

.Investment Products Department
The Securities and Future Commissions
8/F, Chater House
8 Connaught Road Central
Hong Kong
Attn: Miss Christina Choi

April 30, 2005

Re: Consultation Paper on Overseas Investment by SFC-authorized real estate investment trusts.

Further to the two meetings with the Investment Products and Licensing Departments of your esteemed organization, I write to express my personal view on the captioned topic. I would draw mostly examples from Chinese properties, which appear to be one of the more logical asset types for the incorporation into Hong Kong REIT.

Gearing of 35%:

The Arguments for Imposing Gearing Limit are:

- Protects investors for undue financial risk and volatility.
- Increases transparency of capital structure.
- Promotes strong capital rationing and financial discipline as needed to access equity markets for material acquisitions – greater investor scrutiny.
- Ensures taxable profits (if any) are not absorbed by interest cost, thereby increasing the dividend income tax taken from investors – though interest income may be taxed in hands of debt providers.
- Returns would most closely follow underlying property.

The Arguments against Imposing Gearing are:

- International experience shows that the market will require conservative gearing anyway.
- Restrictive gearing limits often need to be relaxed or abandoned e.g. Singapore, Belgium, and Australia. (see table below)
- Reduces financial flexibility and increases reliance on equity capital market funding (particularly if high payout requirement).
- Potentially inhibits overall size of growth of REITs.
- Enforcement of gearing breaches potentially disruptive and costly – may

impact management behaviour when close to limit.

- Too low a limit would restrict scope for gearing to enhance income yield and financial returns.
- Debt providers also impose financial discipline on REITs.

Gearing – International Comparison (As of June 2004)

Country	Current Gearing Limit	Historical Gearing Limit	Gearing Limit Revision Date	Current Average Gearing (%)
Australia	None	65% of assets	30 Sept 2001	35
Belgium	50% of assets	33% of assets	19 June 2001	48
France	None	N/A	N/A	42
Hong Kong	35% of assets	N/A	N/A	35
Netherlands	60% of book value	N/A	N/A	36
Japan	None	N/A	N/A	38
Singapore	35%	25%	28 March 2003	25
US	None	N/A	N/A	43

From the table, it is obvious that Hong Kong and Singapore fall on the more conservative stand. Of course, there are a number of factors drive the use of debt within a REIT structure which incorporate local, or more so for overseas, properties including:-

1. the relative cost of debt versus equity;
2. debt instruments can lock into attractive fixed long-dated costs, although these are relatively scant in the Asian capital market, including Hong Kong;
3. debt is nominal, and depending on the debt/equity mix, movement in the value of properties (as shown by the drastic NAVs that go up and down drastically in the past years in Hong Kong) rewards equity exponentially;
4. equity is not always readily accessible as in the case of China, thus debt represents a diversification of funding sources.

In consideration of the above, I would recommend for your kind considerations:

1. **40% Gearing Ratio:** a marginal increase of gearing ratio to no more than 40% based on the following reasons:

- i. 40% gearing is the average industry norm for loan-to-value for commercial mortgage in Asia
 - ii. Interest rates are rising, but marginally and gradually. So 40% should be the ceiling. This would be reduced if interest rise to a higher rates, i.e., 8%.
 - iii. 40% is still a conservative limit compares to other major markets
2. **DSCR:** However, I propose that the 40% limit should be accompanied by another limit, debt service cover ratio (her after “**DSCR**”) of at least 2X (i.e., debt servicing cash is at least two times of interest).

Debt servicing capability of REIT is affected by the a combination of factors: rental yield from underlying assets, the cost of debt (interest rate), and the more senior obligations such as turnover tax and urban real estate taxes in China. Therefore, the criteria to define debt servicing should not be limited to the single benchmark of Gearing Ratio, but more importantly DSCR, which is after all a more relevant, and a simple finance concept.

3. **Nature of Allowable Loan:** In addition, I propose that SFC should specific that Loans are restricted to loans that carry interest and principal repayment obligations in line with the general market benchmarks. In another word, loans in the REIT structure should be genuine, third-party bank loans with interest obligations in line with market practice. This would avoid unscrupulous sponsor to be profit at the expenses of public investor by installing related party loans at prohibitively high interest rate that would eventually wipe out the free cash to investors.
4. **Shareholders’ Loan:** SFC should give a special waiver for a particular type of loans in REIT structure: quasi-equity-like shareholder loans with interest obligation deeply subordinated to free cash to investors. It is common for Hong Kong or other international investors to provide its shareholders’ equity in the form of shareholders’ loans that carry interest. Such arrangement is a tax efficient arrangement and is regarded as legitimate by the tax regimes in Hong Kong and China. For property market like China where taxes are burdensome (5% turnover tax, 12% urban real estate taxes, and 33% profit tax), such a shareholder loan is a tax-efficient arrangement that work for the interest of the investors. If such loan is structured for tax efficient purpose and deeply

subordinated to free cash to investors, such a shareholder loan should not be counted into the gearing limit.

Professional indemnity insurance and title insurance?

Professional negligence is a serious matter for an asset management company. I propose that SFC should adopt the use of fine, which is similar to the regulations governing Financial Advisor, instead of professional indemnity insurance. The argument is simply born out of conventional business wisdom, and after discussing with insurers. The cost of professional indemnity insurance would be prohibitively expensive because of the very limited number of licensed REIT managers in Hong Kong. The insurance premium would come out almost similar to the cost of self insured premium.

For title insurance, such insurance is only offered on trial basis by some small insurers. I think that SFC should rely on fiduciary competence of Hong Kong registered lawyers in title registration of overseas market, an approach that has been commonly adopted by the financial industry in China for decades. I believe the use of Hong Kong registered lawyers to handle property title registration would be sufficient protection for investors in the title registration for market like China which has adopted the Hong Kong system of title registrations. Hong Kong registered lawyers have gained significant experience in title registration and related conveyancing in Chinese properties market.

Qualification of the Management Company

It is a very comprehensive proposal by SFC on the requirements of the asset management company, and also a major improvement from the initial consultation to more real estate-centric requirements.

I agree entirely that geography-specific experience is crucial to the assessment of the asset manager. However, we must be fully aware that real estate asset management is a skill that can be applied internationally and universally in many ways by experienced international asset manager. A capable international asset manager can provide effective asset management with the aid of experienced local staff. This is probably the case of China where major international property agents have gained their recognition and achievement in building management, leasing and sales functions of commercial properties in a very short time. Therefore, SFC should take

consideration that international asset management skill is something that has many universal applications in different overseas jurisdictions. An asset manager with proven track record, resources, experience, internal control and organization, with the aid of well trained local staff, or a local joint venture partner, should be viewed as competent organization in asset manager.

In the public consultation, there are vague guidelines (point 12, 13, 14 of Appendix 1-3) on the qualification of a management company. I wish this would be explained in more concrete terms for interested parties.

In general, I view the whole SFC approach to REIT codes as prudent, well thought and comprehensive, in line with the usually fine work of your esteemed entity. I believe in times, the SFC codes should set another useful milestone for corporate governance, risk control and financial innovation for property developers and investors in the Greater China region.

BEST REGARDS

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David Chance is an Independent Board Director for Canadian publicly listed developer Pacrim International Capital, which is in the process of forming a REIT joint venture with Colonial First State Properties Ltd., Australian third largest REIT manager.

He has over 20 years real estate structured finance and property portfolio experience, first with Citicorp as a Vice President of Real Estate Finance for Hong Kong and China. Prior to Citicorp, he was an AVP at First Chicago Bank (now, JP Morgan) handling some of the largest real estate transactions in China in the mid '80s. In the '90s, he worked for a major developer in its South East Asia markets, China and securitization initiatives. He transacted three commercial mortgage-backed securities securitization in Hong Kong between 1992 and 1998, representing the coming of securitized real estate financing in Asia.

He has been lobbying for REIT initiatives in Beijing in the past few years. He is an advisor to the Research Centre of Ministry of Construction on REIT and securitizations, and a lecturer at the nation's think tank, Tsinghua University, where he teaches Real Estate Financing, Securitization and REIT. He holds a MA and MBA from the University of Chicago.