Closing Dinner for Mapletree Logistics Trust

Keynote Address by Ms Ho Ching, Executive Director & CEO,

Temasek Holdings (Pte) Ltd

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Friends,
Distinguished guests,
Ladies and gentlemen:

Good evening.

Three years ago[1], Singapore's first Real Estate Investment Trust (REIT) was launched with CapitaMall Trust[2]. It was the culmination of 6 years of persistent effort. The CapitaMall launch also marked the beginning of more such listings here in Singapore.

Having witnessed the launch of CapitaMall then, I am very happy to see the successful launch of the Mapletree Logistics Trust (MapletreeLogs) today. I am sorry that I can't get back in time from Mumbai to join you at this closing dinner.

Growth and Development of S-REITs

The debut of MapletreeLog brings the total number of Singapore listed REITs, or S-REITs, to 6. This includes an S-REIT comprising properties solely in Hong Kong. In due course, MapletreeLog too will include assets from around Asia.

Since the launch of CapitaMall, the market capitalization of the S-REIT sector has risen 14-fold to more than S$10 billion[3]. This is equivalent to a growth rate of 140% every year for the last three years. Over this same period, the S-REIT

[1] CapitaMall launched in Jul 2002.
[2] Size of CMT at launch: 213m units at S$0.96 each.
[3] Source :UBS. S$9.85 billion on 25 July 2005 compared to S$709 million at CapitaMall launch.

sector has outperformed the STI Property Index by 92% and the Straits Times Index by 100%[4].

Numerous factors have set the stage for the birth and growth of the S-REIT market on the SGX (Singapore Exchange).

First, in the aftermath of the Asian financial crisis in 1997, more realistic asset prices had translated into acceptable yields. This allowed the capital market to intermediate between vendors and investors. The S-REIT market has also liquefied the relatively frozen physical asset market of large chunky properties.

Second, regulatory adjustments in Singapore have facilitated greater market efficiency:

a) The gearing cap for S-REITs was raised from 25% to 35% of deposited properties in 2003;

b) Tax free status was extended last year (2004) to individual investors residing in Singapore;

c) Earlier this year, we saw the remission of stamp duty for the acquisition of properties by S-REITs; and

d) Tax rate for non-resident investors was also halved from 20% to 10%.

These moves allowed the S-REIT market to flourish[5].

Third, these regulatory changes also helped to lower yields. CapitaMall Trust made its debut offering with a maiden yield of 7% back in July 2002[6]. Today, it is trading at around 4%. The average distribution yield is 4.5%[7] for the overall S-REIT market. The IPO of MapletreeLog was priced at a yield of 6.0%. The closing price of 88.5 cents this evening gives an annualized yield of 4.6% this

[4] Source: UBS
[5] Source: UBS. Deposited properties was S$10.7 billion on 30 Jun 05, 11 times the S$969 million in Jul 02.
[6] Source: UBS. Debut annualized yield was 7.06% based on an issue price of S$0.96.
[7] Source: UBS

year. I don't know how MapletreeLog managed it - I can't help but notice that they also managed to open at an auspicious price of 88 cents this morning on top of the 43.88 times over subscription to be precise, as they told me.

Yield compression over the last 2-3 years is the result not just of improved efficiency in the S-REIT market. It also reflects the higher than expected capital gain from the growth in the S-REIT portfolios, as well as the confidence of investors.

Opportunities for Asian REITs

Looking ahead, there is still tremendous scope for Asian REITs to grow. There is a confluence of aging demographics and under-funded international pension liabilities in the developed economies. This structural trend will fuel the global search for investment returns in Asia. At the same time, Asia is hungry for capital to feed its growth.

This is an opportunity for Asian REITs to marry the structural shift in global demand for high-yield income products with the growing appetite for capital in Asia.

For instance, the logistics industry in the Asia Pacific region is expected to show an estimated compounded annual growth rate of 12.6% over the next 4 years, between 2005 and 2009. In comparison, the global equivalent growth rate is only 3.2%[8]. REITs like MapletreeLog can dovetail naturally into the expansion plans of their logistics customers by following them, and providing logistics real estate solutions for them in the region.

There is also a huge potential for conventional real estate companies and asset-heavy conglomerates to lighten their balance sheets. They can free up capital by offloading capital-intensive real estate assets into REITs. Even governments

[8] Source: CB Richard Ellis

can impose better fiscal discipline and efficiency, by freeing up capital through REITs. A ground-breaking example is the Link REIT in Hong Kong.

Today, the global REIT market capitalization is more than US$400 billion. This makes up 70% of the total listed real estate market in the world in 2004. In contrast, the Asian REIT market is projected to account for only 17% of the total real estate universe in Asia by 2006[9]. Clearly, there is a lot of head room for Asian REITs.

Against this exciting backdrop of opportunities in the region, sponsors and managers, regulators and policy makers, owners and investors, bankers, lawyers and accountants, the SGX, and other interested stakeholders can all play their part to develop a strong S-REIT market.

Though other Asian markets are now beginning to put legislation in place for REITs, there remains a distinct possibility for Singapore to carve out a role as the venue of choice for quality REIT listings in Asia. Regulators can make it conducive for overseas or cross border REITs to list here. This will both deepen and broaden our S-REIT market. Apart from the sectoral or geographical REITs, we can also develop Islamic REITs to meet Middle-eastern investor demands. Even conventional REITs can carve out Islamic tranches, as REIT structures are inherently Shariah friendly.

It would be an interesting challenge to see if Singapore can be a hub for another 30 - 50 of the top quality Asian REITs over the next 10 to 20 years. It will need bolder decisions, hard work and imagination from all stakeholders, especially from regulators and policy makers as well as market players, but it can be done.

Some Risks and Concerns

[9] Source: UBS

For Singapore to be a hub for Asian REITs, it is important to ensure that the REIT market here remains guided by the integrity of REIT managers, supported by savvy regulators and active stakeholders.

One benefit of the REIT market is its open doorway for retail investors and individuals to invest directly themselves in a new high yield asset class. Shopping malls, industrial, logistics and commercial assets would previously have been inaccessible to most retail investors. It was fortuitous that we had shopping malls in CapitaMall to kickstart the S-REIT market. Retail investors could simply take a walk around the malls to gauge whether the REIT is doing well or not.

I am please to note that retail investors have a relatively large representation in Singapore listed REITs. They account for 16% of investments in S-REITs, compared to only 5% in general equities[10]. But it is also a cause for concern, as REITs are not risk-free investments.

In any market, all it takes is one black sheep to taint the reputation of the other players and set the market back. How do we minimize this risk?

Role of board and management

First, I would like to reiterate the vital role that the boards play in protecting the collective interest of unit holders.

The importance of a strong and experienced board with a high level of integrity becomes even more critical, as more S-REITs venture abroad for more assets, or as more regional assets from different emerging economies and judicial regimes are listed here as S-REITs.

Normally, the role of a board is to guide and direct management, acting as an experienced guide, friend and mentor. To properly fulfill their fiduciary duty, it is wise for a board to keep a healthy distance from their management and not be held to ransom by their CEOs. It is crucial that boards have the courage to hire

[10] Source: UBS.

and fire CEOs. Their hardest test comes when they have to make a hard choice between high CEO performance and core institutional values.

As the Chinese say, 居安思危 戒奢以 [ju an si wei, jie she yi jian]: “Watch for danger in times of peace, Be thrifty in times of plenty”. Without a culture of strong values and self restraint, success can lead to corporate hubris and CEO imperialism. Such hubris is often the seed of eventual disaster.

Next come the REIT managers. Apart from being real estate specialists with deep knowledge and experience in the market, trust managers must also be familiar with credit, financial, operational and regulatory as well as real estate and market risks. Financial transparency is especially important for REIT managers.

Potential management risks

Fundamentally, the strength of any REIT lies not only in the physical and financial quality of its assets and tenants, but also the integrity and business acumen of its managers in extracting and enhancing embedded value from the properties. The greatest risks are the subsequent poor assets acquisitions. Individual managers may also change over time, and asset acquisition norms may deteriorate.

Without a sense of fiduciary duty and moral obligation to the unit holders, a trust manager may ramp up the portfolio size indiscriminately without due care and regard for quality and sustainable value. This agency problem is even more acute if the trust manager is paid based on a percentage of the value of the portfolio it manages, and the size of acquisitions made. An incompetent or negligent manager can also simply store up future time bombs if they don’t understand the risks involved.

Let me illustrate with a few simple examples.

An irresponsible or incompetent trust manager could collude knowingly or unknowingly with financially troubled or desperate vendors. The latter needs cash and the trust manager needs more assets in order to earn more fees. The trust manager agrees to buy assets at highly inflated prices, and the vendor agrees to lease back the asset, also at inflated rents which are well above market rates. Prerequisite hurdle yields are technically met. And both the vendor and the manager walk away, happy to be “winners” in an apparently win-win transaction.

In such a situation, the losers are the unit holders. In substance, they would be sitting on a capital loss right from the start, as the purchase price consideration far exceeds the fair market or replacement value of the asset. They would also be unwittingly saddled with a much larger credit risk than appropriate.

Imagine what happens if the economy takes a nose dive, and the troubled vendor goes belly up. The trust manager would have to scramble to find replacement tenants. Rentals would realistically be much lower than the previously inflated level. The unit holders would be hit with a drop in distribution yield. The value of the asset in the trust will similarly take a serious beating.

Thus, in reality and substance, the trust manager would have destroyed value, through deliberate fraud or through incompetence, by poor asset acquisitions. In the worst case, poorly supervised REITs may even evolve into a nasty pyramid game for crooked managers.

Another potential way to circumvent short term investment hurdle rates is to defer issue of trust units to the future in an asset purchase. This may make the investment case look better initially. In reality, the pain will come later.

Such charades shore up short term performance indicators at the expense of longer term pain. Worse still, they leave little buffer for the REITs to weather future storms. If, for whatever reason, rental rates cannot improve or asset enhancements fail to raise operating income, such deferred financial burdens could become very painful for the unit holders.

It is therefore vital that unit holders are made aware of the possibility of subsequent dilution of distribution yield. They need to understand the true all-in economic cost of any acquisition, and not be taken in by the initial understated costs.

In substance, such deferred capital payments may be nothing more than a form of shareholder's loan. If so, they should be captured in the trust's gearing ratio at the point of purchase commitment. Not doing so allows a trust to circumvent the prevailing 35% gearing cap imposed by the regulators.

Role of Professional advisors

Bankers, lawyers and other financial advisors too have a professional and fiduciary duty to ensure comprehensive, timely and accurate advice to investors. As shown in the earlier examples, it is critical that they cut through artificial structures and financial constructs to assess the substance and potential risks of any transaction. In their recommendations to unit holders, all critical information and advice should be put clearly and simply, so that retail investors can easily understand the import of their advice.

Role of Regulators

The regulators and policy makers too can play their part to promote and foster a financially transparent and well regulated environment. This allows the market to perform fairly and efficiently.

Harmonizing the tax regime will certainly help open up the S-REIT market up to an even bigger pool of international investors. Reducing or dismantling double taxation of S-REITs with foreign income is likely to attract more foreign REITs to list here.

Financial disclosure rules may need to be more prescriptive initially to help an emerging asset class like REITs to establish itself. Given their responsibilities, trust managers too should be regulated and monitored – they are not just real estate managers, but should be highly skilled financial professionals as well.

Perhaps a mandatory credit rating from established credit agencies should be a requirement for S-REITs. Behind the credit rating is the underlying credit worthiness of the trust. This in turn reflects not only its financial health but also the credit standing of its key tenants. Such credit information will help unit holders to make more considered investment decisions, and serve as a trip wire for any deterioration in asset quality.

Measures like these will help support an orderly growth of quality players, build up the confidence and trust in the market, and minimize untoward risks.

Role of unit holders

At the core of the REIT market are the investors, both institutional and individual unit holders. Like shareholders, they have every right to question board and management decisions and actions. Smart investors will not allow REIT managers to expand their portfolios without cashflows which can meet prerequisite investment hurdles.

REIT investors should learn to scrutinize the different REITs and differentiate the strong from the weak. For instance, a REIT with short term land leases is a portfolio of fast depreciating assets. Put simply, a portfolio of assets with say10-year underlying land leases would depreciate at 10% a year, so a distribution yield of 12% is really a weak net yield of 2%. Likewise, a top line yield of 8% would actually be value destroying. These seemingly high yield REITs would be poor alternatives to a portfolio of freehold assets with long term yields of 6%.

Retail investors should also be cautious of REIT managers who are heavily remunerated by the size of the portfolios they manage. Although the history of the S-REIT market is short, retail investors should begin to distinguish those managers who can consistently deliver or exceed their distribution growth projections through shrewd acquisitions, creative asset enhancement and effective capital and risk management.

As the S-REIT market continues to grow, global and local investors will also have more choices to pick from. In doing their own homework, individual unit holders can minimize the risks of following the herd and getting burnt by weak or unscrupulous managers.

Conclusion

To conclude, REITs are an interesting high yield asset class that is just emerging in Asia. Apart from global and institutional investors, this can be particularly interesting to retail investors as part of their retirement or investment portfolio. All of us have a part to play in building upon the initial success of the S-REIT market – investors and promoters, boards and managers, financial and legal advisors and professionals, regulators and policy makers.

As with all other investments, there will be risks for REITs too. REITs have failed in other markets – they are not one way up escalators for guaranteed gains. Investors have a responsibility to themselves to understand the various product offerings and their risks.

We must also remain vigilant and instill financial discipline and professional integrity amongst our trust managers. It will be our collective responsibility to guard against clever financial engineering to disguise inherent blemishes.

With a high level of financial transparency and professional integrity, the appeal of Singapore as a venue for more REIT listings will be enhanced. A growing S-REIT market would render greater depth and interest to our capital market. This will help to strengthen Singapore's position as a key regional financial center.

Tonight, I congratulate the MapletreeLog team and their advisors for an outstanding and flawless transaction. Looking forward, may I also wish Mapletree Logistics Trust every success as a quality S-REIT with quality assets and managed by quality managers.

Thank you.