LIFTING THE VEIL: ISLAMIC REAL ESTATE INVESTMENT TRUSTS

Introduction

Islamic Real Estates Investment Trust (Islamic REIT) has attracted much hype and excitement in the investment market. Malaysia, as always, strives to be the first in any aspect of Islamic Finance and thus indeed, has been the first to officially regulate Islamic REIT issuance by fund managers and is the first jurisdiction to issue Islamic REIT via the recent Al-Aqar KPJ REIT.

Do we really know what is REIT in the first place? First, we have to know what is investment trust.

Investment Trusts

Investment trusts are companies that invest in the shares of other companies for the purpose of acting as a collective investment. Here, when a trust fund shares are issued, investors’ money are pooled in the trust fund. The board of trustee of the trust fund will engage professional fund manager to invest in stocks, shares and other investment portfolios to garner positive returns over the investments.

It follows therefore that REIT is an investment trust which fund is collectively pooled from investors and is used to invest in real estate only. The investment is normally in the form of buying, managing, selling and leasing real estates or purchasing shares in public listed real property companies or investing in debt securities of real property companies.

As an investment, REIT combines the best features of real estate and stocks. It gives investors a practical and effective means to include professionally managed real estate in a diversified investment portfolio.

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1 Prospectus dated 24 July 2006 and publicly traded on 10 August 2006, which shares opened at 99 sen, a 4 sen premium on its issue price of 95 sen

2 www.en.wikipedia.org
Typical REIT Structure

A typical REIT structure³ would be as follows:

It should be noted that as in most capital or debt financing, the trustee plays an important role in approving investments proposed by the fund managers in a REIT. Historically, it is proven that a successful REIT (in terms of yield) is usually attributable to the ethics and skills of professional and prudent fund managers under the monitor of conscious trustee.

³ Security Industry Development Center, Securities Commission
Islamic REIT

Structurally, there is no substantial difference between REIT and Islamic REIT. Nonetheless, as in any other Islamic finance product, the true objective is to ensure the permissibility of the subject matter in the context of Syariah, elimination of riba (interest) and gharar (uncertainty).

In addition thereto, Syariah advisers have an important function in Islamic REIT, as illustrated in the following diagram.

In REIT and Islamic REIT alike, return to unitholders will be from the revenue generated through the use of the real estates and any capital gain. In Islamic REIT, the source of this revenue, ie, the use of the real estates is being scrutinized under the Syariah binoculars to ensure permissibility of use.

Whilst the issuance of REIT in Malaysia is governed by the Securities Commission (SC) under the REIT Guidelines, this is supplemented, as for Islamic REIT issuance, by the Islamic REIT Guidelines. So, any issuer for Islamic REIT will need to comply with not only the REIT Guidelines, but also the Islamic REIT Guidelines.

Islamic REIT Guidelines

The Islamic REIT Guidelines in essence lays out criteria on the types of real estate that is permissible to be acquired or invested into by the fund manager. This creates an additional task on fund managers to ensure that before a property can be acquired for Islamic REIT, whether the revenue (in the form of rentals) garnered therefrom comply with Syariah.

As the return to unitholders will be from the revenue generated from the use of the real estate, the criteria set out in the Islamic REIT Guideline deals with the way the real estates are utilized, rather than their physical aspect.

The Islamic REIT Guideline prescribe that if the non-permissible usage is below a certain benchmark (which currently is 20% of the total turnover of the Islamic REIT), then the real estate can still be invested into by the Islamic REIT. If the non-permissible usage exceeds this benchmark, the fund managers will be advised by their syariah advisers against investing in the real estate.

Therefore, as a general rule, not more than 20% of the total turnover of the assets invested under Islamic REIT can come from rentals from the operations of non-permissible operations.
Non permissible operations include hotels and resorts, manufacturing of sale or non-halal products, gaming, manufacture or sale of tobacco related products, entertainment activities contrary to the Syariah, share trading in non-Syariah compliant securities, and also conventional (interest based) banking and insurance companies\textsuperscript{4}.

In addition thereto, the fund managers need also ensure that the operation of the tenants comply with Syariah, for example, deposit, investment and financing instrument comply with Syariah principles and the assets also must be insured using takaful scheme.

The adjudication of permissibility of activities, though such activities have been specified in the Islamic REIT Guidelines, lies with the Syariah advisers. The Syariah advisers can apply their ijtihad (reasoning) in determining certain activities that may be deemed non-permissible.

Thus, the Syariah advisers have huge responsibilities in determining whether fund managers can invest in assets, based on the permissibility rule as prescribed by the Islamic REIT Guidelines.

And on this note, this is what can be seen as lacking in the Islamic REIT Guidelines, ie, on the prerequisites and engagement of the Syariah advisers. There is also no requirements that the Syariah advisers need to be registered with the SC or whether the determination of the appointed Syariah advisers can be subject to the scrutiny by the SC’s own Syariah committee.

Having outlined the principles of Islamic REIT, it is now worth looking at the structure of world’s first successful issuance of Islamic REIT, the Al-Aqar KPJ REIT.

\textsuperscript{4} Islamic REIT Guidelines, Appendix


**Al-Aqar KPJ REIT**

On June 2006, Al-Aqar KPJ REIT was established with its primary objective as a unit trust investing in Syariah compliant real estate assets. As at July 2006, Al-Aqar KPJ REIT comprises of investment in six hospitals worth RM481 million which includes Ampang Puteri Specialist Hospital, Johor Specialist Hospital, Damansara Specialist Hospital, Ipoh Specialist Hospital, Puteri Specialist Hospital and Selangor Medical Centre.

The Al-Aqar KPJ REIT acquired the 6 hospitals from the respective vendors and rent it out to the tenants for rental income. The fund for the acquisition is obtained from the sale of unit trusts in Al-Aqar KPJ REIT to the unitholders who will receive income distributions from the net income of the Al-Aqar KPJ REIT.

The interest of Unitholders is safeguarded by the appointed Trustee (Amanah Raya Berhad). The management of the Al-Aqar KPJ Reit is being handled by the appointed professional fund manager, Damansara REIT Managers Sdn Bhd, whom on Syariah related matters are being advised by a panel of Syariah advisers who have been approved by the SC to act in the capacity of Syariah advisers.

The structure of the Al-Aqar KPJ REIT\(^5\) can be seen in the following illustration:

5 Al-Aqar KPJ REIT Prospectus dated 24th July 2006
**Commentaries**

The inroads made by the Malaysian authorities in promoting and developing Islamic finance has been exemplary and received tremendous compliment and support internationally. Islamic REIT particularly, has only been mere points of discussion only in the past without any real case study, until Malaysia took the bold stage in issuing the Islamic REIT Guidelines and subsequently, the first issuance in the form of Al-Aqar KPJ REIT took place.

From the investors’ perspective, it is the yield and return that matters most. It is then the fund manager’s task to enhance the return in value to the unitholders. This is an arduous order for the fund managers indeed, considering their only investment portfolio is in real estate, which can be rigid at times and less rewarding as compared to other forms of investment.

REIT nonetheless allows managers to unlock the values of the properties and raise fund to reduce the borrowings. A larger pool trust assets can garner better yield and this is what KPJ intends to do; to inject another 6 hospitals to the Al-Aqar KPJ REIT by 2007, depending on the market condition.

The government has also allowed incentives for REIT, in the form of tax and stamp duty incentives. The total income of a REIT for a year of assessment which is equivalent to the total income distributed to the unitholders for a year of assessment shall be tax exempt\(^6\). Any instrument of transfer\(^7\) and deed of assignment\(^8\) for the acquisition of real property by a REIT are exempted from stamp duty.

However, the setback in the Malaysian taxation regime would be on withholding tax to non-resident and the real property gains tax. Income distributions made by REIT to non-resident unit holders are subject to 28% withholding tax in Malaysia whilst any disposal of real property by a REIT before the sixth anniversary from its acquisition, the gains received thereon is subject to real property gains tax.

There have been various calls by the market players for the government to reduce these withholding tax and real property gains tax to make the REIT sectors to be more savoury to foreign investors and to allow more grounds for fund managers to maneuver in maximizing yield to unitholders.

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\(^6\) Income Tax Act 1967, S. 61A  
\(^7\) Stamp Duty (Exemption)(No. 4) Order 2004  
\(^8\) Stamp Duty (Exemption)(No. 27) Order 2005