PRICEWATERHOUSECOOPERS

羅兵咸永道會計師事務所

PricewaterhouseCoopers
33/F, Cheung Kong Center
2 Queen's Road Central
Hong Kong
Telephone (852) 2289 8888
Facsimile (852) 2810 9888
www.pwchk.com

Investment Products Department
The Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
HONG KONG

SFC
Investment Products
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29 April 2005

Dear Sirs

Consultation Paper on Draft Practice Note :-
Overseas Investments by SFC-Authorised Real Estate Investment Trusts ("REITs")

We are writing to submit our comments on the Consultation Paper (the "Consultation Paper") on Draft Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts (the "Draft Practice Note").

Overall, we are supportive of the Commission's proposal to relax the geographical restrictions so that REITs may invest in overseas real estate. We believe directionally, this is an important step forward for the development of the Hong Kong REITs market. The current proposal would bring Hong Kong REITs closer in characteristics to other overseas REITS where no such restriction exist. Whilst it can be argued that market demand and investors' risk appetite would ultimately drive the success of REITs, we also believe it is of equal importance that an effective corporate governance and regulatory framework is in place to protect public interest and confidence in the REITS market. For that reason, we agree with the Commission that allowing REITs to invest overseas will expose potential investors to additional risks and therefore, additional guidance and regulations ensuring such risks are appropriately managed are of paramount importance. We commend the Commission's efforts in developing this Draft Practice Note, not only in connection with the relaxation of the investing overseas restriction, but also to provide additional guidance on areas which may not have been fully covered by the existing Code.

We have a number of observations and comments which we hope the Commission will find useful when finalising the draft Practice Note as well as other comments in respect of initiatives in promoting the future development of REITs in Hong Kong. Our comments, outlined in more detail below, are categorised into the following three areas:

1. Responses to certain specific issues raised by the Commission in the Consultation Paper;
2. Comments on the Draft Practice Note; and
3. Other suggestions for the future development of REITs in Hong Kong.

1. Responses to the specific issues raised by the Commission

1.1. Raising of gearing ratio

The Consultation Paper seeks comments on the proposal of raising the gearing ratio from the current 35% to 40% - 50%. We consider this proposal is in the right direction for the future development of REITs.

1.2. Special product features

We consider that any special features to be incorporated into a REIT will need to be evaluated to ensure they are operationally viable and yet remain commercially attractive.

The payment of management fees by way of issuance of units as quoted in the Consultation Paper would require the following aspects to be considered:

(a) Tax implications: The payment method and which company pays and bear such management fees may have an impact on the tax deductibility under REITs. In addition, this will also affect the calculation of taxable income of the management companies;

(b) Cash available for distribution: the issuance of units is a non-cash payment of management fees expense and therefore will also widen the net income after tax and net cash flows disparity as discussed in paragraph 3.3 below.

2. Comments on the Draft Practice Note

2.1. Reference to REIT operators

Under paragraph 3 of the Draft Practice Note, the management company, trustee, valuers and auditors are collectively referred to as the "REIT operators". The valuers and auditors are not involved in the operations of a REIT but only serve as service providers to the REIT and hence they should not be regarded as REIT operators.

2.2. Applications of financial reporting standards

Paragraph 43 prescribes REITs to *"adopt the same accounting principles regardless of whether they invest locally or overseas"*. We would like to point out that the preparation of consolidated financial statements under either Hong Kong Financial Reporting Standards (HKFRS) or International Financial Reporting Standards (IFRS) effectively achieves the objective of all properties having to be accounted for on a consistent basis irrespective of locations.

2.3. Reconciliation of valuations

Paragraph 44 requires a reconciliation statement to explain any differences between the values of the properties held as recorded in the financial statements and that provided by the valuers in the valuation reports. We support this requirement as it adds transparency to the valuations but we would like to point out that such reconciliation statements have to be presented outside the financial statements as they cannot be regarded as part of the financial statements under HKFRS or IFRS.

3. Other suggestions for the future development of REITs

3.1. Layers of special purpose vehicles ("SPVs")

The existing Code allows a maximum of two layers of SPVs for the purpose of holding properties. As the geographical restriction is to be relaxed to allow Hong Kong REITs to invest in overseas properties, we recommend that the restriction on the number of layers of SPVs should also be relaxed. In this regard, we note that, for taxation and other commercial purposes, investment in overseas property may need to be held via a property holding company and one or more intermediate investment holding companies. The two layers of SPVs restriction may impose unnecessary inhibition on the structural efficiency of Hong Kong REITs.

3.2. Requirement of wholly-owned SPV

We note that there is inconsistency where the Code currently requires all the SPV to be 100% owned by REITs albeit the Draft Practice Note (paragraph 25) allows ownership of property less than 100%. It is not uncommon for certain overseas countries to have requirements on local citizen ownership in domestic companies or properties. A certain level of local participation may also be otherwise dictated by commercial considerations. We therefore suggest the Commission to consider amending the corresponding Code provisions to allow Hong Kong REITs to own a controlling interest (rather than 100%) in a SPV.

3.3. Definition of net after tax income

The Code requires the distribution of 90% of the annual net income after tax. We raised previously in our comment letter dated 23 April 2003, when the Code was still in its draft form, that further clarification of the definition of net income after tax is required due to the disparity between accounting income and the actual timing of cash flows. Financial statements are generally prepared under an accruals basis which may not necessarily represent the actual timing of cash flows. REITs could be faced with a situation whereby they show a positive "net after tax income" but yet do not have a comparable inflow in terms of cash.

In addition, with the convergence of HKFRS with IFRS, which is effective for entities with accounting periods beginning on or after 1 January 2005, the revised or new HKFRS will introduce various requirements that fair value changes or certain assets and liabilities would be taken through the profit and loss account. As an example, the new HKAS 40 "Investment properties" (equivalent to IAS 40) requires all fair value movements of investment properties to be debited or credited to the profit and loss account, thereby increasing the volatility of the profit and loss account from year to year This could potentially further widen the disparity. We suggest the Commission to clearly define the net income after tax for dividend distribution purposes as well as to clarify whether it is intended for REITs to be able to distribute revaluation surpluses as dividends.

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We hope you find the above comments useful and we will be pleased to discuss in further details of any of the above points raised. Please contact any of our following partners for further information.

Robert Gazzi
Partner
Real Estate and Infrastructure – Assurance
Tel: 2289 2212
E-mail: robert.gazzi@hk.pwc.com

KK So
Partner
Real Estate and Infrastructure – Tax
Tel: 2289 3789
E-mail: kk.so@hk.pwc.com

Marie-Anne Kong
Partner
Investment management – Assurance
Tel: 2289 2707
E-mail: anne.kong@hk.pwc.com

Yours faithfully