

by email

# CBRE

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By email ([reitsconsultation@sfc.hk](mailto:reitsconsultation@sfc.hk)) and by post

Dear Sirs,

## **Re: Consultation Paper on Amendments to the Code on Real Estate Investment Trusts**

We refer to the consultation paper (the "Consultation Paper") regarding the amendments to the Code on Real Estate Investment Trusts ("REITs") issued by the Securities and Futures Commission (the "Commission") in January 2014. We appreciate and welcome the Commission's intended objectives of the proposal, which is to continue developing Hong Kong as an international premier asset management centre by cognizing of the importance of REITs in Hong Kong.

We hereby set out our comments for your consideration. Unless otherwise defined, terms used hereinafter shall have the same meanings as those defined in the Consultation Paper.

### **Proposal for introducing flexibility in respect of investments in properties under development or engagement in property development activities**

*Question 1: Do you consider that flexibility in respect of property development investments and related activities should be introduced to REITs?*

Having noticed the current inability to involve in neither property development activities nor redevelopment of ageing assets, Hong Kong REITs are losing their competitive advantages. It is undeniable that there is a lifecycle for development. Early participation in a project cycle could not only allow REITs manager to enjoy a greater bargaining power on the acquisition cost, but also gives the REITs manager the power to control over the cycle of the development project.

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Also, not being able to undertake significant upgrading works of the current property, especially when the benefits from rebuilding the properties outweigh the cost of repair and maintenance, encourages REITs to dispose these assets in a dilapidated condition at less than optimal prices, which adversely impacts the return to investors. The current rule imposes limitation to the REITs manager in making proper and normal commercial decisions to a certain extent.

In this regard, we agree with the principle that flexibility in respect of property development investments and related activities should be introduced to REITs.

*Question 2: Do you consider that the 10% GAV Cap is set as an appropriate threshold?*

Under Note (2) to 7.1 of the REIT Code, the maximum threshold currently applicable to the Acquisition of Uncompleted Units is 10% of the total net asset value of the REIT. Under the proposal, this threshold will be expanded to 10% of the gross asset value (the "10% GAV Cap") of the REIT, which will also encompass the Property Development Costs. It is noticed that such 10% GAV Cap is similar to the requirements of REITs in Singapore and Malaysia, while there is no such threshold limit in United States and Australia.

We are of opinion that setting such 10% GAV Cap is a conservative and modest measure. Such limit can be considered as a benchmark at the early stage of introducing flexibility, but should be subject for review for the possibility of an upward adjustment in the long run.

In practice, the market will decide the degree of development activity of REITs. By having sufficient disclosure of the relevant risks associated with property development such as (i) construction risks; (ii) risk of default of the construction project counterparties and (iii) risk of rising financial costs due to possible delay in completion or changing market environment, REITs investors should be able to make proper investment decisions.

*Question 3: Do you have any comments on how the Property Development Costs should be calculated?*

The Consultation Paper proposed that the Property Development Costs would be the total project costs borne and to be borne by the REITs, inclusive of the costs for the acquisitions of land and the development or construction costs of the project. We would like to further elaborate Property Development Cost in a boarder sense, which should also include acquisition costs of land or development project, demolition costs, construction costs or refurbishment costs, professional and consultant fees, loss of rental in case of renovation project, financing charges and other associated costs etc.

To ensure compliance with the 10% GAV Cap, the Commission proposes that the upfront calculation of property Development Costs, and any increase in such costs subsequent to the commencement of a property development project, should be based on a fair estimate made by the REITs manager in good faith and should be supported by the opinion of an independent expert acceptable to the Commission. General practice surveyors are well recognized as expert professionals in property development process, valuation of land and building, cost estimation and financial analysis. We are of opinion that General practice surveyors are the best choice of independent expert for calculation of property development costs. Further details regarding the professional practice of each division of surveyors can be obtained from the Hong Kong Institute of Surveyors.

*Question 4: Do you have any comments on the frequency of periodic updates that should be provided to unitholders on the status of property development investments and related activities?*

Data and statistics have shown that the Hong Kong property market prices are relatively volatile. In addition, Property Development Costs change during the building cycle, which means that there is a need for a more frequent update on the status of the development.

We are of opinion that a semi-annual update should be provided to unitholders regarding the status of property development investments and related activities. But the frequency of update should also depend on market situation; the REITs managers have the responsibility to disclose material information in case there is any factors that cause substantial change in the Property Development Costs.

*Question 5: What additional safeguards do you consider appropriate to ensure that there will not be any material change to overall risk profile of a REIT despite the flexibility to engage in a limited extent of property development investments and related activities?*

We take the view that disclosure of relevant issues associated with property development such as progress of development, quality of assets, market positioning, capital costs, cost control system, risk management and growth potential should be made in a timely and accurate manner. This is to allow REITs investors to acquire sufficient information to make investment decisions.

In addition, whenever there is material information regarding property development investments and other related activities that are substantial to investors or potential investors, such as exceeding the budget or surge in the development cost, encountering technical difficulties, substantial delay upon completion, etc., the REITs manager should disclose such information in a timely manner.

Furthermore, we also suggest deploying a maximum development period for any intended development to be acquired by REITs manager, say, for a period of 4 or 5 years, as lengthy development imposes substantially higher risk to the profile.

### Proposal for introducing flexibility in respect of investments in financial instruments

*Question 6: Do you have any comments on the proposed scope of the Relevant Investments and the proposed Maximum Cap?*

In view of the difficulties of acquiring quality assets in the current market situation, it is beneficial for REITs to invest in a broader range of investment options. Setting the Maximum Cap ensures the maintenance of REITs' profile as primarily a recurrent rental income-generating vehicle. We welcome such proposal; as such flexibility is generally in line with comparable overseas regimes like Singapore, Malaysia, United States, Australia and Japan.

*Question 7: What other safeguards do you consider appropriate to be put in place corresponding to the proposal to allow for the Relevant Investments?*

Caution needs to be taken when investing in Relevant Investments, which comprises (i) securities listed on the Stock Exchange of Hong Kong Limited or other internationally recognised stock exchanges; (ii) unlisted debt securities; (iii) government and other public securities and (iv) local or overseas property funds. The value of these Relevant Investments is far more volatile than real estates. Risk exposures of these Relevant Investments include not only risks of the property market, but also to other market risks such as interest risk. Daily quote may not be obtained for some of the illiquid investments such as unlisted debt securities. Frequent valuation should be performed and disclosed to ensure that investors are well abreast on the value of these Relevant Investments.

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We are open for discussion for any comments set forth. If you would like to discuss the above or any other aspects of the Consultation Paper, please feel free to contact the undersigned at

Yours sincerely,

