Listing boost for Bahrain-domiciled real estate investment trusts

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Real estate investment trusts (REITs) are due to be listed for the first time on the Bahrain Bourse (BHB) later this year, following new listing rules which came into effect on 17 May.

This latest initiative will have significant benefits for the Bahrain Bourse, the investment community and the real estate sector. For the Bourse it will help improve liquidity and enhance its regional competiveness. For investors it will enable investment in real estate even with small amounts of capital and without having to own or manage properties. And for the real estate sector, which is a significant contributor to Bahrain's GDP, it will add greater depth and stability through institutionalisation.

But what exactly is a REIT? A real estate investment trust (REIT) is a regulated legal structure that holds income-generating real estate assets and issues units to investors. The unit holders effectively become the beneficial owners of the real estate assets in proportion to their unit holdings, and receive a proportionate amount of rent available after paying expenses. In Bahrain, REITs are currently restricted to income-generating properties that can include any subsector such as offices, residential units, and hotels. Globally, however, REITs can invest in other real estate-linked assets such as mortgages and ground-up developments. .

REITs listed on the Bahrain Bourse offer investors a wide range of benefits, including low-cost exposure and accessibility to real estate; a stable, regular income stream and liquidity: and diversification and performance. Real estate as an asset class normally requires large sums of capital to acquire property, whereas listed REITs provide low price exposure, enabling investment in large, high-value real estate projects at low ticket sizes. In terms of accessibility investors interested in buying a unit in a listed REIT just need to set up a brokerage account with a BHB-registered broker and acquire the quantity of units in the REIT of their choice. Listed REITS also provide stable income through regular dividends together with liquidity, as units can be easily bought and sold. Another important benefit is diversification, since listed REITs provide investors with a new alternative investment asset class that has ▸

historically shown little correlation to the returns of the broader stock market.

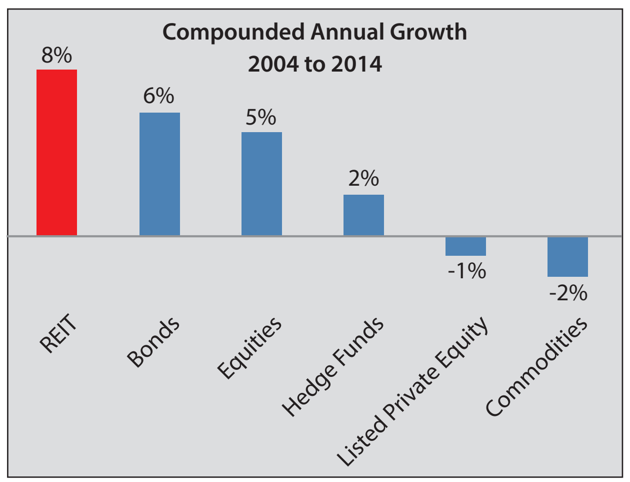
REITs are not new – their underlying structure dates back to the 1880s – but the modern REIT was created by the United States Congress in 1960. By the end of 2014, there were over 1,100 active REITs in the USA, of which 216 were listed on the country's major stock exchanges, with a market capitalisation of over US$ 1 trillion and more than US$ 2 trillion in real estate assets. Today, REITs are regulated in around 40 jurisdictions worldwide.

Since 1960 REITs have outperformed equities

A listed REIT differs from a real estate fund or a company involved in real estate in a number of ways, but most significantly in terms of regulation. A listed REIT is generally open to all individuals to acquire units and trade on the Bahrain Bourse. Because of this openness and accessibility, the Central Bank of Bahrain (CBB) and BHB have strict regulations for oversight. Real estate funds, which have been active in Bahrain and the region for many years, are normally offered on a private basis to high-net-worth individuals and institutions. Furthermore they are usually subject to significantly less regulatory oversight than a listed REIT, as the assumption is that institutions will be suitably qualified to assess the risks and rewards. A company involved in real estate usually has more complicated operations, since it may function across the real estate investment spectrum such as land trading and real estate development projects. A company may also choose to withhold or reinvest its profits, use high levels of debt, or acquire other companies, all of which are restricted in REITs for the protection of the average investor.

While REITs can be established by any institution or individual who owns or can secure income- generating assets, a number of safeguards are mandatorily required to protect investors. Such protection stems from the requirement of all REITs being approved and registered by the CBB prior to establishment and listing; together with the pre-appointment of locally-established, independent and regulated third parties that include trustees, custodians, administrators, REIT managers, property valuers and auditors. REITs can only acquire completed properties that are income generating and are required to distribute at least 90 per cent of their net profits to investors, while debt finance has to be limited to a maximum of 60 per cent of the property's value. To provide some level of risk diversification, REITs must have at least two income-generating properties with a minimum valuation of US$20 million. Bahrain-based REITs are permitted to acquire income-generating properties globally, and there are no specific regulatory restrictions on such geographic composition.

Significantly, listed REITs have a proven track record of performance. Since 1960, they have outperformed equities represented by the S&P 500, Dow Jones Industrials and NASDAQ Composite over most long-term horizons, and provided better returns than corporate bonds. According to data analysed from Bloomberg, the compound annual growth rate per year over 10 years (2004 to 2014) for the Dow Jones Equity REIT Total Return Index was 8 per cent, which compared more than favourably with the Bloomberg US Corporate Bond Index (6 per cent) and the S&P 500 Index (5 per cent). It also significantly outperformed the Thomson Reuters/Core Commodity CRB Commodity Index (-2 per cent), the Barclay Hedge Fund of Funds Index (2 per cent), the Dollar Index (1 per cent) and the S&P Listed Private Equity Index (-1 per cent)



Source: SICO analysis from Bloomberg data

Currently, local market return expectations are for REITs with net distributable yields to unit holders of 7 per cent and above. Unit holders can also benefit from any increase in the price of their units that would result from a growth in market demand for such units, rental increases on the underlying properties, and general real estate price appreciation, among other factors.

While the current low interest rate environment is deemed positive for yielding investments such as REITs, differences remain as to what affect a rising interest rate environment could have on REITs. Expectations for an increase in interest rates for US Dollar-based currencies, such as the Bahraini Dinar, vary; but a gradual increase is generally expected to start later in 2015. One argument is that REITs are negatively impacted by increasing interest rates, predominantly due to the resultant increase in the cost of debt to acquire properties and due to the availability of newly issued bonds at the higher rates prevalent at the time. On the other side of the argument increasing interest rates coincide with a growth environment (as interest rate increases are meant to slow down inflation resulting from such growth). This equates to increased occupancy rates and higher lease rates, together with higher retail and hospitality spend, which are all positive outcomes for REITs. Such a scenario took place between 2003 and 2006 when, despite interest rates (represented by six-month US-Dollar Libor) increasing by 4.2 per cent, REITs (as measured by the Dow Jones US Select REIT Index) returned 26 per cent annually over the same three-year period. Furthermore, REITs offering distributions that are higher than alternative-yielding investment options and that are less leveraged, would outperform and be more resilient to increasing interest rates, as are REITs with fixed leverage costs. Due to more stringent leverage restrictions on REITs listed in Bahrain (at a maximum of 60 per cent of the underlying properties' value) and generally less attractive debt structures locally available compared with the US and Europe, local REITs would likely be less affected by increasing interest rates.

A determining factor in the success of listed REITs in Bahrain will be the underlying performance of the real estate sector

In Bahrain, the Financial Trust No. 23 Law of 2006 paved the way for the establishment of REITs. Regulations concerning REITs were initially covered under the collective investment unit (CIU) module of CBB Rulebook Volume 6 in 2007, and the first private and unlisted REIT in Bahrain is believed to have been authorised by the CBB in 2009. REIT regulations were further updated with the introduction of CBB Rulebook Volume 7 in 2012, but did not have clear provisions to be offered to the public. Investment in these REITs was only on a private basis, and was limited to investors who met certain strict restrictions.

A determining factor in the success of listed REITs in Bahrain will be the underlying performance of the Kingdom's real estate sector. Positive developments include new regulations that were issued in 2014, such as the Real Estate Development Law and the Lease Law; the establishment of the Committee for Settlement of Stalled Property Development Projects in 2015; and the planned establishment of a new Real Estate Regulatory Authority. The new BHB listing rules issued in 2015, which allow REITs to be listed and traded on the BHB by both Bahraini and foreigners, mark a significant step forward in the development of the REIT industry in the GCC. Eskan Bank is the first institution in the Kingdom to formally announce its intention to list a REIT (based on properties owned by Bahrain Property Musharaka Trust), and has appointed Securities & Investment Company (SICO) as lead arranger for the listing. This listing on the Bahrain Bourse planned for later this year is likely to be the second in the region following the listing of Emirates REIT on Nasdaq Dubai in 2014. ■

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