Wealth Management and Islamic Finance: Synergies and Opportunities

by

Dato’ Stewart LaBrooy
CEO Axis REIT Managers Bhd
INCEIF Inaugural Colloquium
Sime Darby Convention Centre
19th December, 2013
Program

1) Islamic REITs – What they represent
2) M REIT’s – an overview.
3) Challenges in taking Islamic REITs global
4) Challenges ahead
- Islamic capital market (ICM) where market transactions are carried out in ways that do not conflict with the conscience of Muslims and the religion of Islam.

- There is assertion of religious law so that the market is free from activities prohibited by Islam such as usury (riba), gambling (maisir) and ambiguity (gharar).

- ICM is a component of the overall capital market. It plays an important role in generating economic growth for the country.

- In Malaysia, the ICM functions as a parallel market to the conventional capital market, and plays a significant complementary role to the Islamic banking and takaful in broadening and deepening the Islamic financial markets.
What is a REIT?

“A real estate investment trust is a listed vehicle that invests in a portfolio of income-generating properties. Rents collected from tenants, less expenses are distributed on a regular basis to provide stable yields to Unitholders”

This distributed income to Unitholders is subject to a one time withholding tax of 10% for individuals. The REIT is not taxed by the IRB”
What does a REIT Represent?

✓ Units in a REIT represents equity ownership

✓ Indirect access of large, stable estate portfolios in a tax efficient manner (This distributed income to Unitholders is subject to a one time withholding tax).

✓ Investors are only taxed once – only 10% tax for REITs investment in Malaysia

✓ Governed by a Trust Deed, the stock exchange and the securities commission regulations which define the operating procedures ensuring a high level of corporate governance
Why Listed REITs

- Liquid proxy to physical assets
- Priced daily in the market
- Liquid pool of stocks
- Hedge against inflation
- Low entry
- Excludes Property Business risk
REITs vs Property Companies

Earnings Profile

✓ A REIT is driven by recurring rental income

A property company seeks a combination of property sales, development profits, rental income and property investments

Capital Structure and Cash Flow

✓ A REIT has low and defined level of retained earnings, low debt level defined by the regulators and strong cash flow from operations

A property stock has a high gearing ratio due to high capital expenditure required for property development and sometimes negative cash flow. Low dividend payouts
Dividend Distribution Policy

- A REIT will distribute 90-100% of its retained earnings before tax.

* A property stock has no certainty of a dividend payout.

Risk Profile

- A REIT is a low risk, passive investment vehicle with a high certainty of cash flow from rentals derived from lease agreements with tenants.

* A property stock has a high development and financial risk.
Corporate Governance

✓ REITs are governed by multiple layers of stakeholders - unitholders, manager, trustees, regulating authorities ensuring that interest of minority unitholders are protected.

A property stock is often dominated by a controlling shareholder which raises conflict of interest issues with minority shareholders.
REITs vs Unit Trusts

✓ A **REIT** unitholder has a **direct** investment in the underlying assets of a REIT.

✓ A **Unit Trust** unitholder has an **indirect** investment in the investments held by the Unit Trust.
## REITs vs Unit Trusts

<table>
<thead>
<tr>
<th>Type of Fund</th>
<th>REIT</th>
<th>Unit Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Can Fund size be increased?</td>
<td>Yes</td>
<td>Yes/No</td>
</tr>
<tr>
<td>Dealings/Trading</td>
<td>Bursa Malaysia</td>
<td>Fund Manager</td>
</tr>
<tr>
<td>Pricing</td>
<td>Growth &amp; earnings</td>
<td>NAV</td>
</tr>
<tr>
<td>Income Distribution</td>
<td>Quarterly/ Semi annually</td>
<td>Varies</td>
</tr>
<tr>
<td>Distribution</td>
<td>Cash</td>
<td>Units</td>
</tr>
<tr>
<td>Payout Policy</td>
<td>&gt; 90%</td>
<td>Subject to performance</td>
</tr>
</tbody>
</table>
Islamic REIT - “In general, an Islamic REIT is a collective investment scheme in real estate, in which the tenant(s) operates permissible activities according to the Shariah” (Source: SC Guidelines for Islamic REITs)
Features of a Shariah Compliant REIT

- Structured along the lines of a unit trust with managers and Trustees

- Investment funds are pooled to purchase real estate assets to produce income streams.

- Purchasers of Units are considered as beneficial owners of the purchased assets.

- Units can be bought or sold at market price agreeable by both sellers and buyers.

- Negotiability of the units are not a problem from the Shariah perspective as units represent direct interest in tangible assets – a plus point for REITs
Countris with Islamic REIT Guidelines

MALAYSIA
Malaysia’s Guidelines on Islamic REIT’s

- Issued on November 21 2005

- Non-Permissible rental activities must not exceed the 20% benchmark based on the total turnover or area occupied;

- Not permitted to own real estate in which all the tenants operate non-permissible even if the percentage based on turnover/floor area is less than the 20% benchmark;

- All forms of investments, deposits and financing must comply with the Shariah principles;

- Must use the Takaful schemes to insure its real estate;

- The Manager must engage a Shariah advisory panel of 3 scholars or company approved by the Securities Commission.
Non permissible activities

Shariah rules state tenants in Shariah compliant properties cannot be involved in the following businesses:

- The Serving, distribution and manufacture of Alcohol products
- The sale, manufacture and distribution of tobacco products
- Pork related products
- Conventional financial services based on interest (Riba). [Includes Data Centers storing conventional bank data or document storage facilities]
- Weapons or defense
- Entertainment activities not permissible under Shariah Law (e.g. casinos, cinemas- now extended to include TV stations, music distribution, magazine publications)
- Hotels and resorts
- Stock broking or share trading in Non-Shariah compliant securities
Typical REIT Structure

- **Unit holders**
  - Minimum 25% Public Spread
  - Maximum 75%

- **Investors**
  - Cornerstone investors
  - Institutional funds
  - Retail

- **Vendors**

- **REIT Management Company**
  - Property Management Company
  - Services
  - Fees

- **Properties**
  - Management Services
  - Management Fees

- **REIT**
  - Acts on behalf of Unit holders
  - Investment in REIT Units
  - Trustee Fees

- **Trustees**
Typical Islamic REIT Structure

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- **Institutional funds**
- **Retail**

**Unit holders**
- Minimum 25% Public Spread
- Maximum 75%

- **Vendors**
- **Investors**
- **Trustees**

- **Shariah Advisor**
- **REIT Management Company**
- **Property Management Company**

**REIT**
- Investment in REIT Units
- Acts on behalf of Unit holders

**Distributions**
- Management Services
- Management Fees
- Trustee Fees

**Shariah Compliant Properties**

**Services**
- Fees
## Comparison conventional REIT/Islamic REIT

<table>
<thead>
<tr>
<th></th>
<th>Conventional REIT</th>
<th>Islamic REIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shariah Committee/Advisors</td>
<td>No need</td>
<td>Islamic REIT must appoint Shariah advisor to ensure Shariah compliance</td>
</tr>
<tr>
<td>Permissibility of activities</td>
<td>No restrictions</td>
<td>Only permissible activities allowed</td>
</tr>
<tr>
<td>carried out by tenants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance for properties</td>
<td>Conventional insurance with insurance companies</td>
<td>If available: Islamic insurance/Takaful</td>
</tr>
<tr>
<td></td>
<td>as approved by trustees</td>
<td>If unavailable: May opt for conventional insurance</td>
</tr>
<tr>
<td>Financing</td>
<td>No restrictions</td>
<td>Must be Shariah compliant</td>
</tr>
</tbody>
</table>
Listed Islamic REITs Globally

Malaysia has 3 listed Islamic REITs and one Shariah compliant REIT

✓ Axis REIT – Office and Industrial Assets
✓ Al’ Hadhara Boustead REIT – Plantations (expected to go private this year)
✓ Al’-Akar KPJ REIT – Hospital Assets
✓ KLCC REIT – stapled securities – Office, Malls & hotel assets [Shariah Compliant]

Singapore has 1 listed Islamic REIT [Note Singapore has no formal Islamic REIT guidelines]

✓ Sabana REIT- Industrial Assets
M REITs Performance
<table>
<thead>
<tr>
<th>Trust</th>
<th>Office</th>
<th>Retail</th>
<th>Industrial</th>
<th>Hospitality</th>
<th>Others</th>
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</thead>
<tbody>
<tr>
<td>Al-Aqar KPJ</td>
<td></td>
<td></td>
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<td></td>
<td>Healthcare</td>
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<tr>
<td>Al-Hadharah</td>
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<td>Plantation</td>
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<tr>
<td>AmanahRaya</td>
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<td>⭐️</td>
<td></td>
<td>⭐️</td>
<td>Education</td>
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<tr>
<td>AmFirst</td>
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<td>⭐️</td>
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<tr>
<td>Atrium</td>
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<td>Axis</td>
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<td>Hektar</td>
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<td>Quill</td>
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<td>Car Parks</td>
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<td>KLCCPH</td>
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Shariah compliant REIT
Distribution Yields (as of May 8 2013)

- Amanah REIT: 5.32%
- Amanah Raya REIT: 6.88%
- AmFirst REIT: 6.25%
- Atrium REIT: 7.64%
- Axis REIT: 5.08%
- Al-Hadharah Boustead REIT: 5.32%
- CapitaMalls Malaysia: 4.54%
- Hektor REIT: 6.63%
- Pavilion REIT: 4.38%
- Quill Capita Trust: 6.92%
- Starhill REIT: 6.44%
- Sunway REIT: 4.98%
- Tower REIT: 7.38%
- UOA REIT: 7.33%

Average: 6.4%

10-year Govt Bond: 3.4%
Distribution Yields (as of December 13 2013)

Average 6.6%

5.90%  6.70%  7.50%  6.80%  6.20%  4.80%  6.30%  6.90%  5.67%  5.50%  7.10%  7.40%  7.70%  7.30%

10 year Govt Bond 3.4%
Challenges in taking Islamic REITs Global
Challenges taking Islamic REITs Global

✓ Majority of global assets that are shariah compliant reside in the developed world.

✓ Hospitals, Industrials and plantations/farms and some office assets are the available grouping which can form very large liquid funds.

✓ Yields are currently compressed and so may not resonate well with the investment community

✓ These countries do not have an Islamic financial market of any scale and so it would be hard to get Islamic finance for such vehicles

✓ Takaful is not readily available

✓ Marketing will be difficult as the assets and yields do not attract the GCC funds.
The Challenges facing Islamic REITs and Islamic Financing
A case for Islamic Finance: Viability and driving factors

- Islamic Finance growing 50% faster than the overall banking sector

- Islamic banking assets are expected to grow beyond $2 trillion by 2014

- Ernst & Young’s 3R’s: a) Regulatory Transformation b) Risk transformation c) Retail banking transformation

- Continued skill development of Islamic Finance professionals – e.g. Int. Centre for Education in Islamic Finance, the Islamic Banking and Finance Institute of Malaysia

- Non-Muslim majority countries are starting to tap into the potential of Islamic Finance and adapt their legislation – e.g. UK, Luxembourg
A case for Islamic Finance: Viability and driving factors

- Government’s commitment to make Malaysia an Islamic Finance Hub/ Establishment of MIFC

- Comprehensive regulatory, legal, corporate governance & Shariah framework in Malaysia

- Islamic Finance seen as more just alternative to conventional finance

- Malaysia’s Islamic capital market represents 58% of the total Malaysian capital market

- 88% of Malaysia’s stock exchange = Shariah-compliant (MIFC, 2013)
Challenges

✓ Different interpretations of Shariah (what’s Shariah compliant in Malaysia might be haram in the GCC region)

✓ Making Islamic Finance more profitable - Industry’s ROE (Return on Equity) only 12% compared to 15% for conventional banking

✓ Necessity to achieve economies of scale (due to higher cost-to-income ratio of Islamic banks)

✓ Educate public and customers on Islamic Banking – existence of misconceptions, e.g. only for Muslims or not profitable as no interest

✓ Establish appropriate risk and liquidity management techniques

✓ Achieve consistent Sharia supervision

✓ Manage the talent pool (People who have knowledge of the Islamic law as well as both banking systems)

✓ Addressing legal and tax restrictions
The Shariah rules vary from country to country - affecting Malaysia’s Islamic REIT Guidelines

**Counties in the gulf sometime have different rules on compliance**

- Some gulf countries have a zero- 5% tolerance to non-permitted activities (*Malaysia has a 20% tolerance*)
- Some don’t require total debt to be Islamic (limited to 1/3 of total debt may be conventional) (*Malaysia Does require this*)
- Some don’t require insurance to be takaful if unavailable
- Some jurisdictions require that if the tolerance limit is 5% then that income must subject to “Purification” – that is has to be donated to charities.
- Review can be on a quarterly basis
Asset availability are confined to Office, Industrial, Plantation and Hospitals. Popular assets like Malls, Hotels and Offices with conventional banking and Insurance tenants are excluded.

GCC investors are not keen on Industrial and Hospital assets.

Scholars are in short supply as they need to have a banking and shariah background and be conversant in both Arabic and English.

It takes time to train new scholars.

Such assets are not available yet in the gulf states.

A narrow interpretation of shariah rules may stifle growth.
The Potential is Huge

- Muslims account for 20% of the world’s population but Islamic Finance accounts for less than 1% of its financial instruments.
- Western Finance cannot service capital that wants to find a Shariah compliant home but Islamic Finance can satisfy everyone.
- Initially transaction costs were expensive and complicated but Malaysia led the way in designing products that could compete with conventional financing.
- New products like Shariah hedge funds, interest rate swaps, CMBS are now making an appearance on the market.
The biggest problem Islamic Finance faces is the difference in interpretation of shariah between countries.

After a blistering growth phase the industry is experiencing growth pains. This year it will achieve 13% growth to USD 1.3 Trillion against growth rates on 19% previously.

HSBC and UBS are downsizing their Islamic finance operations in their banks in the west and just focusing on the GCC states and Asia (Malaysian and Indonesia).

Defaults in the Sukuk space, which has been the driver of growth, is generating a debate.
Challenges imposed by the introduction of the Islamic Financial Services Act 2013 (IFSA) – for example:

- Bai-al-inah contracts, which underpin most financing transactions were deemed non-compliant.
- The Takaful industry will face higher capital requirements as IFSA requires players to have separate licenses for life and general takaful.

Accounting and Auditing organization for Islamic financial institutions (AAOIFI) and industry body criticized a common form of Sukuk issuance that guarantees the price at which the issuer will buy back the asset underpinning the transaction thereby enabling investors capital to be repaid. Such behavior contravened a AAOIFI standard demanding assets must be bought back at market prices. This has yet to be ironed out.
Thank You