

IREITs: An Unrealized Potential in Gulf, Issues and Recommendations

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ABSTRACT— *Islamic finance has gained attention of the world especially after rich Gulf States petrodollars have flushed their coffers due to record high oil prices. Setting up of sovereign funds by many countries which hold billions of dollars, investing ethically is a challenge.*

New Islamic financial institutions are being set up and organizations like AAOIFI are introducing standards for stakeholders to follow and invest according to Islamic principles. However as compared to the west these initiatives still lag behind and have a great scope to further expand.

Islamic Capital Markets and Instruments are in their infancy. Islamic Real Estate Investment Trusts [IREITs] are one of the investment vehicles with huge potential and which can contribute to these capital markets. This paper examines the challenges and proposes certain suggestions to the concern parties on IREITs in the gulf region.

Keywords— REITs, IREITs, Gulf, Challenges

1. INTRODUCTION

Real Estate Investment Trusts or REITs is an investment fund which pools finance from investors to develop real estate based projects and generate revenue to be distributed to the shareholders.

Most of the REITs are listed in the stock exchange whose stocks are traded on the basis of Net Asset Value on the respective day of trade (Ong, Teh and Chong, 2011). Other REITs are private in nature thus they cannot be subscribed by general public. Researchers have concluded them to be good hedge against inflation and moderate risk investments (Anuar and Soi, 2011).

In 1960s, REITs were legislated and introduced by USA for the world to follow. However in the gulf region, where governments and nationals have taken keen interest in real estate sector, these innovative trusts have not gained much attention. As Islam plays a dominant role in all affairs of the Middle East, it was deliberated that IREITs might provide the necessary stimulus required.

IREITs in structure are same as conventional REITs. However there are two distinctions in their approach, based on Islamic principles. They are to use shariah compliant real estate assets and financing sources respectively. The shariah compliant asset means that the property should not be used for any activity prohibited by Islam. The financing of the asset should be interest free as usury is forbidden in the religion.

The following issues are acting as hindrances to the non realization of REITs potential in the Gulf region. All points discussed below are also applicable to IREITs.

2. CHALLENGES

2.1. Financial Crisis

The 2008-09 financial crises resulted in major setbacks to property sector worldwide. A downward spiral of rents and property prices send the financial market into panic. Middle East was no exception where billions of dollars announced projects were scrapped. Almost all infrastructural developments initiated by governments came to halt; meanwhile private sector lost the confidence in real estate.

2.2. Attitudes of Investors

The investors in the region lack the required exposure to exotic real estate investment vehicles which might be too complicated for them to take risk. Wealthy people seek investment in developed countries mostly in the west aiming for premium properties.

It has also been experienced that financier of Islamic financial products tend to hold financial instruments until maturity and not trade regularly. Thus the secondary capital market has not developed as it has in other parts of the world to attract new capitalists.

2.3. Low Returns

The high percentage of share dividends and respective capital gains in the equity market along with risk free investment opportunities in debt market is also the cause of the lack of interest in these property investment vehicles.

2.4. Non Tax Advantage

As the gulf region is personal tax free haven the tax advantage usually extended by other countries to attract REITs investors is not applicable in this region.

2.5. Valuation

Most of the REITs valuation is done on the basis of Net Asset Value [NAV] which is a complex estimation in its own form. A straightforward investor is unable to work out the subtleties in it and thus avoids the instrument altogether.

2.6. Rigid Middle East Shariah Scholars

The shariah scholars of Middle East are more rigid in Islamic law interpretation as compare to their counterparts in other Islamic countries especially in the Far East Countries. This approach usually results in dearth and slow process of introducing innovative halal financial products and services

2.7. Demographics Factors

The population of each gulf country in the region is less in contrast to other Islamic states of the world. Most of the demographic information depicts that the residents in this region are expatriates with large number of them as non muslims, who are not aware or are not interested in the Islamic capital markets.

2.8. Long Term Investment

REITs are a long term moderate return investments especially in the absence of effective secondary market. As most of the population is non citizen or expatriates, looking for short term investment with high return, they do not subscribe to the trusts.

2.9. High Rate of Investment

The entry price to real estate trusts is quite high usually starting from US \$ 100000 and above. This is high amount of capital for most of the risk averse who want to enter the property market.

2.10. Purification of Income

The IREITs have one more restriction in relationship to traditional REITs, who have to purify their income by donating to charities, if any incumbent tenant is involved in non Islamic activity. There is also prohibition to offer any space to new tenants involved in non-halal activity.

2.11. Limited Real Estate Sector of Investment

IREITs is based on Islamic principles which prohibit explicitly many activities such as gambling, and alcohol consumption. These highly lucrative non permissible rental or business activities restrict the occupancy and the value of the property.

2.12. Unlisted REITs

The REITs market is still evolving in the middle east, with non listed REITs in the region. Thus financial statements are not published for the general public, which is one of the highlights of REITs legislated in other part of the world. This discourages many financiers who are skeptical of the corporate governance standards or transparency levels in them.

2.13. Expensive Regulatory Process

An extensive regulatory requirement with high fees charged by the local government for establishment and operating of property also acts as obstacle for private sponsors.

2.14. Designated Areas to Operate REITS

Most of the regulations designate areas for investment in real estate in the region. This limits the opportunity available to interested parties who are looking for premium properties especially in the centre of the cities.

2.15. Leveraging Challenge

The leverage restrictions imposed by the regulatory bodies and shariah also impedes IREITs openings available to the masses and for organizations. As real estate is both capital and labour intensive industry, adhering shariah compliant leveraging level is a challenge in large projects.

3. RECOMMENDATIONS

As the Islamic principles cannot be altered in any circumstance thus the religious limitations imposed on IREITs cannot be reformed. However the regulatory and legislative constraints can be transformed into strengths with reforms. Following are the recommendations to improve the overall environment of investment in REITs:

3.1. Encouragement of Institutional Investors

As Islamic real estate investment trusts are quite complicated in their structure, institution investors can be persuaded to invest in them. These institutions have the required financial and human resources to evaluate and monitor the Islamic capital markets and instruments. Banks and finance houses can float companies and attract people to these vehicles by offering usury free returns.

3.2. Owners' Association

Although to some extent owner's association have been encouraged by regulatory bodies such as Real Estate Regulatory Authority [RERA], Dubai [UAE]. However Owner's association lacks the legal backing from the countries legislative system. They should be provided with legal powers as required thus encouraging more confidence.

3.3. Awareness Campaigns

Road shows, seminars, exhibitions can be quite effective in introducing IREITs concept in the region. As a common man is not aware of sophisticated innovative financial tools available in the market, actions taken in this regard can yield more attention and funds from the public.

3.4. Implementation of Corporate Governance Practices

Corporate scandals in developed countries were taken to task seriously, and numerous committees formed in response, suggested and implemented best practices to improve corporate governance overall. However due to absence of effective regulatory bodies, best corporate governance practices are either overlooked or circumvented altogether in the region.

3.5. Mandatory Stock Exchange Listing

REITs are listed in the stock exchange by law in many parts of the world. As most of the well established conglomerates are family businesses, share market listing is avoided. Statutory listing is necessary to bring in foreign venture capitalists along with local investment.

3.6. More Transparency

Lack of audited published account and confidentiality of financial statement creates a void in the market. Many established companies refused to share any financial information with general public or external stakeholders thus eroding confidence in the trusts. A more openness will ensure creditability of the initiative.

3.7. Attracting Non Muslims

A misconception has developed over the period of time that Islamic financial products and services are for muslims only and non muslims are out of the ambit. This is not the case as these undertaking can be used by any person irrespective of the religion followed. Non Islam followers should be made aware that investing as per Islamic principles is ethical in nature and is actually only a subset without vices of the main products and services.

3.8. Abolishing Designated Areas

As gulf government are sensitive to land allocation to investors especially of foreign origin due to many factors including land shortage and culture sensitivities. Thus property development areas are allotted for general public by the officials with specific laws. However this creates ambiguity and curtails opportunities. Opening up new areas and extending the IREITs regulations all over the country is essential for progress of the concept.

3.9. Low Entry Subscription

The first public offering should be more accommodative especially for retail investors. It is hoped that low entry fee starting from US \$ 10000, with multiples purchase option, will strike a chord with financiers and entrepreneurs.

3.10. Raising Foreign Investment Ceiling

The region also has a history of enforcing investment ceiling upon non citizens. The investment ratio usually is at minimum 51% for nationals and 49% at maximum for foreigners. Raising the bar will draw more foreign direct investment and entrepreneurs will converge from round the world to the region.

3.11. Trained Islamic Finance Professionals

Due to its complex nature it has been experienced that there is shortage of religious scholars who are adept in economics and financial affairs. Trained professionals with religious understanding can be more effective in developing and practicing these financial structures.

4. CONCLUSION

IREITs are not only subject to national law but to religious principles with Shariah supervisory board [Islamic Law Experts Panel] approving all activities. The above mentioned lists are not exhaustive in nature; it should be debated by experts and open to further expansion. It is also recommended to further research on this topic, due to scarcity of information.

As the potential is immense both public sector and private sector should play an active role to create a favorable environment overall. REITs can play a balancing act within the assets portfolio by reducing risk and imparting reasonable returns. The resolution of leverage problem would arguably increase the attractiveness of the Trusts as an asset class to Muslim investors globally (Danny and John, 2009).

IREITs require a lot of research work before being thoroughly implemented with assurance. New income sources should be looked into beside rental income. Farming, manufacturing, education sector can be some of the avenues where REITs can play its part in developing the necessary infrastructure and create new job opportunities.

With large number of young population now reaching the age of formal employment, the gulf has to develop a comprehensive Islamic finance sector to absorb both the hard earned foreign exchange and educated masses.

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