Reit or business trust?

Key differences relate to ownership, management and governance. **By Genevieve Cua**

WITH interest rates still scraping rock bottom, you are likely to be on the lookout for investments that offer yield. Within this segment, real estate investment trusts (Reits) and business trusts are promising investment options.

Both give you access to yield-bearing assets such as properties or infrastructure that as a retail investor, you are unlikely to be able to invest in directly. Most of a trust's underlying assets require substantial amounts of capital to acquire as well as expertise to manage.

By now, Reits are a fairly mature market here, boasting a market capitalisation of roughly US$30 billion as at end-December. There are also a number of business trusts to consider, offering exposure to assets such as utilities, shipping and ports.

The concept of Reits and business trusts may seem broadly similar. An outstanding feature of such trusts is their ability to earn or generate a stable income or cash flow, which is distributed regularly to unitholders in the form of dividends.

Yet, there are key differences in their respective structures, with implications for ownership, management and governance.

A Reit is a collective investment scheme investing in real estate, which could span commercial, industrial, retail or hospitality. It is managed by a licensed manager who is paid an annual management fee.

The underlying assets of a Reit are held by a trustee on unitholders' behalf. With Reits, there is a separation of roles between the trustee and the manager.

In contrast, a business trust is a hybrid structure combining elements of a company and a trust. It runs a business enterprise, investing in sectors and assets with a stable income profile such as utilities and infrastructure. But unlike a company, it is not a separate legal entity.

Instead, it is created by a trust deed under which the trustee has legal ownership of the trust assets, and manages the assets for unitholders' benefit. It is managed by a single entity – the trustee-manager.

The accompanying graphic illustrates some key aspects of three structures – companies, business trusts and Reits.

Here are some issues relating to corporate governance that are worth noting.

Removal of manager or trustee-manager: The trustee-manager of a business trust can be removed only if 75 per cent of unitholders vote against him. A Reit requires a simple majority of votes to remove a manager.

Independence of directors: There are also rules in place to guard against conflict of interest. For business trusts, the majority of its board must be independent of management and business relationships with the trustee-manager. In addition, at least one-third must be independent of management and business relationships with the trustee-manager, and from every substantial shareholder of the trustee-manager.

Wong Partnership deputy head (equity capital markets) Long Chee Shan says that the composition of the board of directors of a business trust is subject to stricter rules relating to the independence of its directors.

"For business trusts, the law requires the majority of its board members to be independent. This is unlike managers of Reits, or the boards of listed companies, where the Code of Corporate Governance requires that only one-third of the directors be independent."

He also notes the higher threshold for removal of a trustee-manager compared to that for a Reit manager. ". . . unlike a Reit which is a passive investment holding vehicle that is externally managed, the trustee-manager of a business trust manages its business and operations. If the threshold is set too low, it may be difficult for the trustee-manager to plan and manage the business of the trust in the interests of unitholders."

Audit committees: Reits and business trusts are required to have an audit committee, which oversees financial reporting and disclosures.

In both structures, sale and purchase transactions with interested parties are subject to safeguards: Any transaction representing 5 per cent or more of an entity's net asset value must be approved by independent unitholders.

Reits are also required under the Code of Collective Investment Schemes to get two independent valuations. Assets cannot be acquired from the interested party at a price above the higher of the two valuations, nor be sold at a price below the lower of the two valuations.

There are, of course, risks attached to investments in Reits and business trusts, as with any other investment. Here are some to consider:

Market risk: As listed vehicles, Reits and business trusts are subject to factors that may now and again cause the stock market to rise or fall. These include fund flows, investor sentiment and risk appetite. While the trusts are generally stable vehicles, there is volatility in their prices.

Liquidity risk: The 2008 crisis eloquently showed that even stable vehicles such as Reits could suddenly become illiquid along with the general market. Compared to unit trusts, Reits and business trusts are subject to greater liquidity risk. Unit trust investors can buy and sell units through banks, and fund managers are bound to redeem units except in certain extreme conditions. For Reits and business trusts, the ease of buying and selling units will depend on the demand/supply situation on the exchange.

Leverage: Business trusts and Reits are allowed to take on borrowings to buy assets. Reits are subject to a gearing limit of 35 per cent. This can be raised to 60 per cent if the Reit obtains, discloses and maintains a credit rating from rating agencies. There is no explicit cap on borrowings for business trusts but the trusts themselves may set their own limits.

Wong Partnership's Mr Long says that the absence of a similar cap on gearing for business trusts is not necessarily a negative. "The absence of similar restrictions . . . allows (business trusts) more flexibility in the borrowing of funds to grow its business in a low interest rate environment. In such an environment, a business trust may take advantage of opportunities to purchase higher yielding assets by gearing up more readily."

The presence of leverage gives rise to related risks – that of refinancing the borrowings as they come due, in addition to the spectre of breaching loan covenants due to negative equity. The refinancing risk was stark during the 2008 financial crisis when credit dried up as banks turned risk averse. The dearth of financing drove a number of Reits to seek funding by rights issues. This can create a strain on unitholders who may not be able to cough up the cash to take up the issue.

On loan covenants, shipping trust Rickmers Maritime had to negotiate value-to-loan coverage requirements and a loan maturity extension to relieve pressure on its balance sheet. Such agreements come at a higher cost of debt and may also entail a cap on distributions per unit.

Between 2008 and 2009, Moody's assigned a negative outlook to Singapore Reits due to concerns over refinancing, asset devaluation and a weak operating environment. This has since been upgraded to a stable outlook. Earlier this year, Moody's said that it expected continued growth in Singapore Reits in an environment of low interest rates, supportive capital markets and improved economic sentiment.

Business risks: Each Reit or business trust will be exposed to specific sectors that may be subject to their own business cycles. While infrastructure and utilities are typically seen as resilient and defensive assets, the same may not be true for industrial properties, for instance. You will need to be cognisant of business and economic conditions which have a bearing on lease renewals and occupancy rates.

There are also unpredictable risks that arise from calamities. The recent Japan earthquake is a case in point. Japanese Reit Saizen was heavily exposed to the worst hit Sendai area, and this dragged down its unit price.

Income risk: Distributions by listed trusts are typically not guaranteed, even though a newly listed trust may undertake to make distributions for a certain period. When business is poor, a trust may reduce or not pay a dividend at all. Saizen Reit, for example, had suspended dividend payments in 2009. It had also proposed that it issue scrip instead of cash as dividends, but this was subsequently abandoned.

Investment/financial risk: Risk could arise from a trust's use of financial derivatives. Under the Code on Collective Investment Schemes, Reits may use derivatives to hedge existing portfolio positions or for efficient portfolio management. Derivatives cannot be used to gear up the portfolio.

Business trusts are not subject to such a restriction. But the trusts use derivatives typically for hedging, and the hedging policy is reviewed and approved by the board of the trustee-manager.

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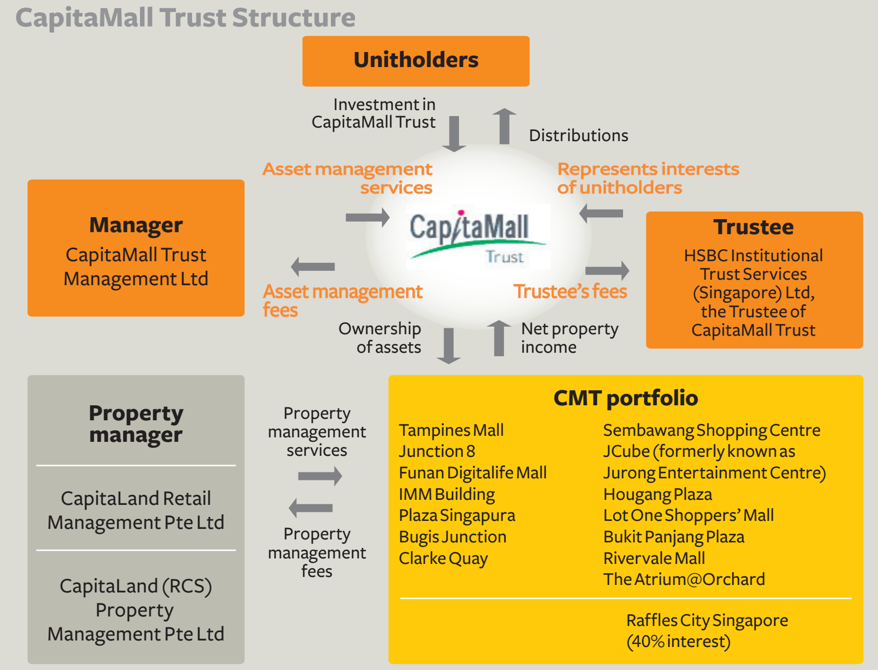
Hungry for yields

Eye on Reits and business trusts

	LISTED COMPANIES	BUSINESS TRUSTS	REITS
Vehicle	Separate legal entity owned by shareholders who have legal and beneficial interest in company	Created by trust deed; trustee has legal ownership of trust assets	Created by trust deed; trustee has legal ownership of trust assets
	Managed by management and board of directors on behalf of shareholders	Trustee is referred to as trustee-manager. Serves to manage assets and hold assets as trustee on unitholders' behalf	Separate trustee and manager. Trustee holds assets and manager manages assets for unitholders' benefit
	Companies Act sets out directors' duties and liabilities	Business Trusts Act sets out duties and liabilities of trustee-manager	Manager licensed under Securities and Futures Act. Trustee must be approved trustee under SFA, which sets out his duties and liabilities
Corporate governance	Board can be removed by simple majority of shareholders' vote	Trustee-manager can be removed only if 75% of unitholders vote in favour	Manager can be removed by simple majority of unitholders' vote at general meeting
	One-third of the board of directors must be independent	Majority of directors must be independent from management and business relationships with the trustee-manager. At least 1/3 of directors must be independent from management and business relationships with the trustee-manager and from every substantial shareholder of the trustee-manager	One-third of the board of directors of the Reit manager should be independent
	Audit committee must comprise at least three non-executive directors, with majority being independent directors	Audit committee must comprise at least three directors who must be independent from management and business relationships with trustee-manager; the majority must be independent from management and business relationships and from every substantial shareholder	Audit committee must comprise only non-executive directors, with the majority being independent directors
	SGX requires AGM to be held within four months of the end of fiscal year. Shareholders have the right to attend AGM, speak and vote on resolutions	SGX requires AGM within four months of the end of fiscal year. Unitholders can attend AGM, speak and vote on resolutions	Listed Reits must hold AGMs within four months of the end of fiscal year. Unitholders have the right to attend AGMs, to speak and vote on resolutions
Gearing limit	None	None, but business trusts may subject themselves to borrowing limit	Code on Collective Investment Schemes sets 35% cap on gearing, or up to 60% if Reit obtains, discloses, and maintains a credit rating from rating agencies
Dividend distribution	No requirement to distribute. Dividend distribution from accounting profits	No requirement to distribute, but the trust may pledge to distribute a certain percentage of income as dividends. Dividends taken from operating cash flow	Must distribute at least 90% of income to enjoy tax transparency under Income Tax Act

Reits structure: an example

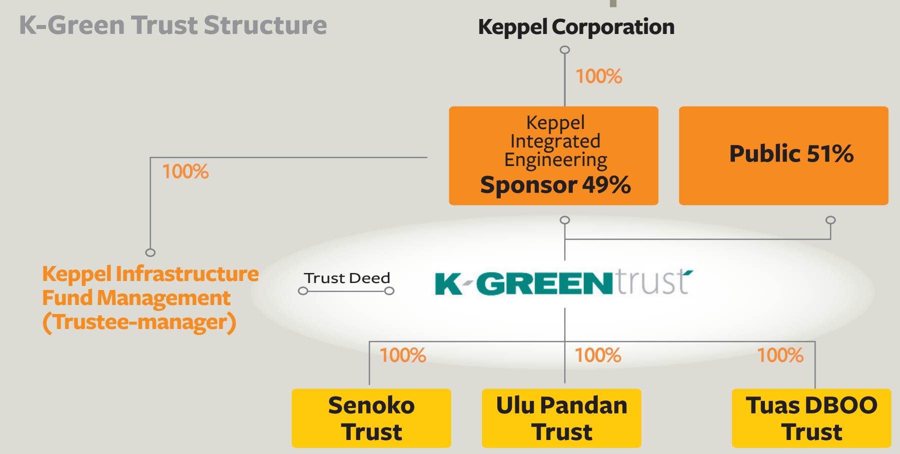
CapitaMall Trust Structure



Source: CapitaMall Trust

Business trust structure: an example

K-Green Trust Structure



Source: K-Green Trust

Key points in choosing a trust to invest in

REITS (real estate investment trusts) and business trusts may seem to be attractive options, particularly as upwardly trending inflation puts savers in an awkward and worrisome quandary of negative real interest rates.

The attractiveness of such trusts lie in their ability to pay a regular and stable dividend. This is a big plus in a portfolio. Research into long-term returns shows that reinvested dividends comprise the bulk of returns, compared to capital appreciation.

But before you take the plunge, you should, as always, examine the listed trusts in the context of your entire portfolio. If you are underinvested in equities, an allocation into such income-bearing instruments may be a prudent way to step up your risk exposure, and yet enhance your portfolio yield. If you are already adequately or even overexposed to equities, you may want to consider trimming some of your risk assets in favour of a more stable dividend-yielding instrument.

As Reits and business trusts offer exposure to a broad range of industries and types of assets, you should do your homework on the ones you may be keen on. Here are some key points to consider:

Your risk tolerance and investment horizon: Reits and business trusts are similar to bonds in that they generate an income stream, but they will be more volatile than bonds, and more highly correlated with stocks. You will also need to be prepared to hold them for a longer period to benefit from dividend payments.

Examine the underlying assets: Each Reit or business trust will offer exposure to a specific sector. Peruse the trust's website for relevant documents – their track record of dividends; statements on their operating environment; gearing levels and debt maturity profile.

How concentrated are the trust's assets? The assets, for instance, may depend heavily on tenants from a specific sector, which would make the trust vulnerable to a downturn in that sector. It would be prudent if the trust's assets are sufficiently diversified in terms of tenant mix, geography and industry exposure.

If it is a foreign Reit or business trust, you will need to be aware of the operating environment as well in the country, including regulatory or political risks. The macroeconomic environment will also impact their businesses. Ascertain, too, the trust's growth potential: is it able to make yield-accretive investments?

Be aware of factors relating to the trust's structure: One is the sponsor, if the trust has one. What is the sponsor's financial strength? Has the sponsor supported the trust on previous occasions when the trust needed help in financing, for instance? This may give an indication of the sponsor's willingness and ability to help should there be another financial crisis. In the recent crisis, a number of Reits resorted to raising capital through a rights issue. This may pose a financial strain on your resources.

The management of the trust is yet another important aspect. Ascertain the quality of management and its track record. How is management remunerated? Some trusts provide for remuneration by units to align the manager's interests with unitholders'.

Fees: Reits and business trusts levy a number of fees, including an annual management fee; performance fee; property management, acquisition and divestment fees. Might the fees incentivise managers to take on more debt? On performance fees, in particular, there is no uniform formula for the calculation, and the benchmark used to measure outperformance may also not be transparent. The prospectus will typically have an illustration of how the performance fee is charged.

Dividend payments: How frequently are dividends paid? There may be circumstances when dividends may be cut or suspended, such as when the trust is loss-making or when rental income has fallen.

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