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Islamic REITs: A Syariah-compliant investment option

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ABSTRACT

With the release of Guidelines on Islamic Real Estate Investment Trusts by the Securities Commission in 2005, two new Islamic REITs have been listed on Bursa Malaysia. Interestingly these two REITs, Alaqar and BSDreit, provide opportunities for indirect property investment in two special property sectors i.e. hospitals and oil palm plantations.

This paper examines the special Syariah-compliant features of Islamic REITs with emphasis on Islamic REITs in Malaysia.

Keywords : Islamic REITS, Syariah-compliant, Malaysia

Introduction

Islamic REITs are collective investment vehicles that pool money from investors to buy, manage and sell real estate. An Islamic REIT is an investment vehicle that invests primarily in:

- (a) income-producing Syariah compliant real estate, and/or
- (b) single purpose companies which are Syariah compliant whose principal assets comprise Syariah compliant real estate.

The incomes from the real estate or companies are used to provide returns to its unitholders.

A portion of the REIT funds can also be invested in other Syariah compliant asset classes e.g. cash or Syariah acceptable deposits.

Islamic REITs provide a new investment opportunity for investors who wish to invest in real estate through Syariah compliant capital market instruments. An Islamic REIT is an effective means of gaining investment exposure to large Syariah-compliant commercial properties. Investments in Islamic REITs provide opportunities to hold stakes in high-grade Syariah-compliant real estate which may otherwise have been difficult or impossible for a retail investor to hold.

Securities Commission's Guidelines for Islamic REITs

The Guidelines for Islamic REITs stipulated the general Syariah-compliance requirements in respect of all Islamic REITs which include the following (Securities Commission 2005):

- Rental incomes are derived from permissible business activities according to Syariah. In the case where a portion of the rental is from non-permissible activities, then these rentals shall not exceed 20% of total turnover of the Islamic REIT.
- An Islamic REIT is not permitted to own properties where all the tenants operate non-permissible activities.
- For new tenants, the Islamic REIT shall not accept new tenants whose activities are fully non-permissible.
- For tenants who operate mixed activities, only 20% of the floor area can be occupied for non-permissible activities to the total area occupied.
- For activities that do not involve the usage of space, the Syariah committee/Syariah adviser will base their decision in ijthad (the process of reasoning by Islamic jurists to obtain legal rulings from sources of Syariah).
- All forms of investment, deposit and financing instruments comply with the Syariah principles.
- The property insurance must be based on Takaful schemes. Conventional insurance schemes are permitted if the Takaful schemes are unable to provide the insurance coverage.

The similarities between Islamic REIT and conventional REIT

There are broad similarities between conventional and Islamic REITs:

- (a) Tax treatment
Both types of REITs receive a similar tax treatment on corporate tax, stamp duty and real property gains tax.
- (b) Structure of REIT
The main structures for both types of REITs are the same in terms of the requirements to have a trustee, management company, property manager, valuation etc.

(c) Regulatory framework

The regulatory frameworks is similar for both types of REITs. But for Islamic REITs there are Syariah requirements that need to be complied with.

The differences between Islamic REITs and conventional REITs

The two major differences are:

(a) Syariah Committee/Syariah Adviser

Islamic REITs must appoint Syariah Committee/Syariah Adviser.

The Syariah Committee/Syariah Adviser is a party to the REIT who is obliged under the Guidelines for Islamic REIT to act as an adviser on all Syariah related matters. The Syariah Committee/adviser is responsible for ensuring that the Islamic REIT complies with the investment guidelines, providing references and consultations to the manager on permitted investments as provided in the Guidelines. It also monitors and ensures that the fund has been managed and administered in accordance with Syariah principles, rulings or decisions issued by SC pertaining to Syariah matters.

The Syariah Committee/Syariah Adviser will provide certification and will also prepare an interim and annual report in respect of the Islamic REIT.

(b) Syariah compliance criteria

The following activities are contrary to Syariah principles:

- (a) financial services based in riba' (interest)
- (b) gambling
- (c) manufacture or sale of non-halal products or related products
- (d) conventional insurance
- (e) entertainment activities that are non-permissible according to Syariah
- (f) manufacture or sale of tobacco-based products or related products
- (g) stockbroking or share trading in Syariah non-approved securities
- (h) hotels and resorts
- (i) other activities deemed non-permissible according to Syariah.

The differences between Islamic REITs and conventional REITs can be summarized in Table 1.

Table 1: Comparison between conventional and Islamic REITs

	Conventional REIT	Islamic REIT
Syariah Committee/Syariah Advisors	There is no need for any Syariah Committee/Advisors	Islamic REIT must appoint a Syariah Committee/Advisor to ensure compliance with Syariah requirements.
Permissibility of activities carried out by tenants	No restriction.	Only permissible activities allowed.
Insurance for properties	Conventional insurance with insurance companies as approved by trustee.	The manager need to consider the availability of Islamic insurance/Takaful before opting for conventional insurance.
Financing	No restrictions.	Financing must be Syariah compliant.

Islamic REITs in Malaysia

(a) AI'Aqar KPJ REIT (Alaqaar)

Alaqaar is the first Islamic REIT IPO in the world. It owns six private hospitals in Malaysia operated by its parent company, KPJ Healthcare Bhd. These six properties are valued at RM481 million but are injected into the REIT at RM461.3 million or a discount of 4.1% on its market value.

A total of 340 million units were issued Alaqaar IPO was oversubscribed by 4.13 times. It achieved an opening price of RM0.99 on the first day of listing providing a premium of 4 sen or 4.2% over its retail offer price of RM0.95. It closed at RM0.985 on the first trading day. The property portfolio comprises six hospitals worth RM461.24 million.

Table 2: Earning projections of Alaqr

	2006	2007E	2008E	2009E
Gross rental income (RM million)	35.5	35.7	36.4	37
Net distributable income (RM million)	24.6	24.9	25.6	26.2
Distribution per unit (sen)	7.2	7.3	7.5	7.7
Gross distribution yield (%)	7.58	7.68	7.89	8.10

Unique features of Alaqr REIT

Rent review

Rent review is calculated based on the following formula:

- First year rent review:
(10 year Malaysian Government Securities + 238 basis points) x market value of the properties at the point of review and subject to a minimum rental of RM33.0 million per annum and a maximum 2% incremental over the preceding year's rental amount.
- Second and third year rent review:
2% incremental over the preceding year's rental amount.

(b) Al-Hadharah Boustead REIT (BSDreit)

The Al-Hadharah Boustead REIT invests in eight oil palm estates and two palm oil mills which are located in Peninsula Malaysia for RM472 million.

The units issued during the IPO :

Types of investors	No of units Alaqr	No of units BSDreit
Vendor units	160,000,000	252,000,000
Institutional units	165,000,000	198,000,000
Retail, director & employee units	15,000,000	22,000,000
TOTAL	340,000,000	472,000,000

Unique features of BSDreit

Ijarah arrangement for the plantation assets

Ijarah is an Islamic lease agreement where rentals are collected for assets leased to the tenant/customer. For BSDreit, the plantation assets are lease back to the vendors as tenants for a cumulative tenure of up to 30 years.

For each of the estates and mills, the tenancy is for three years and will be automatically renewed four times up to twelve years and thereafter renewable up to an additional 15 years.

As result of the Ijarah arrangement, the cost of replanting will be borne by BSDreit.

Rent review linked to CPO prices and other performance indicators of oil palm industry

Under the BSDreit, plantation assets are leased back to the vendors (i.e. Boustead Group) for a three-year renewable tenancy with a cumulative period of up to 30 years. At the end of every three years, the fixed rental will be reviewed and a new rental will be determined based on historical crude palm oil (CPO) prices, prevailing and expected future CPO prices, cost of production, extraction rates and yield per hectare.

Profit sharing

In addition to a fixed income, an annual profit sharing of net incremental income based on a formula pegged to CPO and fresh fruit bunch (FFB) prices.

This net incremental income is determined based on the actual CPO price realized for the year, above the reference price of RM1,500 per metric tonne for the first three years. This income is to be shared on a 50:50 basis.

How Islamic REITs in Malaysia comply with the Syariah requirements

Table 3 shows how Alaqar and BSDreit comply with the Syariah requirements.

Table 3: Syariah compliance of Malaysian Islamic REITs

Syariah-compliance requirements	Alaqar REIT	BSDreit
Rental income are derived from Syariah permissible activities	The rental income is derived from specialist hospitals.	The rental income is derived from oil palm plantations and mills.
Tenants that operate permissible activities	The tenants are operating as specialist hospital in the healthcare sector which are permissible activities according to Syariah.	The tenants are operating as plantations in the agriculture sector which are permissible activities according to Syariah.
New tenants whose activities are fully non-permissible.	The fund manager will not accept new tenants whose activity is not fully permissible under Syariah.	The fund manager will not accept new tenants whose activity is not fully permissible under Syariah.
To ensure all forms of investment, deposit and financing instrument are Syariah compliant	Islamic financing facility is used to finance the acquisitions of the properties for the REIT. All forms of investment and deposits comply with Syariah principles.	Islamic financing facility is used to finance the acquisitions of the properties for the REIT. All forms of investment and deposits comply with Syariah principles.
The use of Takaful schemes for various insurances purposes	The manager obtained and maintain Takaful insurance schemes against fire and public liability and other required insurances.	The manager obtained and maintain Takaful insurance schemes against fire and public liability and other required insurances.
Syariah committee endorsement and approval	The Syariah Committee of the Alaqar has endorsed and approved the REIT scheme to be in compliance with Syariah principles.	The Syariah Committee of the BDSreit has endorsed and approved the REIT scheme to be in compliance with Syariah principles.

Future growth strategies of Islamic REITs

The parent company, KPJ owns another 13 hospitals of which 8 are in Malaysia, 3 in Indonesia and 1 in Bangladesh. KPJ is expected to inject some of these hospital buildings into Alaqar in the future. Currently Alaqar has a gearing of 28.6% which is below the allowable 50% limit thereby having the capacity to make additional acquisitions in the future. In May 2007, KPJ has announced that two hospitals will be sold to Alaqar.

Plantation assets in BSDreit will be expanded through the injections of more plantations owned by its parent company, Boustead Group, which has a plantation portfolio of more than RM1 billion.

Conclusion

The introduction of Islamic REITs provides an investment opportunity for investors wishing to invest in real estate through Syariah-compliant capital market instruments. International investors seeking Syariah-compliant instruments can buy into Islamic REITs without the need for direct ownership of such properties.

Islamic REITs also enhances the competitiveness of the Malaysian Islamic capital market by attracting Islamic investors globally. It also broadens and deepens the Islamic product base and encourages savings to be channeled into investments in Syariah-compliant assets..

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