جدوى للإستثمار
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Real Estate Investment Traded Funds (REITs)

Summary

- Although REITs have only recently been introduced to the region, a large number of countries have permitted REITs for some time, especially so in emerging markets.
- As such, a vast amount of empirical data exists across different financial markets showing the positive contribution of REITs to the development of capital markets. Aside from widening the investment offering, recently observed empirical evidence shows that REITs also offer a different risk-return profile to conventional investment products such as stocks.
- Also, due to the nature of the real estate sector, with frequent rent reviews and asset appreciation, REITs can be an effective hedge against inflation. In the case of Saudi Arabia, returns are likely to be even more attractive due to the special tax conditions vis-à-vis other investment products in the Kingdom.
- Besides their impact on capital markets, REITs can also help realize the broader goals of the National Transformation Program (NTP) and Saudi Vision 2030. Specifically, the NTP lists several initiatives which aim to increase the real estate sector's contribution to overall GDP.
- In the case of Saudi Arabia, REITs can facilitate the participation of the private sector in developing vacant land plots and raising the supply of real estate by bringing forward alternative sources of finance for the private sector.

Overview

Last month, another milestone in Saudi Arabia was achieved as the Capital Market Authority (CMA) approved a set of rules allowing the formation of Real Estate Investment Traded Funds (REITs) on the Saudi Stock Exchange (Tadawul). As with many of the economic reforms enacted recently, the introduction of REITs falls in line with the broader goals of the National Transformation Program (NTP) and Saudi Vision 2030, but, additionally, it fits the narrative outlined by the CMA's own strategic plan for 2015 to 2019.

Besides diversifying the investment offering available within the Kingdom, REITs will also give investors much easier access to local real estate. This should bring about increased participation from the private sector which, in turn, will help stimulate the development of vacant land and raise the real estate sector's contribution in overall GDP, a key target of the NTP. Overall, we believe the introduction of REITs in the Kingdom will not only help confer benefits to capital markets, but also to the wider economy as well.

For comments and queries please contact:

Fahad M. Alturki
Chief Economist and Head of Research
falturki@jadwa.com

Asad Khan
Senior Economist
rkhan@jadwa.com

Rakan Alsheikh
Research Associate
ralsheikh@jadwa.com

Head office:

Phone +966 11 279-1111
Fax +966 11 279-1571
P.O. Box 60677, Riyadh 11555
Kingdom of Saudi Arabia
www.jadwa.com

REITs regulatory framework

In Saudi Arabia, a REIT is defined as closed-ended investment company...

In Saudi Arabia, a REIT is defined as a closed-ended investment company which owns income-producing real estate. Saudi REITs can invest in residential, commercial, industrial and agricultural properties, both within and outside the Kingdom but not in undeveloped 'white' land. The other key points are highlighted below and in Table 1:

- Minimum of **SR100 million** capital for REITs.

- At least **30 percent** of total REITs is owned by the **public**. The public, in this instance, **excludes**:
  1) any unit holders owning 5 percent or more REIT units.
  2) the Fund manager and its affiliates.
  3) the Fund's board of directors.

...with a number of key REITs regulatory framework...

- A minimum of **75 percent** of total asset value should be invested in **income-producing real-estate**.

- A maximum of **25 percent** of the fund's total asset value can be invested in **real estate development, renovation and redevelopment** of properties.

...including a minimum of SR100 million capital for REITs…

- The REITs **borrowing** cannot rise above **50 percent** of the fund's total asset value.

- A maximum of **25 percent** of a REITs' total value can be **invested outside the Kingdom**.

- A minimum of **90 percent** of a REITs profits have to distributed to unit holders.

- **QFIs are able to participate in REITs**, as per previous guidelines laid down by the CMA (please see our report *Recent CMA announcements related to Tadawul*)

...and borrowing not rising above 50 percent of the fund's total asset value.

In addition, the CMA-authorized REITs are required to be structured as closed-ended funds with each unit of the fund holding a nominal value of SR10 which represents ownership of the underlying real estate asset, and, like stocks, are traded on Tadawul.

Table 1. Real Estate Investment Traded Funds (REITs) in Saudi Arabia

Overview		Regulation
Investment opportunities	REIT assets	REITs can invest in residential, commercial, industrial and agricultural properties; whether local, regional, or global.
	Foreign asset restrictions	The value of assets invested outside the Kingdom should not exceed 25 percent of a REITs' total asset value
Legal form		Closed-ended fund
Investor restrictions	Number of investors	Minimum 50
	Public ownership	Minimum 30 percent of total REIT units owned by public
	Investor ownership	Open to Saudi, GCC citizens, and non-Saudi residents in the Kingdom
Nominal value		SR10 per unit
Capital requirements		Minimum SR100 million
Borrowing restrictions		Will not exceed 50 percent of total fund asset value
Investment policy		Minimum 75 percent of total asset value invested in income-producing real-estate
Distribution requirements		90 percent of the fund's net income distributed to unit holders as cash dividends, at least once a year
Reinvesting profits		Minimum of 90 percent of profit has to be distributed with only 10 percent of profits allowed to be re-invested.

How can REITs benefit Saudi capital markets?

Empirical data exists showing REITs contribution to capital markets...

...including:

Although REITs have only recently been introduced to the region, UAE was the first to have listed REITs in the GCC back in 2014, a large number of countries have permitted REITs for some time, especially so in emerging markets. As such, a vast amount of empirical data exists showing their positive contribution to the development of capital markets. Aside from widening the investment offering, recently observed empirical evidence shows that REITs also offer a different risk-return profile to conventional investment products such as stocks. Furthermore, due to the nature of the real estate sector, with frequent rent reviews and asset appreciation, REITs can be an effective hedge against inflation. In the case of Saudi Arabia, returns are likely to be even more attractive due to the special tax conditions vis-à-vis other investment products. Below we outline some of the expected benefits of REITs for Saudi capital markets and investors alike.

...diversification benefits...

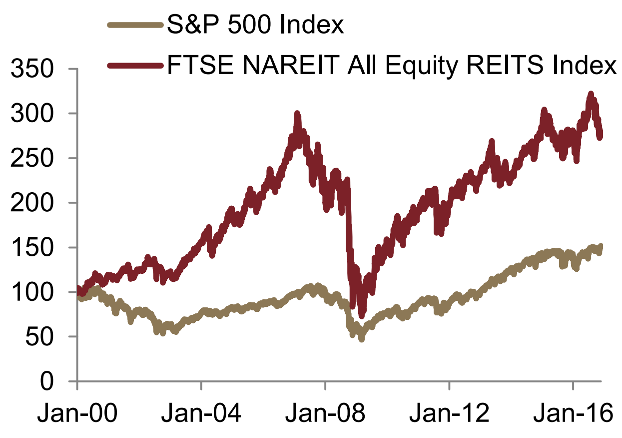
<u>Diversification:</u>

...since REITs' are driven by relatively distinct economic conditions compared to equities…

...and geographical benefits since 25 percent of a REITs total value can be invested outside the Kingdom.

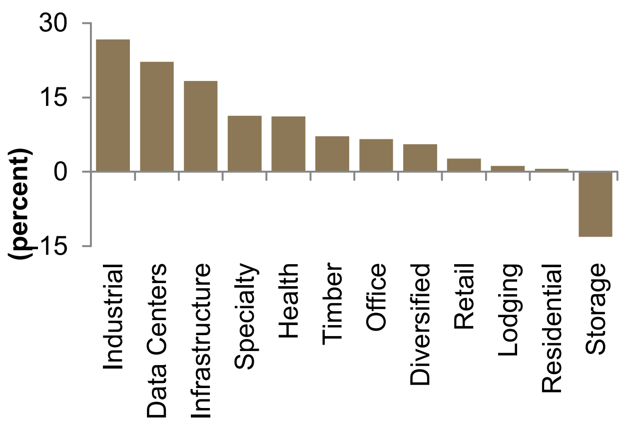
REITs offer financial investors diversification benefits on three different levels. Firstly, due to the absence of an established bond market, the prevailing asset class in the Kingdom has been equities. Since real estate is driven by relatively distinct economic conditions compared to equities, it offers a potentially less correlated alternative to stocks (Figure 1). Secondly, diversification benefits can also be achieved through investing in different real estate sectors. As mentioned above, REITs in Saudi Arabia can invest in residential, commercial, industrial and agricultural properties. All of these sectors have distinct market dynamics which differentiate them from each other (Box 1). For example, hotels are viewed as cyclical real estate since they are more prone to seasonal demand and sensitive to economic factors, such as disposable income. The healthcare sector, on the other hand, is often considered a more stable and defensive sector, due to demand being less tied to economic factors and influenced more by fundamentals such as demographics. Lastly, diversification is also possible since, according to CMA rules, 25 percent of a REITs total value can be invested outside the Kingdom. Local property market dynamics are likely to be less correlated to international property markets, therefore allowing risk to be spread across an even greater number of sectors and markets.

Figure 1: Performance of US stock market versus US REITs*



* Both indices rebased to 100 at Jan 2000

Figure 2: Sizable difference in total return between US REITs offers diversification opportunities*



*Total return from January to October 2016

REITs in the US is one of the oldest and most diversified…

...with 12 sectors, 166 constituents and a total equity market capitalization of $937 billion.

Box 1: REITs in the US

REITs in the US is one of the oldest and most diversified. Since being established in 1960, it has matured to include 12 sectors, 166 constituents and a total equity market capitalization of $937 billion (at October 2016). The sectors range from more conventional real estate, such as retail and residential, to less conventional, such as timber, data centers and self storage. Each sector has its own unique economic drivers, which means the return on investment is differentiated despite all sectors belonging to the same asset class (Figure 2). The differing return on each REIT is due to the distinctive factors affecting their performance, such as particular economic drivers, availability of credit, variation in lease durations, and regional market dynamics.

Stronger historical returns:

Although no guarantee can be made on the future return on REITs…

...recent historical data from the US highlights REITs better performance over stocks.

Although no guarantee can be made on the future return on REITs, recent historical data from the US highlights their superior returns when compared to equities. For instance, the FTSE US NAREIT all equity REIT Index has managed higher annualized returns in seven out of the last 11 periods when compared to the S&P 500 Index (Figure 3). In the case of dividend yield, the performance of REITs is even more impressive, with higher yields, on an annual basis, received in all of the previous ten years. For foreign investors, the special tax conditions for Saudi REITs, vis-à-vis other asset classes, is likely to increase their attractiveness as an investment product. Currently, foreigners investing in the Saudi stock market must pay a withholding tax rate of 5 percent when repatriating dividends compared to zero on REITs, which are exempt from taxes (Figure 4).

The appeal of REITs is further strengthened since they can be used as an effective hedge against inflation.

The appeal of REITs is further strengthened by the fact that they can be used as an effective hedge against inflation. Since the primary source of income from real estate is rent, if rental agreements stipulate frequent reviews, the likelihood of positive real returns during inflationary periods can be enhanced.

Accessibility and QFIs:

REITs offer a number of other benefits which, in general, includes accessibility and, specifically for Saudi Arabia, potentially higher participation from institutional investors via QFIs.

Figure 3: US REITs performed better than US stocks

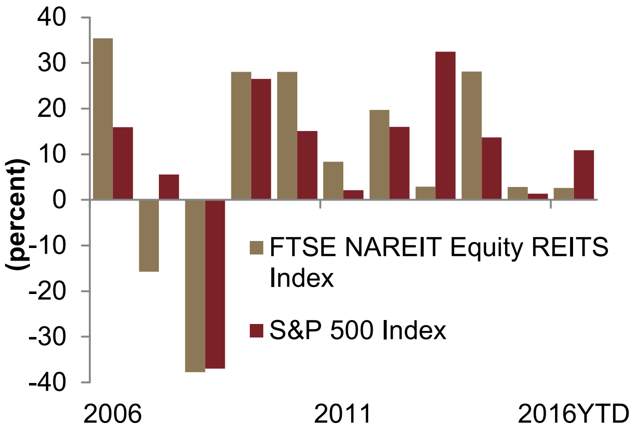
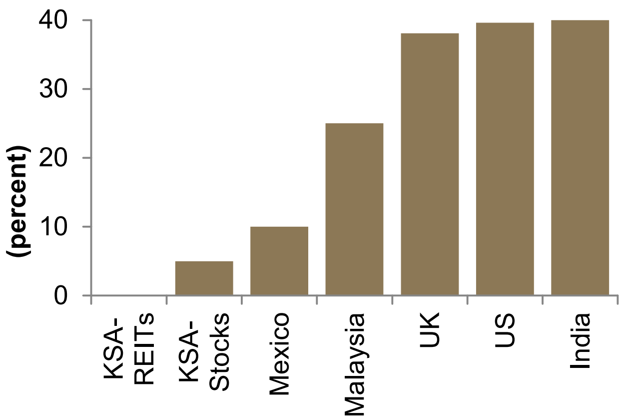


Figure 4: Withholding tax on dividends for REITs (and Saudi stocks) for non-residents*



*Maximum tax band

REITs offer potentially higher participation from institutional investors in the Kingdom via QFIs.

Investing directly in real estate requires a significant level of capital and quite often expected returns are not realized for many years, thereby encouraging a "buy and hold" mentality. Investing in REITs, on the other hand, requires less capital (there is no minimum value requirement for REIT shareholders under CMA regulations), resulting in less strain on the liquidity of investors. The absence of a minimum value requirement for REIT participation, along with zero tax on remitted dividends, could also encourage higher QFI participation. As we have stressed in the past, QFIs can have a positive impact on the Saudi economy and their participation in capital markets can play a part in modernizing the economy along the lines set out by the Vision 2030 (please see our report *Recent CMA announcements related to Tadawul*) .

Greater transparency:

A widely observed benefit of listed REITs is that they contribute to increasing transparency…

...which helps develop property markets through greater participation and flows of capital.

Currently, Saudi Arabia's score in real estate sector transparency indicators is pretty average, ranked 63rd out of 109 constituents, in line with regional counterparts (Figure 5). Unsurprisingly, countries that score highly also have established and well regulated markets for REITs. A widely observed benefit of listed REITs is that they contribute to increasing transparency through disclosure requirements. This, in turn, helps develop property markets through encouraging greater participation and ultimately, attracting greater flows of capital. In Saudi Arabia's case, the CMA has published very detailed and concise provisions related to disclosure requirements, reporting deadlines for audited financial statements and operational disclosures. Over time, the introduction of REITs in the Kingdom, coupled with effective regulatory oversight, can ensure increased levels of real estate transparency and bring about growth in the sector, as demonstrated by other countries.

How can REITs benefit the Saudi economy?

Under the NTP, the government is aiming to work extensively with private developers to promote the real estate sector…

Aside from the specifics of promoting the investment offering within the Kingdom, under the NTP, the government is aiming to work extensively with private developers to promote the real estate sector. On a macro level, these targets include improving the real estate sector's growth to 7 percent per year (from 4 percent currently), with the aim of doubling the sector's contribution towards GDP to 10

Figure 5: Saudi real estate sector ranked 63rd out of 109 countries in transparency (1=best score)

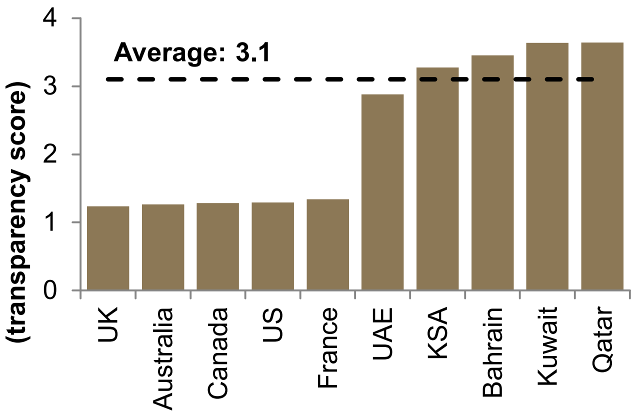
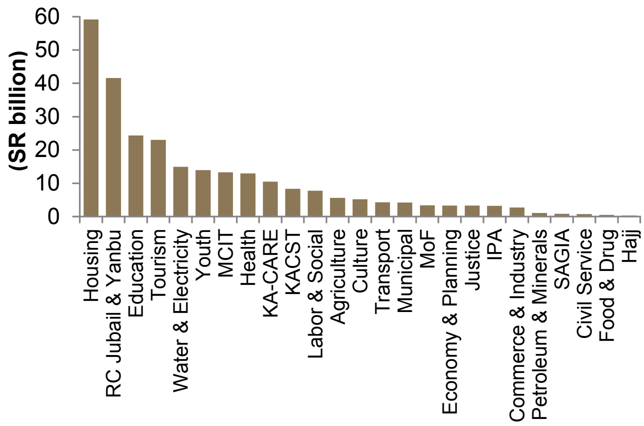


Figure 6: Ministry of Housing allocated largest amount of funds under the NTP



...so to double the sector's contribution towards GDP to 10 percent by 2020.

percent by 2020. The importance of real estate to the economy is further underlined by the fact that the Ministry of Housing has a substantial 22 percent (SR59.2 billion) of total NTP funds allocated to it up until 2020 (Figure 6).

REITs can help in the creation of jobs in the Saudi economy...

...and since the real estate sector has a high level of saudization…

...its development would help place more Saudi nationals into the private sector.

A number of international studies point to the potential of REITs in contributing to the development of the wider economy. For example, according to a study by the Association For Real Estate Securitisation (ARES), the cumulative economic effect of Japanese REITs between 2001 to 2011 was estimated at ¥31 trillion ($270 billion), or 0.3 percent of Japan's GDP growth. Over the same period, ARES states that REITs created 300,000 indirect and direct jobs, with REITs directly employing 83,000 people in Japan in 2012. Furthermore, according to a report commissioned by the National Association of Real Estate Investment Trusts, the total economic contribution of US REITs in 2014 was an estimated 1.8 million direct and indirect full-time equivalent jobs. It seems therefore, that the development of real estate sector in Saudi Arabia could help create additional employment opportunities, especially so for Saudis. This is because the real estate sector currently enjoys a high level of saudization, and its development would therefore help place more Saudi nationals into the private sector (Figure 7).

REITs can also facilitate the participation of the private sector in developing vacant land plots in the Kingdom...

...by bringing forward an alternative source of finance for the private sector.

On a micro level, REITs are likely to facilitate the participation of the private sector in developing vacant land plots (Box 2) and raising the supply of real estate by bringing forward an alternative source of finance for the private sector. As we have highlighted above, REITs are likely to do this by attracting capital, including foreign capital, into the property sector by creating a new vehicle for institutional and individual investors. This, in turn, will reduce the risk for property developers, who, by selling completed assets to REITs, will be able to free up capital that can be readily deployed in new real estate development projects.

One of the priorities for government is residential real estate development…

Although all types of real estate are important to the development of the economy, it is quite clear that one of the priorities of the Saudi government is towards increasing the supply of residential real estate. In the last few years, Saudi home ownership has been on a downward trend, from around 62 percent in 2007 to 47 percent in 2015. This has largely been due to a combination of factors, such as: rapidly rising population levels, a lack of supply of sufficient

Figure 7: Real estate sector has fifth largest ratio of Saudi nationals in employment (percent)

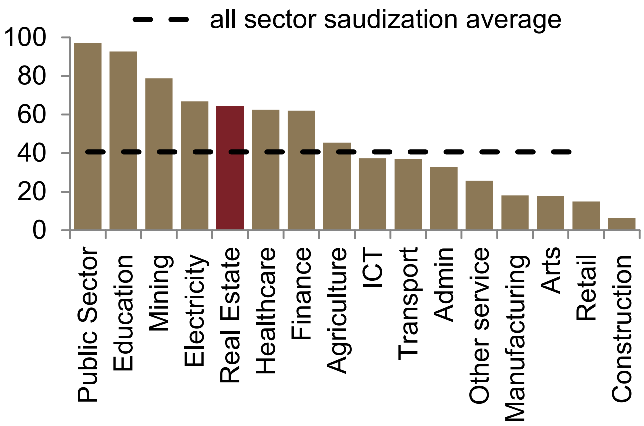
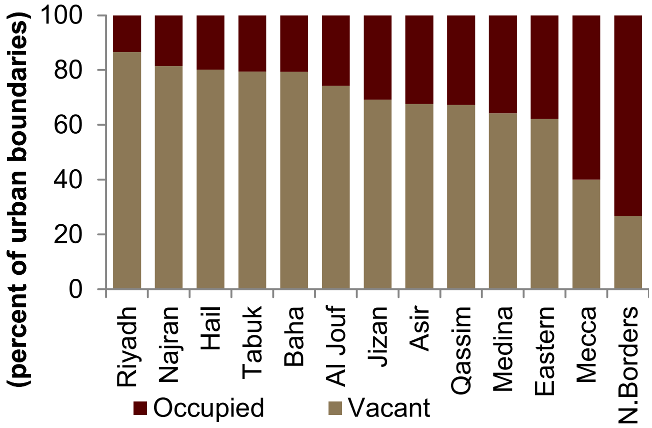


Figure 8: Breakdown of land plots by region in 2015 (percent of urban boundaries)



...and the NTP lists several initiatives which aim to address both the demand and supply of such real estate.

REITs can help achieve NTP targets through the supply side.

Tax on undeveloped land will allow more affordable access to plots…

...which should lead to a rise in land transactions and contribute to lifting the value added generated by real estate services.

residential units and the absence of financial products which facilitate home ownership. The NTP lists several initiatives which aim to address both the demand and supply bottlenecks of residential real estate (Table 2). The relevance of REITs in helping achieve these NTP targets are more likely to fall into the supply side of the equation, through encouraging private sector participation. This, in turn, should play a part in lifting Saudi home ownership levels to the NTP target of 52 percent by 2020 .

Box 2: Tax on undeveloped land

A broad pick-up in real estate development activity is expected with the imposition of fees on undeveloped land plots. We think this will intensify from 2017 onwards, as a deadline to tax undeveloped land plots looms. The increased availability of land will allow more affordable access to plots, which should lead to a rise in land transactions and contribute to lifting the value added generated by real estate services. This should ultimately lead to higher growth in ownership of dwellings. Currently, the supply of undeveloped land plots is substantial, covering 67 percent of the Kingdom's urban boundaries in 2015. This presents a significant opportunity in real estate development since these empty land plots constitute more than 50 percent of urban boundaries in most of the regions, including Riyadh and the Eastern Province, two regions with large populations and dynamic economic activity (Figure 8).

Table 2. Residential real estate targets in the NTP

		Strategic objective
Time		Reducing the approval and licensing process of new residential real estate development projects from 730 days to 60 days.
Cost		Halving the housing unit cost multiples of gross individual annual income from 10 times to 5 times.
Access to finance	Homeownership rise	Enabling citizens to obtain suitable housing financing in order to facilitate a rise in Saudi home ownership ratio from 47 percent in 2015 to 52 percent by 2020.
	Increased financing	Increasing the share of residential real estate financing from 8 percent of non-oil GDP to 15 percent by 2020.
	Mortgage collateral	Provision of mortgage collateral for certain segments not likely to get loans because of the associated risks (such as private sector employees working in SMEs).
Affordability		House buyers and savings programs with a total cost of SR22.9 billion (38 percent of the total budget for the Ministry of Housing).
Availability		Encouraging the development of government land plots, introducing cooperative housing, imposing land fees on undeveloped land and involving large private land owners in developing residential units.

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The data contained in this research is sourced from Reuters, Bloomberg, Capital Market Authority, The National Association of Real Estate Investment Trusts, Jones Lang LaSalle, PricewaterhouseCoopers, EY, National Transformation Plan, Ministry of Municipal and Rural Affairs Ministry, General Authority of Statistics and national statistical sources unless otherwise stated.

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