering REITs as an alternative financing mechanism, which offers liquidity, security and diversified benefits. The growth of Asian REITs is continuing at a rapid pace.

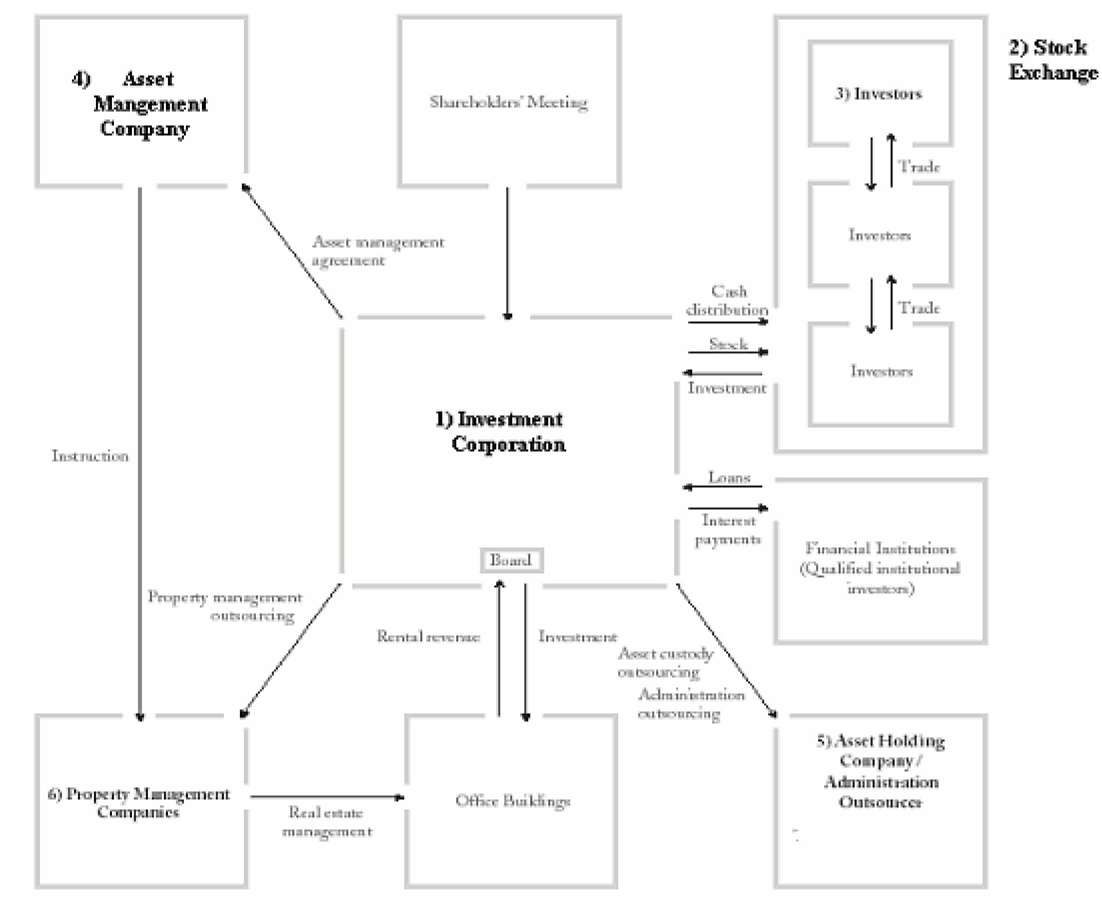
The findings implicate that government play a crucial rule to support REIT market. While Asian REIT market is prosperous from both supply and demand side, there is more room for its further growth and more can be done to reduce the hurdles. REITs have been widely accepted by most of major real estate industrial participants: financial institutions, real estate owners and developers, and common investors. For REITs' suppliers, by transferring the ownership, their financial situation was upgraded and the financing options were broadened. For REITs' investors, the impressive return/risk profiles just satisfied the common investors who always go for safe investment. Considering the trend of increased real estate securitisation and the fact of Asian specific demographic, the future REIT market will be quite bright.

CHAPTER # 6: STRUCTURE AND ANALYSIS

6.1 Typical REIT Structure

The following figure represents a typical REIT structure. The parties to the transaction are typically Investment Corporation, which works as REIT MANAGEMENT COMPANY, equity investors, exchanges, and asset management companies. However, government exerts significant control in providing an environment that is conducive for a REIT to operate. Understanding this relationship is the key to understanding the overall REIT system, which is shown as follows:[12]

Figure 6.1 Typical REIT Structure



[12] http://www.nareit.com

Here **Investment Corporation is a** special type of entity for the specific purpose of owning and operating real estate properties. This investment corporation is incorporated and operated under the Investment Trust Law, for the purpose of owning and operating real estate properties using capital raised from investors. It conducts board of directors and shareholders' meeting just like an ordinary corporation, but as this structure of the investment corporation is simply a mean for owning and operating real estate properties, it is not permitted under its articles of incorporation to engage in any other business activities.

The principal responsibility of the investment corporation is custody and management of its assets, as well as issuance of equity securities. The corporation does not, however, control its assets directly, as all management functions must be outsourced to a licensed asset management company.[13]

As the investment corporation issues the securities, which would be readily available on **Stock Exchanges** so that they can be traded publicly. **Investors** would buy and sell the shares from these exchanges. They provide the capital to Investment Corporation and in return they get the equity securities just like the other stocks issued by Ordinary Corporation. Dividends are also paid usually at the end of fiscal year. These shareholders have no pre-emptive rights with respect to issuance of additional shares. Shares may be issued at the times and upon the terms approved by resolution of the board of directors and are overseen by board of directors and certain decisions usually made by unit holders at a general meeting of unit holders. These investors are usually the individual, own shares of REITs. Other typical buyers of REITs are pension funds, endowment funds and foundations, insurance companies, bank trust departments and mutual funds.

Under the Investment Trust Law, investment corporations are required to delegate the functions pertaining to the management of their assets, the custody of their assets and certain other administrative functions (such as matters related to the issuance of investment securities, the administration of its organization and accounting matters) to external entities. As Investment Corporation may not manage its assets by itself, so they outsource the

[13] About JREIT system

investment decision and administration work to an **Asset Management Company**. The asset management company, therefore, performs a vital role for the real estate investment corporation.

The asset management company is normally involved with the investment corporation from the time of its incorporation, and afterwards performs the role of fund manager for the real estate properties. The asset management company must have a good grasp of the properties held by the investment corporation, and manage the assets to achieve higher earnings. As necessary, it will sell off some of the assets or acquire new ones. In this way, the asset management company performs a series of duties in accordance with the Investment Trust Law. Conflicts of interest may arise with respect to transactions between an investment corporation or an investment trust and the asset management company. The Investment Trust Law provides that an asset management company or the trustee assumes a fiduciary duty of loyalty and must exercise its duties with duty of care.

Damage to the investment corporation or the investment trust as a result of a breach of these duties will lead to the asset management company or trustee bearing liability for the resultant damage.

The investment corporation consigns the property holding function (physical possession of the property deeds) or trust beneficiary certificates to trust banks or similar organizations. Administrative functions such as the transfer of share certificates are also outsourced to trust banks or securities companies, just like for shares of ordinary corporations.

The investment corporation also engages the **Property Management Companies** whose primary responsibility is to manage the maintenance and leasing of buildings. Building maintenance involves proper upkeep of the property to ensure long-term profitability for the investment corporation, and leasing services include monthly invoicing for rents and negotiating contract renewals.

The investment corporation or the trust earn the revenue either in the form of rental or in the form of capital gains received from the sale of the property, are used to distribute among its shareholders or to pay back the interest payment if it is availing any financial facility from financial institution.

6.2 Company's Qualification as a REIT

In order to qualify, as a REIT a company must comply with certain provisions and according to that, a REIT must:

- Be an entity that is taxable as a corporation
- Be managed by a board of directors or trustees
- Have shares that are fully transferable
- Have a minimum of 100 shareholders
- Have no more than 50 percent of its shares held by five or fewer individuals
- Invest at least 75 percent of its total assets in real estate assets
- Derive at least 75 percent of its gross income from rents from real estate property or interest on mortgages on real property
- Have no more than 20 percent of its assets consist of stocks in taxable REIT subsidiaries
- Pay annually at least 90 percent of its taxable income in the form of shareholder dividends

6.2.1 REIT Stocks Valuation

Once the company is qualified as a REIT, then its shares would be publicly tradable on stock exchange and investors can judge their value. Like all companies whose stocks are publicly traded, REIT shares are priced every day in the market and give investors an opportunity to value their portfolios daily. To assess the investment value of REIT shares, investor must look at the following perspectives:

- Management quality and corporate structure
- Anticipated total return from the stock, estimated from the expected price change and the prevailing dividend yield
- Current dividend yields relative to other yield-oriented investments (e.g. bonds, utility stocks and other high-income investments)

- Dividend payout ratios as a percent of REIT FFO
- Anticipated growth in earnings per share
- Underlying asset values of the real estate and/or mortgages, and other assets.

Stock of REITs that are registered with the SEC but not publicly traded on an exchange should be valued in consultation with a qualified financial advisor.

REIT investors often compare current stock prices to the net asset value (NAV) of a company's assets. NAV is the per share measure of the market value of a company's net assets. At times, the stock price of a REIT may be more or less than its NAV. Investors should understand some of the fundamental factors that influence the value of a REIT's real estate holdings. One critical factor is to determine how well balanced the supply of new buildings is with the demand for new space. When construction adds new space into a market more rapidly than it can be absorbed, building vacancy rates increase, rents can weaken and property values decline, thereby depressing net asset values and this would ultimately affect share price.

Growth in earnings typically comes from several sources, like higher revenues, lower costs and new business opportunities. The most immediate sources of revenue growth are higher rates of building occupancy and increasing rents. As long as the demand for new properties remains well balanced with the available supply, market rents tend to rise as the economy expands. Like other public companies, REITs and publicly traded real estate companies also increase earnings by improving efficiency and taking advantage of new business opportunities.

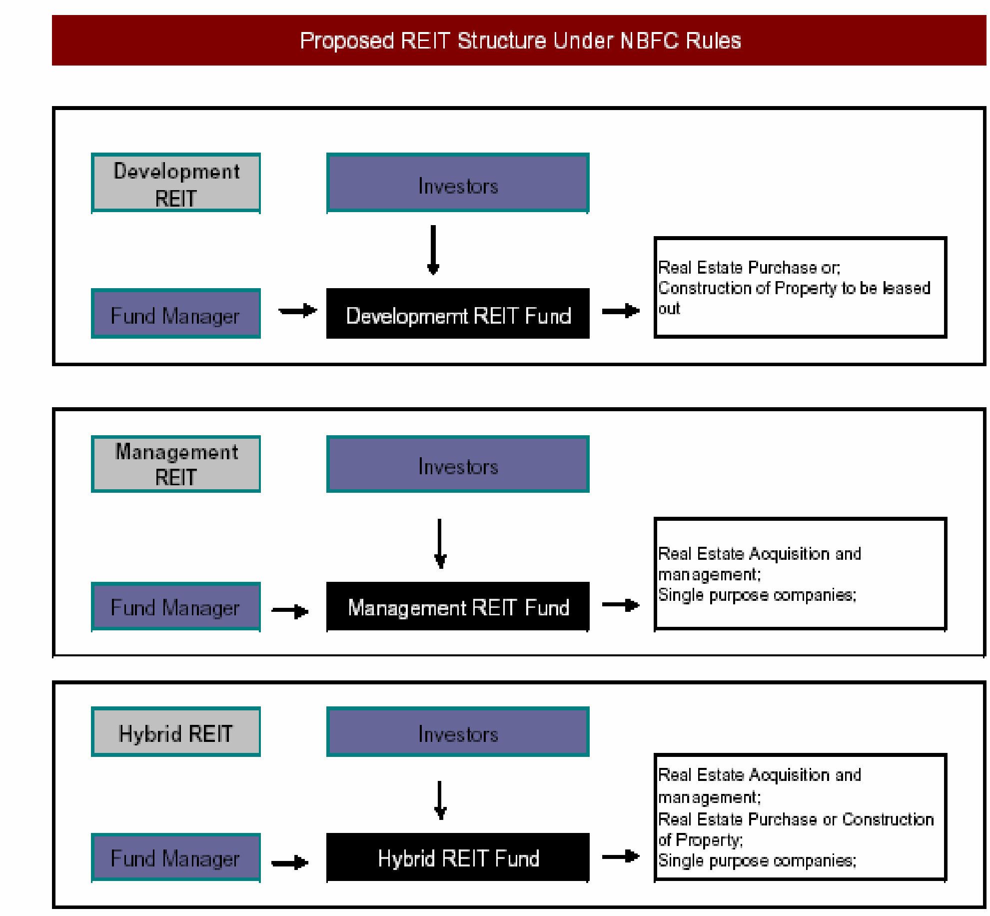
6.3 Optimal Structure for Pakistan

The optimal structure REIT is the one that allows tax transparency, transfer of capital in and out of the country for investment, and operational efficiencies. The AMC Structure is the only vehicle that suits the definition. However, three kinds of license shall be required for effective and efficient functioning of REITs in Pakistan: [KASB Securities Limited, Dec 2005]

1. **Development REIT;**
2. **Management REIT, and;**
3. **Hybrid REIT**

The following figure represents the proposed structure of the two types of REITs in Pakistan.

Figure 6.2 Proposed REIT Structure under NBFC Rules



6.3.1 Development REIT

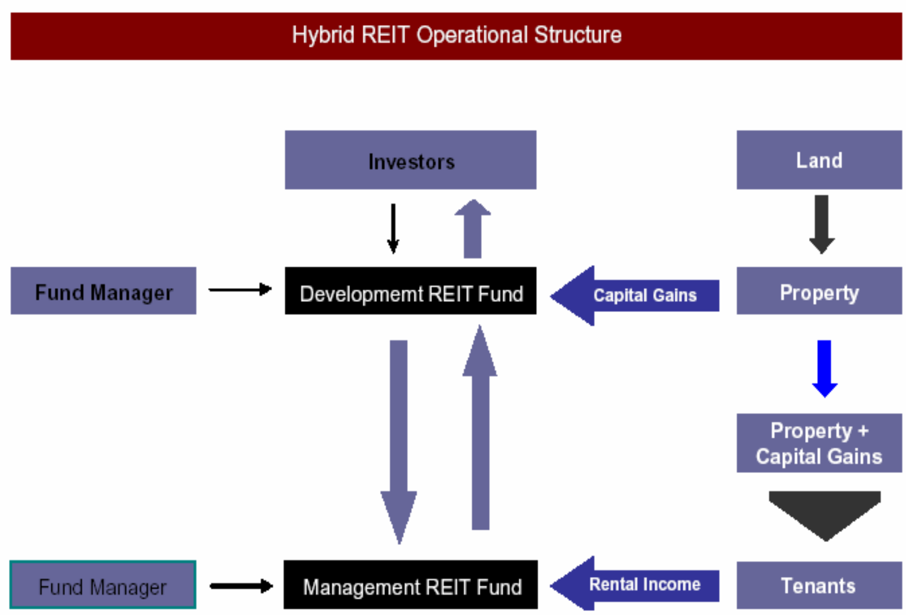
The Development REIT will typically concentrate on real estate acquisition for purchase or construction. After the development is finished, the development REIT will sell the property to either Management REIT or Hybrid REIT or to other interested parties and capitalize the capital gains for the investors. It may then start off another project in due course.

6.3.2 Management REIT

The management REIT will concentrate on concentrate on the management and maintenance of property, and the returns will be in form of rentals. This type of investment will be suited and will acquired from Development REIT or property acquired through sale and lease back agreements.

Investors who are willing to revoke rights to their property to obtain benefits from leasing structures may enter into sale and lease back agreements, with Management and Hybrid REITs, which would then be similar to a paghri structure prevailing in Pakistan. Therefore it can be used to abolish the "Paghri" system, which would then improve the rental, yields. The following figure we present the operational structure of a hybrid REIT.

Figure 6.3: Hybrid REIT Operational Structure



6.4 REIT Attraction for Pakistani Investors

As REITs are total return investments, they typically provide high dividends plus the potential for moderate, long-term capital appreciation. Long-term total returns of REIT stocks are likely to be somewhat less than the returns of higher risk high-growth stocks and somewhat more than the returns of lower risk bonds. Because most REITs also have a small-to-medium equity market capitalization, their returns should be comparable to other small to mid-sized companies. The listed REITs in investors investment program would help to build a diversified portfolio.

REITs offer investors:

- Current, stable dividend income
- High dividend yields
- Dividend growth that has consistently exceeded the rate of consumer price inflation
- High Liquidity, due to which shares of publicly traded REITs are readily converted into cash because they are traded on the major stock exchanges
- Professional management: REIT managers are skilled, experienced real estate professionals
- Portfolio diversification, which reduces risk
- Independent directors of the REIT, independent analysts, independent auditors, and the business and financial media monitor a public REIT's financial reporting on a regular basis. This scrutiny provides an investor a measure of protection and more than one barometer of the REIT's financial condition.
- Disclosure obligations: REITs whose securities are registered with the SEC are required to make regular SEC disclosures, including quarterly and yearly financial reports.

After considering all the benefits and the structures under which a REIT can operate, Pakistani investors would be more than willing to welcome the implementation of REITs in Pakistan.

6.5 Problems in Implementing REIT

Although the AMC structure is considered as most optimal structure for implementing REITs, which could bring the advantages of tax transparency, transfer of capital in and out of the country for investment, and operational efficiencies. But by analyzing the current dynamics of real estate market in Pakistan, following problems are highlighted, which are hindering the implementation of REIT in Pakistan.

6.5.1 Investment restriction

Under the NBFC Rules 2003, Investment Schemes in Pakistan are not allowed to invest in real estate. Because of this, small investors never get the chance to deploy their funds in real estate that is of low risk profile. Further, there is another clause in NBFC rules 2003 that any investor cannot invest in any company more than ten percent of that company's paid up capital or ten percent of the net assets of the fund. This exposure limit restricts the investor from investing in any company with more capital.

6.5.2 Leverage Restriction

Under NBFC Rules 2003, investors are not allowed to borrow for themselves. For REIT it would be a serious problem as the corporation working under REIT relies heavily on outside funding by taking the leverage from the financial institution, so that they could increase their portfolio of investment to diversify the risks. For this reason REITs need modification regarding its leverage clause.

6.5.3 Pension Fund Investment Restrictions

It is evident from the international REITs successfully implemented in U.S, Australia and other countries that apart from individual investors, pension funds are also the investor in REIT. But in Pakistan according to new Voluntary Pension Rules, Pension Funds are not allowed to invest in anything other than capital markets.

Pension funds always prefer the less risky investments with low volatility and real estate investment is one of those investments showing the stability and low volatility. So considering these characteristics the pension funds should be allowed to invest in REITs to increment its returns by higher amount.

6.5.4 Land Record System

In Pakistan real estate is highly unstructured and unorganized sector. There is no proper record maintaining system. Pakistan's land record system is antiquated and raises several concerns including Obsolete and Opaque system of land revenue management.

Land records are usually maintained by district administration for deciding ownership and boundaries of land or property. The process of defining and determining land in favor of an owner is called registry of land. Municipal Corporation also uses the ownership information for tax collection. All land disputes come under the charge of Tahsildar, Naib Tahsildar, and Patwari. These officials assist Collector in resolving land disputes. Land records maintained on paper, which faces the problems in updating and retrieving the data.

6.5.5 Imperfect Tenancy Laws

There have been disputes over rights and delays in courts. In Pakistan tenancy laws favor tenant more rather than owner of the property. Usually the owner of the property feels unsecured by renting the property. It is evident from the past facts that dispute arises from such tenants problems never brings the solution with in reasonable time. Rather there are also the instances in which such disputes remained pending in the court up to twenty or more than twenty years because of lack of credible information that generates considerable delays in resolving pending cases in courts.

6.5.6 Transaction Costs

In Pakistan, transaction cost of real estate related transactions is very high. Usually a simple transaction of real estate includes registration fee and mutation charges and that are approximately 6-7%. In addition to these charges, various authorities also charge the transfer fee separately. However, the regional comparison showes that transaction costs are approximately 3-4%. Therefore total transaction cost in Pakistan is quite high and this could hinder the REIT implementation.

6.5.7 Huge Financial Cost

As the computerization of land record is the most desirable solution for all such problems, but it requires large financial costs in terms of procurement of hardware, software, human resources as training requirements

CHAPTER # 7: RECOMMENDATIONS

After analyzing the optimal structure of REIT in Pakistan and the problems that could hinder its implementation, following recommendations are proposed to get the effective outcomes.

7. 1 Modification to NBFC Rules

The NBFC Rules 2003 imposes the number of restrictions on making the investment in real estate. But if we make amendments in those regulations or eliminate these restrictions, its benefits could be large. In the past policymakers have often underestimated the potential of real estate investment to contribute to greater productivity and increase the welfare of the low-income group. [KASB Securities Limited, Dec 2005]

7.1.1 Investment Restrictions

- NBFC Rules 2003 needs to be modified. However, the REITs should be allowed to invest in Real estate, Single purpose companies, Real estate-related assets, Liquid assets, Non-real estate -related assets, Asset-backed securities. The development REITS should not be allowed to invest in other development REITS and maintenance REITs. Similarly Maintenance REITS should not be allowed to invest in other maintenance REITs and development REITs.

- Moreover there should be modification in NBFC rules 2003 regarding the exposure limit. Either there should be no limit or at least this limit of ten percent should be enhanced.

7.1.2 Leverage

Under the NBFC Rules 2003, the funds may not borrow themselves for. An exemption to this effect is also required.

7. 2 Modification to Capital Gain Tax

Currently only the capital gains on listed equity are tax-free. However, the capital gains on property/land sold to a REIT should also be tax-free. This would encourage the investors to invest in real estate securities. REIT should be granted a status of investment scheme formed under NBFC Rules as a result of which it would be tax exempt.

7.3 Removal of Pension Fund Investment Restriction

Under the new Voluntary Pension Rules, Pension Funds are not allowed to invest in anything other than capital markets. However, given the low volatility of real estate investment, the pension funds should be allowed to invest in REITs with minimal quantitative restrictions.

7.4 Implementation of Progressive Registration System

- It is also recommended that Pakistan should use progressive system. This means that when a new land registration system is introduced, or an old improved, its design should be technically simple, so that it can be upgraded easily and readily adaptable. There should be reduction of functions; It is very often necessary to improve the institutional arrangements and strengthen the technical skills of staff. It may also be worthwhile to consider introducing some incentives for individuals to register their land.

- The need for efficient land management systems in Pakistan is evident. However, the costs for technical equipment and skilled staff are still very high. So government should assess this situation and reach a decision on what is affordable. It is highly recommended to consider a progressive land registration system which will enable future expansion as the equipment and technology will eventually become more accessible for budgets which are tighter as well.

7. 5 Modified Tenancy Laws

The tenancy laws need to be classified as Criminal Law, and not Family Law to allow efficient execution for the property formed under REIT structure. The procedure for eviction of tenants needs to be improved so that there is an incentive to build properties for rental purposes. Moreover, separate courts need to be established to settle the disputes efficiently and it is needed to strengthen the tenancy laws.

7.6 Lower Transaction Cost

The transaction costs including registration fee and mutation charges are approximately 6-7%. In addition, various authorities charge the transfer fee separately. However, the regional comparison showed that transaction costs are approximately 3-4%. Therefore total transaction costs in Pakistan should also be reduced to 3%.

7.7 Computerized Land Record System

As the Land records are not maintained properly. All system is manual, storing the data on paper, which has lots of problems. Computerization is natural solution for all these problems. The government of India has already taken initiatives to computerize land records in the country and has successfully implemented it in the state of Karnataka. Though the process is painful, but will result in single window solution to all land related problems. So Pakistan should computerized its land recording system.

7. 8 Technological Leverage

Rapidly progressing technologies such as GIS, data warehousing and World Wide Web are helpful for the generation, update as well as management of the land record information.

Use of these value added technologies will make land records management easier, effective and efficient. So Pakistan should use GIS.

7.8.1 Urduization

Urdu is the national language of Pakistan and widely understood throughout the country. If the database is maintained in Urdu language through Unicode standardization as National Databases and Registration Authority (NADRA) Pakistan has already done this for personnel registration database, the system will become easy, understandable and transparent.

7.8.2 Un-official Pricing

Buyers of property from REITs should not be asked source of income to avoid problems related with official and unofficial pricing.

7. 9 Recommendations Regarding Structure

Although the AMC Structure is tax transparent, however, it would require modifications to be conducive for both types of REITs to work. It is apparent from the proposed recommendations that it will take some time before REITs can actually operate in Pakistan. However, this should not hinder skilled investors such as banking and non-banking financing who would like to take real estate exposure. Therefore an alternate solution is the sale and leaseback agreement between the Lessee and Lessor, where the underlying is a property or land.

This alternate solution to real estate investments will provide a way to obtain exposure in real estate, thus improving the number of products available for investment. This would also aid the future development of REIT market. Therefore the Banks and leasing companies should be allowed to write leases for property and the Land/property sold under sale and leaseback agreements should be tax-free. So the structure that could be used for investing in real estate property before the implementation of REITs is described below:

7.9.1 Sale and Leaseback by Banks and Leasing Companies

Sale and leaseback is an arrangement in which one party sells a property to a buyer and the buyer immediately leases the property back to the seller. This arrangement allows the initial buyer to make full use of the asset while not having capital tied up in the asset. Leasebacks operate in finance lease structure and may provide tax shield.

Figure 7.1 Sale & Leaseback Agreement

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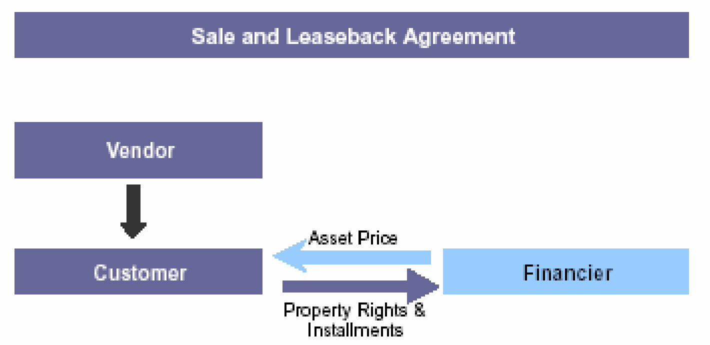
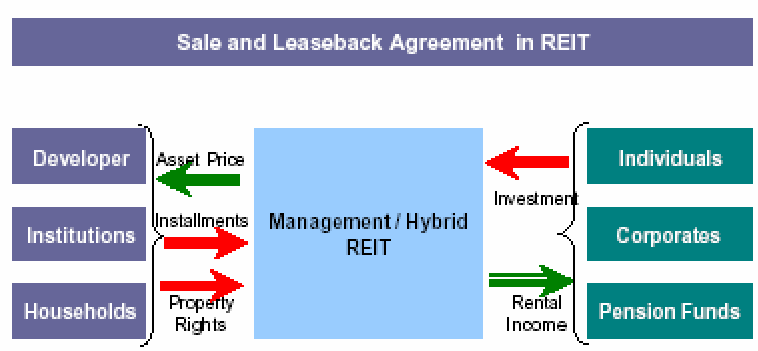


7.9.1.1 Advantages

The key advantages to the sale and lease back agreement are:

1. It negates the need to raise potentially more expensive capital in the marketplace to finance expansion.
2. Leasing normally represents 100% financing whereas a mortgage company will not provide more than say two-thirds of the value of a project.
3. It can also be used both in Management and Hybrid REIT model. The figure represents how sale and leaseback agreements would operate in REITs.

Figure 7.2 Sale & Leaseback Agreement in REIT



This arrangement shows that the investors in hybrid/development REIT will get low risk rental yield. And the lessee will capitalize the capital gains that he would obtain on selling his property, and as a result this will be a structure similar to paghri system whereby the lessee will pay a rental to the lesser.

7.9.1.2 Disadvantages:

There are certain disadvantages to this arrangement:

1. Lessee acts much as the owner of the property rather than as a tenant paying for all repairs, maintenance, insurance and property taxes during the lease.

2. Improvements to the property and any increase in land value added to the benefit of the landlord at the expiration of the lease.

The sale and leaseback agreement is also available in Islamic Financing Modes and is known is "Ijarah". In this case, the term 'Ijarah' is analogous to the English term 'leasing'. Here the lessor is called 'Mu'jir', the lessee is called 'musta'jir' and the rent payable to the lesser is called 'ujrah'. Since the sale and leaseback agreements can be structured in an Islamic mode, the appeal of such products will be higher. Therefore the sale and leaseback agreements would allow banking and leasing companies to write real estate leases and therefore sale and leasebacks should be authorized.

7.10 Recommended REIT Requirements

The investments can only be made in Pakistan. The following is a basic framework that is adopted from the Rules and Regulations present in Turkey and Malaysia.

7.10.1 Authorized Investments

A real estate investment trust may invest in any of the following:

1. Real estate.
2. Single-purpose companies.
3. Real estate-related assets.

4. Liquid assets.
5. Non-real estate -related assets and
6. Asset-backed securities.

Moreover, REIT can be established
1. For a limited time to undertake a certain project,
2. For a limited or unlimited time to invest in certain areas, and
3. For a limited or unlimited time without any limitation of purpose;

7.10.2 Conditions for Establishment

The companies that are already doing the business of real estate can be turned into real estate investment companies by amending their Articles of Association, expressing the purpose of the company. The security and exchange commission can approve this transformation of companies to real estate investment companies. The company to acquire the status of Real Estate Investment Corporation or Trust must fulfill following conditions:

- Companies should be established as NBFC or Public Unquoted Company with registered capital,
- Companies should be established to offer the shares representing at least 49% of the issued capital to public within the period,
- The initial capital should not be less than PKR 1 Billion,
- At least 25% of the shares representing initial capital should be issued for cash,
- The phrase "Real Estate Investment Company" should be included in the commercial title,
- Should have applied to the Commission for providing asset management service;
- The Articles of Association should be in conformity with the provisions of the Law.

REIT developed under the above-mentioned rules and regulations can be categorized as development REIT or Management REIT, if meeting certain other requirements. The Investment Focus for both Management and Development REIT should be different for open-ended and closed-ended funds to incorporate redemptions.

7.10.3 Development REIT

To qualify as a development REI, it must comply with following requirements.

- At least 70% of the fund's total assets shall be invested in real estate purchase or construction of real property to be leased out;
- The remaining 30% of the fund's total assets may be invested in other assets such as liquid assets; real estate related assets, non-real estate-related assets or asset-backed securities;

7.10.4 Management REIT

A Management REIT must comply with the following requirements:

- At least 70% of the fund's total assets shall be invested in real estate acquisition and management;
- At least 30% of the fund's total assets must be invested in liquid assets, real estate related assets, non-real estate related assets, and asset backed securities;

CHAPTER # 8: CONCLUSION

8.1 REITs Conclusion

The previous sections have discussed the modifications to regulations to provide a framework that allows investment in real estate. The overall research shows that Real estate has been absent or under-represented in many investors' portfolios due to the challenges of direct property investing such as limited transparency, high amount of investments and poor liquidity. It's highly needed to highlight the importance of Real Estate Investment Trust that is overcoming all these limitations. The conversion of real estate investment to REITs creates a more attractive option by opening up the untapped market for investors.

By making the comparison with all other investment vehicles it is evident that real estate is attractive because it has a low correlation with equities and bonds. This means that investors can reduce their total portfolio risk either by diversifying their bond portfolios or allocating a portion of their equity exposure to this asset class. Real estate offers higher income and also greater stability than equities because rental streams are backed by medium to long-term commercial agreements. Also, in contrast to bonds, whose fixed income stream suffers during periods of high inflation, real estate companies can also provide inflation protection through upward rental revisions.

All the previous analysis has shown that REITs and other types of public real estate companies have become increasingly prominent participants in the commercial property business around the world. More and more nations are discovering the benefits of REITs in terms of transparency, liquidity, more permanent management and corporate structures. Its simpler tax structures, easier access to all forms of capital including unsecured debt, and its greater overall market efficiency attracted many investors. Because of these advantages many countries have altered their laws to successfully implement REIT-like investment vehicles to realize these benefits. After U.S and Australia, recently Japan, France, Singapore, Korea and Hong Kong join the REIT bandwagon on their relative better market system. It was broadly acknowledged that US and Australia introduced REITs after its real estate industry had accumulated decades of experience, but much of Asia real estate market is relatively new and it is considered that Asia is more speculative than US and therefore more volatile. Asian REITs should be restricted to non-speculative instruments and related regulators should guard against the speculation trend in Asian REITs market, and keep the Asian REIT to build dividends and diversification. Moody's expects more nations to create REITs, with Mexico, Taiwan and the United Kingdom seemingly next on deck but it is still too early to expect that REITs will be wide spread in all these countries. The demand for global real estate securities has grown significantly recently as investors search for asset classes, which provide high, stable income, protected from inflation.

In the past decade, the global Real Estate Investment Turst (REIT) market has registered healthy growth. Aging population around the world is changing the way in which pension funds are being invested. Investors are increasing their asset allocation to real estate as a source of diversification, capital stability and income stream as through this mode of investment the major hindrance to investments in real estate i.e. its illiquidity have been removed.

Government plays the most crucial role in establishment and development of REITs. If government does not offer any additional incentives, then it would be difficult to successfully implement this in Pakistan. So it's absolutely necessary to have strong legislative framework that allows and supports the development of REITs. This includes favourable regulations with fewer restrictions on real estate investment, taxation and gearing. Specific designed incentives such as exemption from property related taxes and fees would also help the growth of this industry.

In this regard the Government of Pakistan has given the relaxation to property holders. Property tax on rented property and on the property for self-occupancy has been rationalized. According to latest information all new construction of housing on plots, measuring up to 150 square yards and flats/apartments having an area of 1000 square feet, have been exempted from all types of taxes for a period of 5 years, Stamp duties and registration fees are being rationalized for housing mortgage.

Another important issue that can hinder REITs implementation is the improper land recording system. The conventional land record system is still in use in Pakistan. Although the system of local governance has changed for the better management, but the mechanism of land records handling and revenue assessment remains same as followed since Mughal era.

The flaws and shortcomings of existing system of land records can overcome REIT implementation, so it's strongly needed to abolish such practices and bring in the new ones and according to the demand of time it has one and only solution and that is to computerize the land records. As with expansion of communication infrastructure, increased awareness more and more people can access computerized information.

In conventional system, query of land records is laborious, time consuming and revolves round a single person (Patwari) that is why integration of geographic data and their pertinent alphanumeric data is indispensable to develop and maintain a comprehensive Land Records Information Management System (LRIMS). The upcoming technologies such as geographical information system, data warehousing and web are very much helpful in land records management for decision-making, strategy planning and predictive modeling. The use of these technological leverages can make land records management efficient and easier.

The GIS techniques of the present information age can prove to be very useful to transform the conventional system into an efficient, easy-to-use, practically applicable LRIMS. The proposed system will not only be useful for the revenue department regarding Information updating, query, reporting, customization, leakage detection and predictive modeling but will also beneficial for other system stakeholders regarding the identification of legal sector of their respective lands. The computerization of records would involve large financial costs in terms of procurement of hardware, software, and human resources as training requirements, but the government has to take this step and to bear the expenses for more profitable returns.

The government along the SECP has passed the regulations regarding the implementation of REIT in Pakistan and is confident that REIT implementation would have multiplicative effects on the economy of country. The implementation of REIT in its true sense and spirit would definitely contribute to the revival of housing and construction sector. Besides this it would help to generate maximum employment opportunities, it would alleviate the poverty, raises the living standard of the people and improve the overall economy of the country

However, all analysis shows that REIT's market will not function smoothly unless the rental yields improve, tenancy laws are strengthened, official and unofficial pricing issue is settled, paghri system is abolished, and the time consumed in legal proceedings is reduced. And we believe that the REIT's structure that has developed over the last 40 years is sound and sensible and will continue to bring rewards to its shareholders if it is implemented successfully in the future. Although this concept is in its infancy stage, but we still hope that REITs market would show strong potential for growth.

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