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Indonesia Property: REIT Market Development Is Progressing But Some Way To Go

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Key Takeaways:

- Conceptual hurdles are low for the development of the Real Estate Investment Trust (REITS) sector in Indonesia which means a move of Singapore REITS to Indonesia could just be a matter of time.
- However we see the structural hurdles from Indonesia's patchy implementation track record as the key stumbling block.
- Combined with currently unclear intentions from the sponsor, it is somewhat difficult to put a timeframe in play.
- **In any case, our view is that this is likely to be a medium term event (2-3 years) rather than a 2016 consideration.**

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Details

In response to the release of the Indonesian government's 5th Economic Policy Package late last year, Lippo Group CEO James Riady in late October 2015 raised the notion of moving Lippo's Singapore listed REITS back to Indonesia. This resulted in a sell-off in the bonds issued by Lippo's two Singapore listed REITs, Lippo Malls Indonesia Retail Trust (LMIRT) and First Real Estate Investment Trust (FREIT). Prices for the shorter dated bonds have somewhat recovered but prices for the longer dated bonds remain depressed. Most recently, more news flow has come out as Indonesian property companies begin to position themselves to establish REITs domestically. We think the news flow has increased as companies believe that the government is continuing to finalize its policy towards the REIT sector. Just this week on 3rd March 2016 it was reported that the government has agreed to lower taxes on property acquisitions by REITs although such a move requires local government approval (source: The Jakarta Globe). We also believe that activity is building in the REIT sector because Indonesian property company leverage has risen and property developers need ways to recycle capital to fund further developments while keeping leverage in check. Below is a breakdown of the key risks facing the further development of the REIT sector in Indonesia (regulatory, execution, completion) and the implications of these risks on expected timing.

Regulatory risk: The question is whether there is anything conceptual standing in the way of the sector's development. The impetus comes from the inclusion in the government's 5th economic policy package of a proposal to eliminate double taxation at the holdco and REIT level for investment funds engaged in real estate, property and infrastructure. Its aim is to promote investment in infrastructure and real estate, growth in construction services and encourage greater depth in Indonesia's financial markets. We think that there is low political risk or implications although clarification of land ownership laws and other tax related issues could complicate the development of the regulations. In any case, our view is that conceptual risk is low with the potential to develop an additional asset class in Indonesia and spur economic and financial market development if the proposal is implemented as intended.

Execution risk: Are there structural impediments to development of the sector? When the 5th economic policy package was announced, Indonesia's Finance Minister stated that the government would release the finance minister's regulation on tax reduction for real estate companies the following week to officially scrap the double taxation practice on REITs (source: The Jakarta Post). Since then however, there have been limited updates. These developments are not new for Indonesia – the government has a history of announcing new rules and regulations without appropriate clarity on implementation. As the saying goes, the devil is always in the details. REIT market proposals have actually been in place since Dec 2007 but there's been little progress in development of the market due to a lack of clarity on foreign property ownership and tax. It should also be noted that established REIT markets in the US and Singapore went through some teething problems initially although their strong regulatory frameworks and clarity eventually helped in the REIT sector's development. Although we are still seeking clarity, it could be that the new tax regulations do not need parliamentary approval and so could be established relatively quickly. That said however, formation of a REIT market is not easy and there remains uncertainty as to how this will be implemented. Further, the market would need time to develop and mature and iron out unforeseen issues. Given developing policy effectiveness and no fiscal urgency to its implementation, we think that execution risk remains high for REIT sector development. Put another way, there is no negative from a delay to its implementation.

Completion risk: The final question deals with a possible move of the Singapore REITs to Indonesia and how a transfer would be effected. This is the largest unknown. A dual listing of the REITs is possible given the sponsors strong pipeline of assets and the current REITS leverage but this would increase operating costs. Another alternative is the establishment of separate REITs in Indonesia to inject additional assets. Lippo Karawaci recently announced that it is targeting to raise IDR6 trillion over the next two years from REITs and is reportedly planning to initially inject three office buildings (Lippo Kuningan, Menara Matahari and Menara Asia) into a REIT to raise IDR1.5 trillion as part of its overall plan. Ciputra Development is also reportedly planning to raise IDR5 trillion from the establishment of REITs (source: The Jakarta Globe). In any case, we think the implications for a newly listed Indonesian REIT or one transferred from Singapore would be:

- Renegotiation of master leases with base rent currently pegged to SGD for FREIT;
- Increased financing costs in Indonesia;
- Termination of the REITs if unit holders approval is obtained by passing an Extraordinary Resolution at a unit holders meeting duly convened per the Trust Deed
- Approval for delisting in Singapore by a fragmented unit holder base who will demand fair value;
- Exposure to a nascent market with potentially constrained foreign investor interest, especially for mid-cap companies (<USD1bn market cap) ; and
- Operating in a weaker regulatory and corporate governance environment.

REITS are regulated as a collective investment scheme under Singapore's Securities and Futures Act although the Code on Collective Investment Schemes is non-statutory in nature. Having said that, the code does request consultation with the MAS where actions by the manager are inconsistent with equitable principles. MAS closely monitors the REIT market through existing regulations and we expect that MAS would need to be heavily consulted for any movement of the REITs.

Finally, Lippo Group CEO James Riady has been silent on a potential transfer and further developments since his statement in late October 2015. At the time, his statement was immediately followed by responses from both Lippo Malls Indonesia Retail Trust and First Real Estate Investment Trust stating that they were not aware and had not been informed by Lippo Karawaci of their plans to shift the REITS back to Indonesia. This raises questions as to whether there was anything tangible to the comments or whether they were perhaps misrepresented or misinterpreted.

Taking the above into account, we view completion risk as high given the uncertainty on the sponsor's true intentions for the Singapore REITs and uncertainty on whether due consideration has been given to implications for this deal.

Implication on timing: Conceptual hurdles to REIT market development in Indonesia are low which means this could just be a matter of time. However we see the structural hurdles from Indonesia's patchy implementation track record as the key stumbling block. Combined with currently unclear intentions from the sponsor, it is somewhat difficult to put a timeframe in play. **In any case, our current view is this is likely to be a medium term event (2-4 years) rather than a 2016 consideration.**

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