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Islamic REITs in Malaysia

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Since the 1980s, Malaysia has been at the forefront of global initiatives to create a sustainable Islamic capital market (ICM) to cater to the needs of Muslim and non-Muslim investors alike for products that are Shariah compliant. Based on the contributions of participants led by the Securities Commission Malaysia (SC), there is now a reasonably comprehensive ICM with a broad range of Shariah compliant products, ranging from securities, debts, unit trust funds and real estate investment trusts (REITs) to some modest derivative products like crude palm oil futures and crude palm oil kernel futures contracts.

Of these, Islamic REITs (I-REITs) in Malaysia have proven to be a winner, staging a remarkable three best performers in the top dividend generatorsô list. To facilitate the development of this new investment opportunity, the SC issued guidelines on the issuance of Islamic REITs. These are the first guidelines on Islamic REITs in the global Islamic financial sector and supplement the existing REIT guidelines.

Following the release of the I-REIT guidelines in May 2006, the worldõs first Islamic REIT, the Al-ÓAgar KPJ REIT, was listed on Bursa Malaysia. Sponsored by KPJ Healthcare, it had an initial public offering (IPO) valued at more than RM340 million (US$100.6 million) with an underlying asset focus on hospitals.

Subsequently, in January 2007 the worldõs first Islamic plantation REIT was listed on Bursa Malaysia. The Al-Hadharah Boustead REIT owns and invests in plantation assets comprising oil palm estates and palm oil mills in Malaysia. The latest addition to the Malaysian I-REIT market is a property REIT, Axis REIT, which owns and invests in a hybrid of properties ð commercial, office, industrial and retail.

In Malaysia, REIT investors are granted access to high quality assets which generate a stable stream of cash flow backed by a steady portfolio of tenants. They are offered high yield returns and certainty of income. Based on the interest shown by investors, particularly from the Gulf region, the future of the I-REIT market in Malaysia looks promising.

Characteristics of I-REITs
Different countries set different levels in determining the requirement for a REIT, especially with regards to the ratio of investing in real estate. For example, the USôratio is at 75% while Korea and Singapore have set it at 70%. Conventional and Islamic REITs have the same criteria in terms of structural requirements such as valuation, trustees, management companies and property manager.

The difference is the Shariah compliant assessment that is undertaken by a Shariah committee or advisors entrusted with overseeing the operation of I-REITs to ensure compliance with Shariah principles. This includes investments, deposits and financing decisions, acquisition and disposal of real estate and rental earnings and tenantsôactivities. The following are some of the issues involved in the compliance assessment process:

Non-permissible rental activities
As rental income constitutes the bulk of the income stream for REIT investors, it is essential to ascertain that this is derived from halal or permissible activities. The I-REIT guidelines classify the following tenant activities as non-permissible: financial services based on interest; gambling/gaming; manufacture or sale of non-halal products or related products; stock broking or share trading in Shariah non-compliant securities; conventional insurance; entertainment activities that are non-permissible according to Shariah; manufacture or sale of tobacco-based products or related products and hotels and resorts.

However, the Shariah committee or advisors are allowed to use their discretion based on Ijtihad to determine other activities that are deemed non-permissible. Likewise, they may also use their discretion to determine if an activity that is normally non-permissible is allowed as permissible.

For example, in the third round injection of assets into the Al-‘Aqar KPJ REIT, a hotel was one of the properties included and was approved by the Shariah committee of the REIT and the SC. It was argued and accepted that the hotel is Shariah compliant as it served only halal food and drinks, terminated all non-permissible entertainment activities and provided separate floors or wings for families and singles, among others. This proves that the will to accommodate such a lifestyle is in effect possible.

Rental from tenants who operate mixed activities
In the case of real estate where tenants operate mixed activities, (for example its core business is Shariah permissible but it has other minor activities which may contain a small dose of prohibited elements), then the Shariah advisors must perform an additional compliance assessment which is to determine whether the rental from non-permissible activities is more or less than 20% of the total turnover of the Islamic REIT for that financial year. If the rental exceeds the 20% benchmark, then the Shariah committee is duty bound to advise the manager of the REIT to refrain from investing in such real estate.

Method of calculating the ratio of rental from tenants who operate mixed activities
The most commonly used method is the use of space. For example, in the case of a supermarket, the rental for non-permissible activities such as the selling of non-halal meat and alcohol, can be based on the ratio of area occupied for non-permissible activities to the total area occupied. So, if the supermarket leases 10,000 sq ft and uses 1,000 sq ft for its non-halal activities, then 10% of the total rental paid by the supermarket is deemed to be from non-permissible activities but would still be deemed to be permissible if it is still within the acceptable benchmark of 20% of the total turnover of the Islamic REIT.

Acquisitions
In the case of new acquisitions, Shariah compliant assessment must be carried out by the appointed Shariah committee or advisor. An I-REIT is not permitted to acquire real estate where all of the tenants operate non-permissible activities, even if the percentage of rental derived from that one particular real estate or building is within the accepted benchmark.

New tenants
In cases where the new tenants are obviously involved in non permissible activities such as casinos, then an I-REIT fund manager is not allowed to accept such tenants.

Investments, deposit and financing instruments used for Islamic REIT
The Shariah committee must also ensure that all of the I-REIT's investments, deposits and financing instruments are Shariah compliant. For example, the manager should not accept a riba-based conventional facility to finance the acquisition of real estate or open a riba-based conventional current account for its operating use.

Takaful
The I-REIT guidelines also stipulate that an I-REIT must use Takaful products or schemes to insure its real assets. However, in cases where there is no equivalent Takaful scheme in the market which can provide the insurance coverage required, then the I-REIT is permitted to use conventional schemes.

In summary, the key feature and difference between a conventional REIT and an I-REIT is how the incomes from the REITs are earned and how the fund itself is to be managed.

The introduction of I-REITs was hailed as a significant move to enlarge the product base of ICM in Malaysia. It helps to enhance competitiveness by attracting global investors hungry for new Shariah compliant investment instruments.

ARSA Lawyers (Abdul Raman Saad & Associates) remains the principal solicitor for the Al-‘Aqar KPJ REIT, now completing its 3rd property injection, bringing the size of the REIT to almost RM1 billion (US$296.1 million).
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