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AN OVERVIEW OF MALAYSIAN REAL ESTATE INVESTMENT TRUSTS' MANAGEMENT ADVISORY STYLE

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Abstract

The establishment of Malaysian real estate investment trusts (M-REITs) through introduction of Malaysian REITs Guideline in 2005 has adopted the REITs practices in counterparts with few modifications that tailor to the local need. However the aspect of M-REITs' management advisory style has not been mentioned clearly. This study is appraising the M-REITs' management advisory style by overview the United States (US) REITs experiences. A content analysis of previous literature on US REITs, Malaysian REITs Guidelines and M-REITs' annual report was conducted to review the practices of M-REITs' management advisory style. This study reveals that understanding of external, and internal advisory management in Malaysia was different. Malaysian REITs appointed an external advisory manager company which was established by the REITs themselves. The REITs hold a significance amount of share in this external advisory managing company. The role to determine the new acquisition and plan for expansion remained in the REIT firm. This preliminary study is essential to stimulates further attention on M-REITs management advisory style since US literatures suggest advisory influence firm value, debt financing and profit maximization.

Keywords: *REITs, management advisory style, property portfolio, decision making*

1.0 INTRODUCTION

The Malaysian real estate investment trusts (M-REITs) have started in 1989 through the introduction of listed property trust (LPTs) traded in Bursa Malaysia (BM). Unfortunately, the LPTs received the tax treatment similar to the common stock, which affected the LPTs' net profit after interest and tax (NPAIT) because higher tax was imposed. This made Malaysian LPTs less favourable to investors (Newell *et al.*, 2002). In 2005, the Malaysian government took initiative to unlock the potential of investment properties through the introduction of Malaysian REITs Guidelines 2005. These guidelines permitted the Malaysian REITs to adopt few REITs' practices used in the United States (US) and Australia.

Since the US REITs' have undergone many differences cyclically experiences which make it a good model for newer REITs (Miller and Springer, 2007; Miller *et al*., 2005; Young and Elayan, 2002; Ambrose and Linneman, 2001), Malaysian Inland Revenue Board (IRB) followed the path. It outline the tax treatment for M-REITs in order to make it more attractive, such as tax waived if REITs are able to distribute at least 95 percent or more of its NPAIT to the shareholder. From the investors' point of view, this tax treatment is an advantage to the investors for which they might enjoy higher rate of dividends. However, in a long run REITs seemed to be less attractive due to the rigid company structure. The five percent of retained earnings brought forward, limits REITs potential to expand via internal sources of funding. In reality, REITs are given the option to either go for more debt or opt for issuance of new units for raising its capital. Nevertheless, both of these options affect REITs total returns (Ott *et al*., 2005; Kilpatrick, 2002; Howe and Shilling, 1988; Erickson and Fredman, 1988). Campbell *et al.,* (2002) suggested the implementation of REITs in European countries with few alterations determined based on local need. In line with this, the Malaysian REITs model made few modifications that tailor them to the local need such as the introduction of Islamic REITs, *Syariah* compliance requirement, the restriction for new REIT to be Equity REIT only and REITs management advisory style.

There exists no literature to compare the US-REITs management advisory with its counterpart in Malaysia. This paper attempts to fill this void, highlighting some aspects of the Malaysian REITs Guidelines especially that which relates to the party in charge of the decision-making about properties portfolio investment of M-REITs, particularly one responsible for new acquisitions of properties in the portfolio. The study is based on the existing literature, as supported by Annual Reports from year 2006 to 2014.

2.0 LESSON LEARNT FROM MANAGEMENT ADVISORY STYLE OF US-REITS

Before 1986, REITs in US is operated by the external advisory which required them to hire professionals to run its day to day operation such as managing rental, acquisition, disposition, selecting contractor and financing decision for the properties (Chan *et al.,* 2003). This scenario, which had granted the external advisory so much power on REITs, was a great concern to the developers and major property owners as there was fear of risking their rights by losing control of their properties if they choose to opt for REITs. This made property owners hesitate to convert their properties to REITs, which affected the reputation of US REITs and resulting in the collapse of REITs in the early 1970s.

During the early stage of REITs development external advisory management is preferred, due to outsourcing the expertise and benefit from operating in the economy of scale. The external advisory management company work for REITs that acquired their services in term of managing REITs' property portfolio investment. They charge professional fees based on the value of properties in portfolio they monitor. However, there is likelihood of conflict of interest as the external advisory management company serve for too many REITs companies at one time. They earn commission upon disposal and acquisition of the same properties. As a consequence, due to quality of properties in REITs portfolio, investment returns may be affected.

The issues relating to the appointment of the external advisory led to the emergence of the internal advisory to US REITs in 1986 through a private letter ruling. The 1986 Tax Reform allowed REITs to gain self-advised or self-managed status. This resulted in the internal advisory revolution, which allowed many REITs converting themselves to the internal advisory or self-managed status (Chan *et al.,* 2003; Ambrose and Linneman, 2001).

Internal advisory could be operated by personnel hired by REITs Company. The incentives of the personnel employed were based on the performance of the properties in the portfolio investment. As result of internal advisory management, the US REITs witnessed a tremendous good performance (Chan *et al.*, 2003; Ambrose and Linneman, 2001). In the portfolio, there were a big number of quality properties.

Yet the internal advisory REITs had its own agency problem. The majority shareholders controlled the position of advisory. This limited the authority of internal advisory to make investment decisions in REITs (Miller and Springer, 2007; Miller *et al*., 2005). Chan *et al.* (2003), notes that the acquisition of new properties by internal advisory is influenced by the majority shareholders' interest where the manager has to cater to the party who has more control on REITs through the provision of US REITs structure ownership. The welfare of small investors was neglected (Han, 2006; Chan *et al.*, 2003). Meanwhile, the internal advisory regime has the advantage of reduced operating expenditure and the freedom to make unbiased judgment on selection of maintenance contractor for REITs buildings and for acquisition of new properties (Chan *et al.*, 2003; Ambrose and Linneman, 2001).

Due to the weakness of internal advisory, many of US REITs continued to keep external advisory management (Benefield and Pyles, 2009; Ambrose and Linneman, 2001). The weakness of the internal advisory regime caused the external advisory regime to work hard to improve its performance efficiency so that there is no difference between them (Benefield and Pyles, 2009). At the end, many REITs preferred to operate by internal advisory rather than external advisory due to the weighted benefit in comparison to external type of advisory. Figure 1 shows the attributes that support the advantage of both internal and external advisory types.

The attributes supporting the internal advisory management include the responsiveness of internal advisory to risk aversion and debt policies (Chan *et al.*, 2003), lower operating cost and interest rates (Capozza and Seguin, 1998); maintenance costs (Ambrose and Linneman, 2001; Capozza and Seguin, 2000; and Capozza and Seguin, 1998); better dividends distributable to unit holder (Lee *et al.*, 2007; Ambrose and Linneman, 2001; Capozza and Seguin, 2000; Capozza and Seguin, 1998), and internal advisory behaviour over investment of new properties (Young and Elayan, 2002; Allen and Sirman, 1987). The internal advisory is salaried employee of REITs, and its incentives relate to REITs performance, lower capital costs for new property acquired, lower operating cost as well as lower maintenance cost. As a consequence, it can result in higher dividend distribution, investors' confident, and maximized unit holders' wealth. Nevertheless, there is also disadvantage of internal advisory, since larger unit holder will have larger vote (Miller *et al.*, 2007; Miller *et al.*, 2005; Chan *et al.*, 2003), that could make REITs' properties acquisition more at the pleasure of majority unit holders and ignoring the fundamental of property investment acquisition.

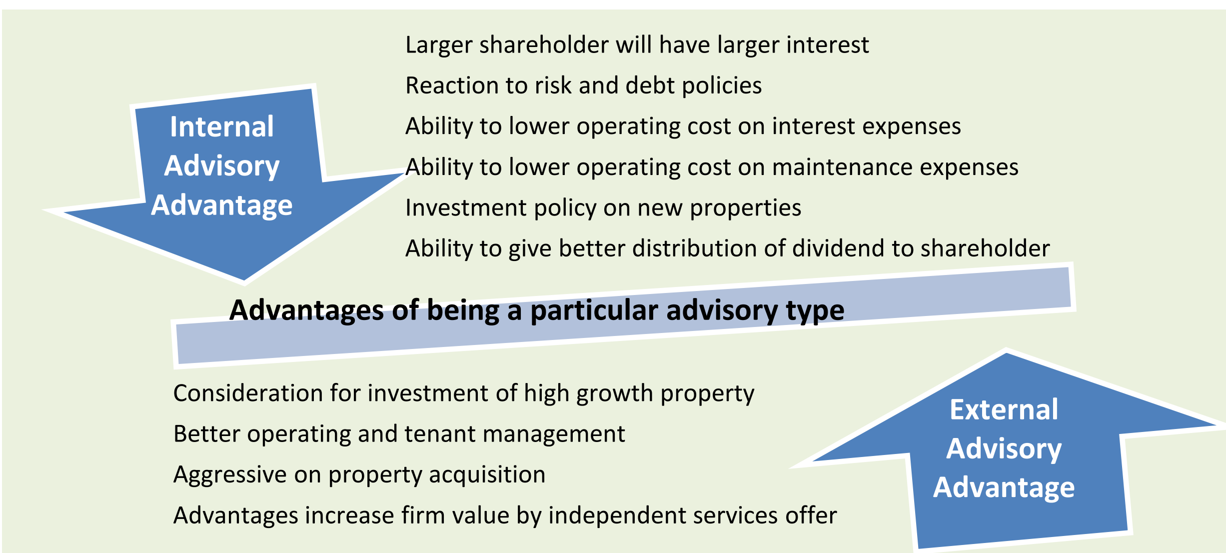

Figure 1: The relevant determinants that support advantage of advisory type

Meanwhile the attributes supporting external advisory management include its ability to provide better services operation and tenant management compare to internal advisory (Benefield and Pyles, 2009; Howe and Shilling, 1990; Howe and Shilling, 1988), the appetite for and aggressiveness on property acquisition (Benefield and Pyles, 2009; Howe and Shilling, 1990; Howe and Shilling, 1988), the ability to increase firm value through independent services offer (Chan *et al.*, 2003), and to provide high growth property for properties portfolio investment (Benefield and Pyles, 2009; Howe and Shilling, 1990).

By early 1990s, the US REITs proved that in terms of performance, internal advisory had more advantages (Miller and Springer, 2007; Miller *et al*., 2005; Young and Elayan, 2002; Ambrose and Linneman, 2001; Scott *et al.*, 2001; Cappoza and Seguin, 1998; Friday and Sirmans, 1998; Chopin *et al.*, 1995). Thus, this has caused newly launched REITs to declare themselves as internal advisory although they were not. The internal advisory had less likelihood of conflict of interest between REITs management and shareholders as compared to the external advisory, earning higher ratios of rental to total revenue, lower pay-out ratio and lower costs of capital before 1993. However, as soon as REITs manage to control a certain firm size and property sector of REITs, their performance declined.

The growth of internal advisory resulted in the external advisory REITs to respond to the market pressure and conform to the performance standards established by the internal advisory. It was observed that the external advisory REITs between 1991 and 1996, improved the REITs equity market capitalization from $6 billion to $20 billion, which indicated investors confidence in their professional services, the ability of providing higher distribution for REITs and good ethical practices in handling property portfolio investment. This was a transformation to remain competitive.

A new study examined the difference between the external and the internal advisory about their operating performance such as corporate structure, growth prospects, revenue and expenses, cash flow and profitability, equity return, REITs' beta and cost of capital. It was concluded that there is a significant relationship between the internal advisory REITs manager and the REIT performance. Some characteristics of both the internal advisory REITs manager and external advisory REITs manager could be used as variables to show their influence on the REITs performance.

In the US, external advisory recognized a company which offers independent professional services on real estate including, the evaluation of new acquisitions, disposals, property management and so on (Chan *et al.*, 2003). These companies may service more than one company at the same time. The staffs of external advisory are salaried by the company itself and no other authority can influence its opinion. The external advisory manager has the absolute power and responsibility in determining the wealth of the REITs (Young and Elayan, 2002; Ambrose and Linneman, 2001; Allen and Sirman, 1987). Therefore, at the end of the financial year, once the performance of REITs was presented to the shareholders they can decide to keep or terminate the external advisory manager. Moreover, the fees for the service offered by the external advisory are made based on the size value of the company, before the new remuneration method of compensation was introduced due to various issues. Meanwhile, the internal advisory manager was a professional staff who had been hired and salaried by the REITs to conduct services on real estate including evaluations, new acquisitions, disposal, and property management and so on. The positions of the expert staff were at the favour of the REITs shareholders (Chan *et al.*, 2003). No additional fees were charged to REITs as all the staff of internal advisory was salaried by the REITs.

3.0 THE MALAYSIAN PRACTIC

Malaysia seems to have not followed all aspects of US REITs. She has adopted both external and internal management advisory types but in a different manner. First, Malaysian REITs appoint an external advisory manager company, which was established by the REITs themselves. The REITs hold a substantial part of external advisory manager company's shares. In many cases, the external advisory manager gave services to particular REITs alone.

The decision making power on new acquisition and disposal remains in the REIT firm. Therefore, it was not a surprise that all the REITs in Malaysia declared themselves as externally managed, despite the fact that these advisory companies were owned by the REITs themselves.

Second, the M-REITs have internal advisory management form, though they declared themselves as externally managed. M-REITs' annual report shows that external sub-contractor manages facilities management and building operating management. These consisted of day-to-day operation of REITs. There is lack of evidence in neither Malaysian REITs Guidelines nor M-REITs' annual reports clearly spell out the responsible parties involved in evaluating the new acquisition properties for expansion purpose and determining the wealth of the REITs.

4.0 CONCLUSIONS

As conclusion, the external advisory was unable to perform well in M-REITs due to two reasons. First, there is an ambiguity relating to the function of external and internal advisory in Malaysia. Second, M-REITs management advisory style is important to determine the unit holder wealth maximization since both types of advisory style portray the aggressiveness of a REIT in it expansion and growth plan. The quality of properties portfolio promises higher distribution in year ahead.

Malaysia government must have made amendments on certain issues in REITs before adopting REITs practice and traded in Malaysia. Therefore this study is important for the investors to examine the management advisory style of M-REITs before they invest. Besides, this study on appraisement on M-REITs' management advisory style is revealing the important aspect of M-REITs behaviour that never had been highlighted before. This preliminary study is essential to stimulates further attention on M-REITs management advisory style in future.

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