RESPONSE TO CONSULTATION PAPER

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Consultation topic:	Consultation Paper on Proposed Amendments to the Requirements for REITs
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General comments:

CFA Society Singapore notes that the increase in leverage limit is a pro-business move. This will improve the odds of success when S-REITs are acquiring overseas assets from third parties as such acquisitions tend to involve competitive bidding processes and are highly time-sensitive.

The further growth of the S-REIT sector will benefit investors in the following manner:

- S-REITs with a larger property base in terms of number of properties, net lettable area and number of tenants will further reduce concentration risks. A well-diversified portfolio is one of the key selling-proposition of this asset class.

- Growth in overseas assets in S-REITs provides further diversification in terms of geographical location of properties and rental income currency.

- Singapore and Hong Kong impose a leverage limit of 45%. Malaysia has a 50% limit while Thailand allows leverage of up to 60% with an investment grade credit rating. There is no cap for US REITs. Upping the leverage limit may help the Singapore Exchange attract more REIT listings and broaden the choice of REITs for investors.

However, we are also concerned with investor protection issues:

- Not all retail investors fully appreciate the risk of investing in REITs particularly when leverage is employed. REITs to these investors are considered safe and provide a stable source of recurrent income.

- Over-leveraged REITs could suffer a meltdown in a financial crisis and such an event and consequent risk aversion among retail investors could impair the long-term prospects of the S-REIT sector.

We suggest MAS pay attention to investor education on REITs and how the asset class is portrayed especially amongst retail and vulnerable investors should the proposals set out in this consultation paper be adopted. MAS should also look to more comprehensive education on REITs, including driving home the message on risks when leveraged is employed.

Question 1. (a) MAS seeks views on whether the use of ICR in combination with leverage limit is appropriate; (b) Are there any other approaches or credit metrics that could be considered in determining the amount of leverage?

a. The use of ICR in combination with the leverage limit is appropriate.

   Nevertheless, in our view, investors should not take a broad-brush approach to assume that S-REITs are a low credit risk investment. REIT as an asset class is not homogeneous. The demand for industrial units is relatively more volatile due to the cyclical nature of the economy compared to hospital units where major medical expenditure is considered non-discretionary. Similarly, the demand for grade-A offices is relatively more stable and the tenancy leases tend to be longer. Lease tenancies for hospitality assets are shorter and closely correlated with factors influencing global travel and the tourism industry. Even within the industrial space, for a more granular classification, industrial assets as sub-sectors can be further categorized into manufacturing facilities, data centres, mini-storage facilities and warehouses where each one of them faces different operational as well as demand and supply dynamics.

   In view of the heterogeneity nature of REITs, there should be a differentiation between the degree of ICR and leverage limit combination for the various sectors and sub-sectors in REITs.

   We also note that as technology, key drivers and macro-economic factors change, the risk profile of different REIT sectors and sub-sectors will change in tandem. Regulatory measures and statutory limits on leverage levels should reflect these changes as well.

b. A supplementary measure to consider would be liquid assets to interest and short-term debt coverage ratio measured in number of months. Should rental income collapse the ratio gives investors an indication of the maximum period where the REIT can stay afloat before defaulting on interest repayment and being unable to cover short term debt (should this measure be adopted, MAS may want to revisit the ruling that S-REITs must distribute at least 90% of taxable income each year to obtain tax exempt status which is a break away from other REIT jurisdiction). A healthy ratio of this nature is particularly important as it takes a longer time to sell off an illiquid asset such as property, more so in times of economic crisis where there are few buyers and loans to finance property purchases have all but dried up. It has to be noted that household, corporate and sovereign debt has increased significantly since the global financial crisis in many countries; an irony considering it was debt that plunged the world into turmoil in 2008. A fire-sale of distress property to reduce debt and bolster the coffers may not help either.

Another scenario that leverage can sink a REIT is the inability to repay the bullet sum/principal debt. Staggered bullet repayment of loans over a stretched-out period of a couple of years is much less risky than a majority of bullet portion of loans maturing in one period of time. Most sell-side analyst reports do already publish debt maturity profile in their reports by year. MAS may consider a metric/measure to capture the risk of bullet repayment brought on by increasing use of leverage.

Question 2. MAS seeks views on the option of allowing a REIT's leverage to exceed 45% but not more than 50% if the REIT has a minimum ICR of 2.5 times after taking into account the interest payments arising from the new debt.

There are mixed sentiments amongst CFA Society Singapore members with regards to this option. We recognise increasing the debt headroom is a pro-business move which may yield benefits over the long run and bodes well for the S-REIT sector which is amongst the biggest in the world after the US, UK, Japan and Australia.

But we are also concerned with investor protection. In a low interest rate environment, the marginal property might not have been yield accretive for REIT investors based on the 45% leverage limit. With a higher leverage limit more debt could be used to fund property acquisition as opposed to using more expensive equity financing. DPU may rise at the expense of higher credit risk which some retail investors may not realise or fully appreciate its inherent implications. S-REITs have been seen as a low risk and a good source of stable recurring income to pay its capital providers, particular retail unit holders.

Although there is a minimum ICR to be met, should the limit be raised, investors should delve more closely into examining:

- Strategic direction of the REIT.
- Asset quality and cash flow stability.
- Capital structure which may change when the 45-percent leverage limit is lifted. The credit profile of REITs will likely worsen. A leverage of 50% would translate to a net gearing (net debt over equity) of approximately 1.0x for S-REITs, which is certainly an increase from a leverage of 45%.

Question 3. MAS seeks views on whether it is appropriate for a REIT that has demonstrated good financial discipline, such as having a higher ICR Threshold, to be allowed a higher leverage, say 55%.

We welcome this form of flexibility to regulate differently REITs with varying degree of financial discipline as it may encourage more stringent financial practice in the long run.

For S-REITs, the majority or even all the SGX-listed REITs have an ICR above 2.5x, which seems to be a norm in the industry. MAS can afford to impose a more stringent ratio should the leverage limit go higher.

However, we would place emphasis on what is deemed as good financial discipline. ICR threshold is useful, but that on its own may not be sufficient. There has to be other metrics to measure robust financial discipline which also needs to be communicated clearly to investors.

For example, Singapore industrial properties typically have land lease periods of not more than 30 years. REITs typically borrow and repay lumpsum upon maturity (i.e. only servicing interest and on maturity refinance for same amount – evergreen borrowing). Therefore, it would be increasingly more difficult for industrial REITs to borrow indefinitely for bullet repayments if the remaining lease of its portfolio of assets goes lower with passage of time. A possible resolution would be for REITs to repay interest and part of the principal regularly to avoid bullet repayments at the end of the loan tenure. This may reduce the credit risk associated with leasehold properties.

On the contrary, commercial assets sitting on 99-years tenure or freehold titles would be able to borrow and increase its leverage without lease expiry being much of an issue. Therefore, a REIT must be able to differentiate these factors when deciding on borrowing.

In addition, more resources are required to assess the reasonableness of risk computations, including assessing, mitigating and disclosing the additional risks brought on by the marginal increase in use of leverage.

Question 4. MAS seeks views on the proposal to require REITs to disclose both their leverage ratios and interest coverage ratios in interim financial results and annual reports.

We are in favour of the proposal. This encourages transparency and openness which will allow investors to assess risks and compare between REITs.

Disclosing these ratios should not pose an operational issue for REITs. The key lies in making it a best practice or mandatory for REITs with complex business models to explain in detail the calculation of key metrics if it is not apparently clear based solely on financial statements.

MAS may also want to consider a universal set of definitions for such ratios to reduce ambiguity and allow for ease of comparison for listed REITs.

Question 5. MAS seeks views on the proposal to define the interest coverage ratio as earnings before interest, tax, depreciation and amortisation (EBITDA) (excluding effects of any fair value changes) divided by interest expense.

MAS may wish to consider the use of EBEITDA (Earnings before extraordinary items, interest, taxes, depreciation and amortization) instead of EBITDA (Earnings before interest, taxes, depreciation and amortization) as a more appropriate metric.

EBITDA, being a measure of financial performance of any given (historical) period, may comprise one-off / non-recurring / extraordinary items (such as fair value changes and gain/loss on disposal of assets) which occurred in that financial period. Therefore, EBITDA does not wholly factor the current / ongoing / future earnings of the company, and accurately reflect the ability of the firm to meet its interest requirements.

Question 6. MAS seeks views on the proposed removal of the requirement for REITs to comply with the Notification Requirements when they rely on the section 305 exemption.

A primary concern of investors is equitable treatment upon issuance of new shares. When a company issues additional shares (such as private placements), it reduces existing shareholders' proportional ownership in that company if they do not have the opportunity to participate in the new issue. Worse, these new shares usually are issued at a discount to current share price.

Retail investors may feel that they are disadvantaged vis-à-vis high net worth individuals. As such, the proposed waiver may be deemed by retail investors as unfairly favouring high net worth investors. If this sentiment becomes entrenched, capital market development may be hampered.