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**GULF ONE LANCASTER CENTRE FOR ECONOMIC RESEARCH**

## **REPORT**

# **The Outlook for Islamic REITs as an Investment Vehicle**

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Islamic REITs (iREITs) are gaining momentum as a viable alternative channel for Shari'ah-compliant investments, but the extent to which this investment vehicle will tap the trillion dollar Islamic finance industry remains to be seen. Before examining the many attributes of iREITs and their potential for becoming the preferred choice for Islamic investors, it is perhaps useful to highlight the attributes and relevance of conventional Real Estate Investment Trusts (cREITs).

## Conventional Real Estate Investment Trusts

Investment trusts acquire shares in other companies to provide a collective investment. In the case of REITs, that investment is in real estate only. The investment may take the form of buying, managing, selling and leasing real estate; purchasing shares in publicly listed property companies or investing in the debt securities of property companies. By combining the best features of real estate and stocks, REITs provide a practical and effective way of including professionally-managed real estate within a diversified investment portfolio. There are three types of REITs:

- Equity REITs own and operate income-producing assets. Many are fully integrated organisations that engage in the acquisition, development and management of commercial real estate
- Mortgage REITs extend credit to owners of real estate
- Hybrid REITs combine aspects of the other two.

Each type can be structured either as a public or private REIT.

## Major Benefits of REITs

Major reasons why REITs are a popular investment

vehicle include:

1. Diversification: participants broaden their investment portfolio and diversify risk
2. Liquidity: shares in REITs can be readily purchased and sold
3. Tax transparency: with no tax levied on its profits, full dividends accrue to shareholders, who pay tax according to their personal rate
4. High dividend yields: REITs are typically required to distribute at least 90% of their income to shareholders

In the case of Shari'ah-compliant investment, the additional attractions of iREITs to investors are: low correlation with common stocks and as a potential hedge against inflation; high dividend yields and the higher certainty of income.

## Islamic Real Estate Investment Trusts

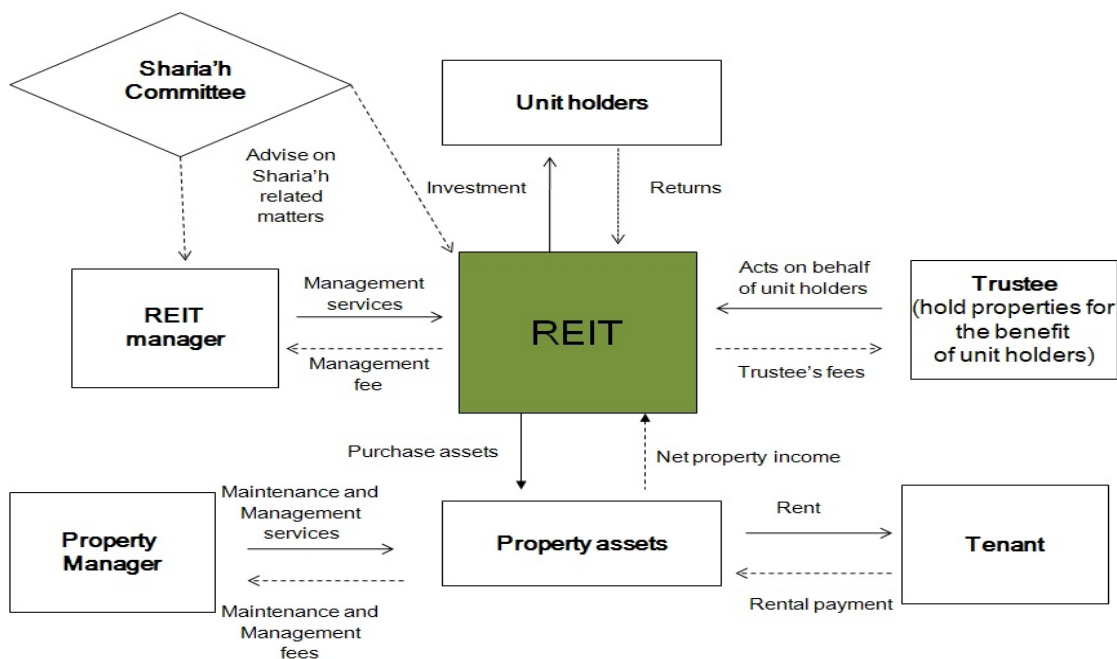
The unique characteristic of an iREIT is that it invests primarily in income-producing, Shari'ah-compliant real estate and/or single purpose companies whose principal assets comprise Shari'ah compliant real estate.

The structure of an Islamic RIET is shown below.

A portion of iREIT funds can be invested in other Sharia'h compliant asset classes; e.g. cash or Shari'ah acceptable deposits.

## Malaysian Securities Commission Guidelines for iREITs

In Malaysia the growth of iREITs has been facilitated by guidelines issued by the Securities Commission, which include the following:



**Source:** *Islamic Banking and Finance Institute Malaysia (IBFIM) and Securities Commission Malaysia*

- Rental incomes from non-permissible activities must not exceed 20%
- An iREIT cannot own properties where all the tenants operate non-permissible activities
- An iREIT shall not accept new tenants whose activities are fully non-permissible
- Tenants engaged in non-permissible activities may occupy no more than 20% of the total area
- For non-space using activities, decisions must be based in ijthad (the process of reasoning by Islamic jurists)
- All investment, deposit and financing instruments must comply with Shari'ah principles
- Property insurance must be based on takaful schemes. Conventional insurance schemes are permitted if no takaful schemes are available.

Rental activities that are classified as non-permissible are:

- Financial services based on riba
- Gambling/gaming
- Manufacture or sale of non-Halal products or related products
- Conventional insurance
- Shari'ah non-compliant entertainment activities
- Manufacture or sale of tobacco-based or related products
- Trading in Sharia'h noncompliant securities

iREITs and cREITs differ primarily in how incomes are earned and how the fund is managed. Each of these aspects must be in compliance with Shari'ah principles.

### Investing in iREITs - Issues and Risks

Although their business model is a stable one, iREITs are not without risk. Dividend payments are not guaranteed and the real

estate market is prone to cyclical downturns. In addition high distributions of annual profit and lower reinvestment lead to a slower growth rate. Although iREITs are exposed to the same risks as cREITs, Shari’ah non-compliance risk’ requirements restrict investment options. Two major issues which can hinder the growth of iREITs are the lack of a developed secondary market for Islamic instruments; and the absence of a guidance and regulatory framework.

**The Scope for Development in Asian Markets**

Malaysia took the initiative of issuing the Islamic REIT guidelines and since that time the promotion and development of Islamic finance by the Malaysian authorities has been exemplary. The Al-Aqar KPJ REIT, with seven hospitals within the KPJ Healthcare group as its main asset, was the first iREIT to be established in the world.

Malaysia currently has fourteen REITs, of which three are Shari’ah-compliant. Each specialises in a different asset subclass. For example, Al-Hadharah specialises in oil palm plantations. Another, specialising in office buildings and industrial properties, was formed by the conversion of a cREIT.

Malaysian iREITs have performed steadily in terms of the income generated from rental income and capital gains and have maintained a healthy dividend payout rate (see Table 1). The key arrangement of ‘sell and lease back’, between owners of real estate and the iREIT, is that the owner sells an asset to the iREIT and simultaneously enters into a back-to-back asset lease arrangement. This is an effective risk mitigation tool allowing the iREIT to secure its income while avoiding the issue of finding a

long-term tenant and buyer for the property at the end of the tenancy.

**Table 1: Dividend Distribution to unit holders**

iREITs	2008	2007	2006	2005
Al-Aqar	8.10	7.32	2.72*	n/a
Al-hadarah	3.69	7.22	n/a	n/a
Axis	15.27	13.63	12.95	4.7

*Source: Faizah C. Din, Malaysia Report, Islamic Finance, July 2009*

All the iREITs were fully subscribed when they were launched and all involved high-quality assets expected to generate a stable cash flow. In the case of Al-’Aqar KPJ REITs, for example, a portfolio of hospital buildings had a 100% guaranteed occupancy rate. According to the Rating Agency of Malaysia (RAM), good quality assets are more likely to command sustainable resale values through economic cycles, thereby ensuring timely repayment of financial obligations through refinancing and/or disposal of assets.

Malaysia is also drawing investors from the Middle East as two UAE based real estate developers are currently looking to list iREITs in Malaysia worth a total of RM2 billion .

Several iREITs are in train in Asia. Bahrain, Saudi Arabia, Singapore and the UAE are also working towards establishing their real estate sectors. In 2009, the Bahraini asset management company Inovent initiated fundraising for \$79.5 million of property within an iREIT. The principle objective of the BHD 30 million (\$79.8 million) iREIT is the acquisition of income-generating properties in the Gulf Cooperation Countries (GCC). The purpose is to ensure an acceptable, risk-adjusted return on investment in the form of quarterly profit distribution, in addition to ‘reasonable capital appreciation’. The iREIT is estimated to earn an annual 8.5% return from a ‘buy and leaseback’ approach. Inovent also intends to list

the iREIT in Kuwait and Saudi Arabia.

In the UAE, Dubai Islamic Bank and Eiffel Management launched the country's first Shari'ah compliant REIT. Established in November 2010, Emirates REIT is Dubai's first iREIT. It will initially list on the Dubai Nasdaq stock exchange before undertaking a second listing within the next 18 months, most probably in London.

Despite a slow start for iREITs in the GCC and Middle East, the prospects for iREITs in the region are still positive due to the marked-down valuations of asset prices after the recent financial crises. The distressed sales of assets open attractive investment opportunities for managers of iREITs.

Another notable development, indicating the growth of iREITs in the region, was the launch of the Sabana iREIT, the world's biggest publicly-traded iREIT. Sabana made its debut in the Singapore market and raised SG\$664.4 million (US\$539 million) in an initial public offering that was oversubscribed by 2.5 times. Sabana invests in properties such as warehouses and high-technology office space.

### **iREITs in European Markets**

European financial markets have been in the forefront in attracting and promoting Islamic financial services by unwinding the regulatory framework and devising strategies to encourage and support the growth of Islamic finance. For instance, the Luxembourg Central Bank is the first European central bank to be a member of the Islamic Financial Services Board and is working actively to gain experience of supervisory practice in this area, identifying instruments, practices and solutions for managing liquidity in a Shari'ah compliant manner.

France, which has the largest Muslim population in Europe, has taken notice of the importance of this sector by appointing an Islamic Finance Specialist, Thierry Dissaux to help create legal routes for financial instruments based in accordance with Shari'ah. Last year, new rules relating to Islamic finance were published in the official French tax bulletin, facilitating the development of sukuk bonds, murabaha, ijara and istisna. The changes address company tax, value-added tax and registration fees. In addition the issue of double taxation is under review and if this is resolved satisfactorily it should encourage investment in real estate.

Although London has provided Islamic financial services for 30 years, it is only recently that this service has achieved a significant profile. A key aspect of supportive government policy was the establishment in 2003 of an enabling fiscal and regulatory framework for Islamic finance. The removal of double taxation on Islamic mortgages, and the extension of tax relief on Islamic mortgages to companies and individuals, makes investing in real estate more attractive. Moreover, in the UK, a REIT is considered to be a resident company that benefits from tax advantages. UK REITs are exempt from tax deduction both on rental income and on capital gains. In short, it replicates the tax treatment on direct property investment. With more than 20 banks offering Islamic services in the UK, iREITs expect to find a positive response to their high return/low risk attributes.

The growing interest shown by European governments in accommodating and encouraging the development of Islamic finance in the region is a positive mood and should create an environment in which iREITs should thrive.

## Going Forward

There is a considerable opportunity for iREITs to expand, not least because of their natural fit with Islamic finance, which looks for stability by investing in the real economy. As a tangible asset, real estate is the preferred asset class amongst Muslim investors and institutions. iREITs fit the bill perfectly for affluent Arab investors who are seeking viable investment avenues to channel their funds. iREITs can provide such investors with selected projects that yield good returns and a stable income. The interest shown in the Asian Pacific region, across Singapore and Malaysia and the launch of multimillion dollar Industrial Islamic REITs in Singapore suggests that the GCC will continue to prosper.

The Gulf One Lancaster Centre for Economic Research (GOLCER) was established in May 2008 by Lancaster University Management School and Gulf One Investment Bank. The centre is funded by a donation from Gulf One Bank.

The main purpose of the Centre is to conduct empirical research focused on key economic and financial developments in the Middle East and North Africa (MENA) region, with special emphasis on the Gulf region. This region includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates, countries that form the Gulf Cooperation Council.

GOLCER's research agenda will include, as primary topics, energy economics, Islamic banking and finance, telecommunication and infrastructure economics. Recent developments in these fields will be assessed in the light of their impact on the economy of the Gulf region.

In addition to its research activities, GOLCER will provide tailored training courses in specialised areas, including quantitative methods and applications of state-of-the-art econometric and statistical software packages to economic and financial phenomena. GOLCER will also provide consultancy services.

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